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Fiscal Discipline between Levels of Government in Germany

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The essential actors in co-ordinating fiscal discipline in Germany are the Federation and the 16 Länder. This article presents an overview of the legal basis of the budgetary process and how it is designed with respect to Federation-Länder relations. Developments since 1945 are also described, including the budget reform of 1969, German adherence to the European Economic and Monetary Union, and the work of the Federalism Commission (2003-04). Particular instruments for fiscal discipline in the German context include the Financial Planning Council and the national stability pact, and their roles are described as well as the procedures for submission of budget accounts and accounting control.

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1. Introduction

Decentralising public budgets is of central importance in modernising budgetary practices. This is expressed in the concept of “merging expert and fiscal responsibility”. Decisions with regard to expenditure should be taken at the level of government which best knows how the funds can be deployed in the most efficient manner possible. The central national powers of budgeting are split up and responsibility is transferred to subsidiary or decentralised areas. Various levels of political subdivisions are endowed with the power to prepare and administer their own budgets.

What happens in countries which have never had a strong centralised structure? Germany is an example. On historical grounds, the Federal Republic of Germany was organised along federal lines after 1945, in contrast to the example of other, centrally-organised, European countries. This means that, in addition to the Federation, there are federal states (Bundesländer) with their own governments and autonomous competence. This autonomy is reflected not least in the field of budgeting. How, then, is it that the Federal Republic, by participating in the European Economic and Monetary Union, committed itself to a supranational structure which limits national powers to decide on budgetary matters, monitors how the budget is executed, and can even impose sanctions where necessary?

What is the meaning of accountability and control of budgets between various political subdivisions given the conflicting areas of regional autonomy on the one hand and European deficit monitoring on the other? This article presents an overview of the legal basis of the budgetary process and how it is designed with respect to Federation-Länder relations. The final section covers new rules drawn up in the Federalism Commission.

2. Legal basis and historical development

The federal structure of Germany is made up of the Federation and 16 Bundesländer. Furthermore, the approximately 13 000 municipalities in Germany also play an important role in the exercise of government. These have the constitutional right to self-governance with regard to matters relating to the local community. Under the constitution, however, they are classified as being part of the Länder. Accordingly, the provisions on public finance set out in the Basic Law for the Federal Republic of Germany (Grundgesetz, GG) stipulate that the revenues and expenditures of municipalities are also deemed to be expenditures and revenues of the Länder, administered nevertheless autonomously.[1] Budgetary policies are only ever co-ordinated at higher levels, *i.e.* between the Federation and the

Länder. However, the municipalities are represented in all the relevant commissions and their positions can thus be included in the political process.

The budgetary process of the Federation and the Länder is based on revenue and expenditure and is founded on the provisions of the Basic Law for the Federal Republic of Germany (Articles 109 to 115) and the Law on Budgetary Principles (Haushaltsgrundsätzegesetz, HGrG). The Law on Budgetary Principles contains common provisions for budgeting at the federal and state levels.

The central provision underlying the relation between the Federation and the Länder in budgetary matters is given in the Basic Law[2]: "The Federation and the Länder shall be autonomous and independent of one another in the management of their respective budgets."

This budget management autonomy has consequences for the entire fiscal spectrum and means that no central, supreme body exists with the power to decide at a national level on budgetary matters, as one might have expected of the Federal Ministry of Finance. Agreements and decisions are reached and adopted by independent partners of equal status, *i.e.* the Federation and the Länder.

2.1. Budget reform of 1969

The act of co-ordinating budgetary planning between the Federation and the Länder is embedded in the process of medium-term financial planning, which can be traced to the budget reform of 1969. During this period, theoretical approaches to macroeconomic management were put into practice for the first time at all levels of government and were accounted for, in particular, in the provisions governing public finance set out in the Basic Law[3]:

- In managing their respective budgets, the Federation and the Länder must take due account of the overall economic equilibrium.
- It is possible to regulate through federal law public borrowing or the creation of anticyclical reserves to avert disturbances of the overall economic equilibrium.
- Borrowing by the Federation must not exceed investments; exceptions are permissible only to avert a disturbance of the overall economic equilibrium.[4]

Another provision appears in the Law to Promote Economic Stability and Growth (Gesetz zur Förderung der Stabilität und des Wachstums der Wirtschaft, StWG)[5]:

- Macroeconomic equilibrium is observed by measures contributing simultaneously to the stability of price levels, to a high level of employment and to external balance, and accompanied by steady and adequate economic growth.

The 1969 budget reform established a binding, standardised framework for the budgetary law of the Federation and the Länder, the Law on Budgetary Principles (HGrG). This law contains the common principles for the Federation and the Länder, in accordance with which their respective budgetary procedures must be conducted.

The central provisions in terms of Federation-Länder relations are:

- The Federation and the Länder each base their respective budget management on a financial plan covering a five-year period (section 50 of the HGrG).
- A Financial Planning Council chaired by the Federal Ministry of Finance (FMF) is set up to submit recommendations for co-ordinating the budget and financial planning of the Federation, the Länder, the municipalities and the associations of municipalities (section 51 of the HGrG).
- In order to ensure that the budgets of the Federation, the Länder and the local municipalities can be judged by uniform criteria, a standardised budget system was developed. This comprises a common system of classification by object and by function. Classification by object groups expenditure and revenue according to types (*e.g.* tax revenue, personnel expenditure, interest and investment expenditure). Classification by function groups expenditure and revenue according to functions of the public administration (*e.g.* defence, environmental protection and nature conservation, health).

Thus, the basis of fiscal relations between the Federation and the Länder was specified. They must first address macroeconomic requirements in their respective budgets. This is co-ordinated via financial planning and the Financial Planning Council. A uniform system of budgeting is the formal instrument which makes the aggregation and comparison of budgets possible in the first place.

2.2. European Economic and Monetary Union

The creation of the European Economic and Monetary Union (EMU) in the Maastricht Treaty focussed the attention of the EU institutions and other Member States on national budgetary policy. In addition to other criteria, countries were obliged to hold the annual government deficit to a maximum of 3% of GDP at market prices and government debt to a maximum of 60% of GDP before being allowed to enter the EMU.[6] At that time, a lively debate ensued as to how the wholly expansionary expenditure policy of some EU Member States would influence the stability of the new currency. These discussions led to the Stability and Growth Pact being adopted in 1997. The Pact reiterates adherence to the maximum annual government deficit of 3% of GDP in drawing up and executing the budget by threatening severe sanctions.[7] Thus the budgetary policies of the euro countries, hitherto determined on a national level alone, became exposed to the strong influence of the EU institutions. This manifests itself primarily in the monitoring procedure to avoid government deficits exercised jointly by the Commission and the Council (Article 104 of the Treaty).

Because of the federal structure of Germany, the Federation alone cannot guarantee adherence to the European requirements. Rather, there is a joint responsibility on the Federation, the Länder and the municipalities to avoid excessive deficits within the context of the EMU. In order to express this joint responsibility and to better co-ordinate the budgetary policy of the Federation and the Länder with a view to adhering to the deficit criteria, the role of the Financial Planning Council as a central body was strengthened by an amendment to the Law on Budgetary Principles.[8] The following new provisions were introduced:

- The Federation and the Länder meet their responsibility to adhere to the European commitment to fiscal discipline and seek to reduce net indebtedness with a view to more balanced budgets.
- The Financial Planning Council submits recommendations for fiscal discipline, in particular a common expenditure policy, and elaborates on the compatibility of budget developments with adherence to Article 104 of the Treaty establishing the European Community ("Maastricht criteria") and the European Stability and Growth Pact.
- Where the fiscal discipline of the Federation, the Länder and the municipalities is insufficient, the Financial Planning Council issues recommendations on the restoration of fiscal discipline.

3. Fiscal discipline of the Federation and the Länder

Thus, since the introduction of the EMU, the German government has had a particular obligation to Brussels. Due to a lack of legally-binding opportunities to influence the budgetary policy of the Länder, the necessary co-ordination of budgetary and financial planning between the levels of government must be done in the Financial Planning Council (see section 3.1). To this end, a national stability pact serves as an instrument to co-ordinate at the domestic level the expenditure of the Federation and the Länder (see section 3.2). The “Maastricht criteria” apply in all stages of the budgetary process; the effects on reporting and control are described in sections 3.3 and 3.4 below.

3.1. Financial Planning Council

The Financial Planning Council meets twice yearly (spring and autumn), and decisions are adopted in mutual agreement. The Financial Planning Council consists of:

- the Federal Minister of Finance (chair);
- the Federal Minister of Economics and Labour;
- the Länder ministers responsible for finance;
- four representatives of the municipalities and the associations of municipalities, nominated by the Bundesrat (upper house of Parliament) upon being proposed by the central associations of local authorities. A representative of the Deutsche Bundesbank attends the discussions of the Financial Planning Council as a guest.

Based on the macroeconomic benchmark data (including nominal and real GDP, private consumption, government consumption, gross fixed-asset formation, price movement) and the tax revenue estimates[9], a budget prognosis is made for the Federation, the Länder and the municipalities. Based on these data, the Financial Planning Council issues recommendations on the development of public budgets. These can entail quantitative information on the desired developments in expenditure and how this is financed.

The macroeconomic data on which the given year's budget and the medium-term financial planning are to be based are then discussed in the spring meeting. At this point in time, the budget is still being discussed internally in the government. While the autumn meeting is taking place, the budget is going through the parliamentary agreement procedure and the latest assumptions and modifications can be integrated before it comes into force.

In the past decades, the focus of the Financial Planning Council has been on various topics. In the 1980s, the emphasis was placed on consolidating public budgets; it was decided that public expenditure should be allowed to grow by only 3% over the medium term. In the following decade, discussions in the Financial Planning Council were dominated by the fiscal consequences of German reunification. A recommendation to keep growth of expenditure by the Federation, the Länder and the municipalities to a maximum of 2% was issued. Following the start of the third phase of monetary union, adherence to the stability criteria has become increasingly important.[10]

3.2. National stability pact

In order to implement the agreements reached within the context of the EMU, a "national stability pact" was agreed in spring 2002 between the Federation and the Länder. The pact contains a detailed roadmap up to 2006 with a balanced national budget as the objective.[11]

The members of the Financial Planning Council mutually agreed[12]:

- The Federation will reduce its expenditure by an average of 0.5% in 2003 and 2004 compared to 2002.
- The Länder and the municipalities will limit their average annual expenditure growth to 1% over the same period.
- The basis of this expenditure recommendation was an apportionment of the permissible deficit in 2004 allowing the Federation and social insurance funds, on the one hand, to avail themselves of 45%, and the Länder and the municipalities, on the other, to use 55%. This rate of apportionment is to apply also in 2005 and 2006.

The Financial Planning Council's decision was aimed at securing a balanced general government budget by 2006. The agreed deficit apportionment of 45% to 55% reflected the willingness of the Federation to shoulder a larger share of the consolidation efforts than the Länder and the municipalities on the way to a balanced budget. However, where central financial indicators such as expenditure and debt are concerned, the Federation's share reaches 55% to 60%.

The unfavourable economic developments of recent years mean that a balanced general government budget cannot be reached by 2006. As the federal budget essentially has to shoulder a significantly larger share of economic burdens than the Länder and the municipalities, the Federation was unable in the last few years to remain within the deficit framework agreed in 2002.

With regard to the budget cycle, agreements are reached in the Financial Planning Council during the process of drafting the annual budgets. Nevertheless, as indicated earlier, the Federation and the Länder remain independent of one another in the management of their respective budgets.

Within this process, the municipalities are deemed to be part of the Länder and their budgetary policies are monitored by the interior ministries of the respective Länder. This control looks for disproportionate debt in the draft budget in relation to the economic capacity of the individual municipality.

3.3. Submission of budget accounts

At the end of each fiscal year, the Federation and the Länder must submit an account of all revenue and expenditures.[13] This is done for each political subdivision, as no mutual accountability exists. In other words, there is one annual report by the Federation, 16 by the Länder and roughly 13 000 by the municipalities. The Federal Statistical Office, in its role as independent authority within the federal administration, condenses these data for information purposes into an aggregated general government financial statistical statement of account (financial statistics). These data are fed once more, via the submission by the Federal Ministry of Finance of a macroeconomic projection, into the co-ordination process of the Financial Planning Council.

Under German budget law, accounts are submitted based on expenditure and revenue, *i.e.* cash transactions and cash stocks. A clear distinction must be made here between the methodology and purpose of this system of accounting and those of the Maastricht criteria. In the course of the EMU, general government thresholds were determined for the deficit (3% of GDP) and for the level of debt (60% of GDP). These data are accumulated using the methods prescribed by the European System of National and Regional Accounts 1995 (ESA 95).[14] They serve to place the differing budget systems of the EU Member States on a compatible, and thus comparable, basis and to review adherence to the agreed threshold values.

In contrast to the German financial statistics, with their emphasis on cash movements, the ESA 95 is based on accrual accounting and pursues an objective of recording movements in financial asset positions of the state over the period observed. Thus, from a cash movement point of view, the alienation of a financial asset (*e.g.* sale of a share) represents income, *i.e.* the cash stock has increased. Looked at from an accrual accounting point of view, there is no change to the asset position. The capital tied up in financial assets is exchanged for cash stock. Assets have been exchanged; there is no net change in financial assets. Moreover, the ESA 95 focuses on the economic point in time in which a transaction occurs and not on the point in time of the resulting cash movement.

The data reported to the EU are based on the annual accounts of the territorial entities (Federation, Länder and municipalities) as well as the social insurance funds, which under the German budget system are also included. The budget reform of 1969 provided a uniform system to facilitate consolidation. From a German point of view, the ESA 95 therefore represents a derived computation. The data required are not collected directly, but are collated from various statistics. Thus, in contrast to the submission of accounts, it is not an instrument for steering budget policy on a national level, but rather a collection of data compiled especially for European purposes. The actual deficit is determined by the Federal Statistical Office, the level of debt by the Bundesbank. The Federal Ministry of Finance draws up only the projection for the current budget year.

Notification of the Maastricht values is sent by Germany to the European Commission twice a year[15]:

- On 1 March, the results of the four previous years and the projection for the current year are transmitted (example: the notification on 1 March 2005 contains the financial statistics for 2001-04 and the projection for 2005).
- On 1 September an updated version of the March notification is sent.

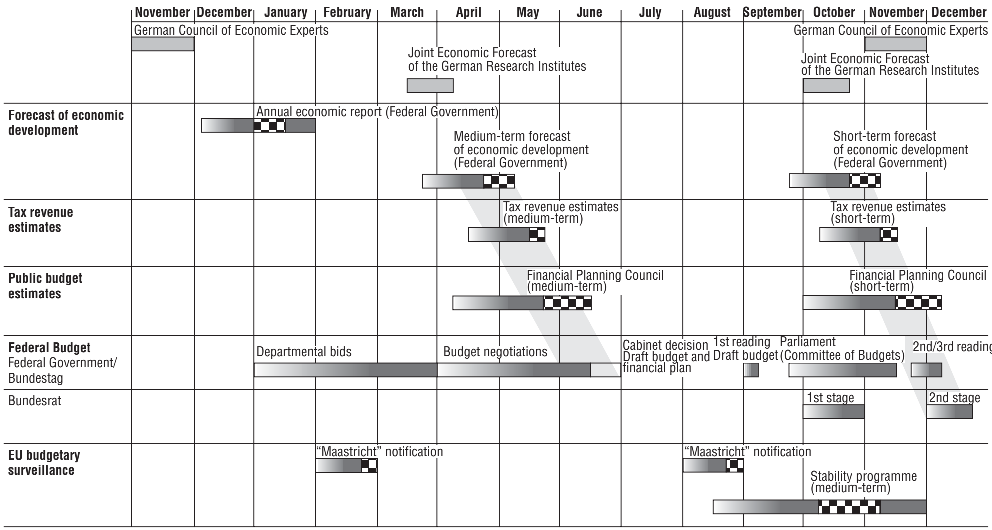
Figure 1 shows when the Maastricht notification is sent with respect to the planning of the public budgets in Germany.

3.4. Accounting control

The accounts are actually controlled on a national level, with the focus on the budgets previously approved by the respective federal and Länder Parliaments and how these budgets are executed. This must be distinguished from the review of the Maastricht criteria as part of the EMU, which involves a policy audit of the statistical quality of individual data reported and the assessment of the budgetary policy of an EU Member State.

The competent and legally authorised national institutions are responsible for reviewing the accounts submitted at the individual levels of government.[16] These national institutions include the Federal Court of Audit, the audit courts of the Länder, and the individual Parliaments which must approve their governments. Here, the proper and efficient administration of public finances is checked, but not whether budgetary policy goals have been adhered to. The judicial independence of the audit courts guarantees that the audits are conducted in a proper and objective manner.

Figure 1. Forecast and budgeting process in Germany



Source: Federal Ministry of Finance, Division I A 4.

The results of the audit report – the so-called comments of the Federal Court of Audit or the audit courts of the Länder – are published in the autumn of the year following the fiscal year in question. The report represents parliamentary approval of the governments and, in the following accounting period, a check is made on whether the comments of the audit courts have been put into practice by the governments.

By entering the EMU, the German government has made part of its national budgetary legislation subject to supranational control. The contracts concluded as part of the EMU mean that the net financial investment and the general government debt are now subject to control by the EU institutions. Thus, the EU Commission monitors the developments in the overall budgetary process in the Member States and issues recommendations to the Council (ECOFIN) as to which measures should be taken with a view to eliminating the deficit or which sanctions are to be imposed on countries running excessive deficits.[17] In the worst case, the sanctions can lead to the Member State being obliged to lodge a non-interest bearing deposit with the EU or to pay a fine to be decided by the Council. The budgetary policy monitoring procedure looks at the reported indicators (Maastricht criteria) and budgetary policy goals. The organs of financial control in the narrowest sense (*e.g.* Federal Court of Audit, European Court of Audit) are not involved in this procedure.

4. Federalism Commission: Modernisation of the federal system

4.1. Remit of the commission

Developments in the federal structure in Germany are marked by the increasing interlinking of responsibilities between the Federation and the Länder. This has led to unclear responsibilities and to more bureaucracy. For this reason, the Bundestag and the Bundesrat appointed in October 2003 a joint commission to modernise the federal system (Federalism Commission).[18]

The commission's remit was to draw up proposals as to how to modernise the federal system with a view to improving the capacity of the Federation and the Länder to take decisions and act on these decisions, assigning the political responsibilities more clearly, and increasing the usefulness and efficiency of work. In addition, it was charged with reviewing the apportionment of legislative powers between the Federation and the Länder, the responsibilities and participation rights of the Länder in legislating on a federal level in different areas, and the financial relations between the Federation and the Länder. In doing so, it was also to take into account the further development of the European Union and the situation in the municipalities.

4.2. Further development of the national stability pact

The national stability pact was also to be extended as part of this comprehensive work. The joint responsibility of the Federation, the Länder and the municipalities to adhere to the European provisions on fiscal discipline was to be clarified in Article 109 of the Basic Law and the clear, constitutional authority to regulate by federal law the apportionment between the Federation and Länder of possible sanction payments by Germany, in accordance with Article 104(11) of the Treaty establishing the European Community, was to be created. A draft implementation law provided for the apportionment of fines as follows:

- Sixty-five per cent for the Federation and 35% for the Länder.
- In apportioning the 35% share of the Länder, 65% was to be apportioned to the Länder at fault and 35% apportioned in solidarity over the population.

The Federalism Commission was unable to agree on a package of joint recommendations and decided to wind up its activities at its meeting of 17 December 2004, without having adopted any proposals for amendments to the Basic Law.

Proposals adopted by the Federalism Commission would have represented an important element in extending the national stability pact and would have strengthened domestic efforts to implement the European fiscal discipline provisions. Nevertheless, the reform of the federal system remains an important topic and should be revived as soon as possible.

5. Summary

The essential actors in co-ordinating fiscal discipline in Germany are the Federation and the 16 Länder. Their special relationship is a result of the fundamental principle of independence in their respective budgetary policies and procedures. It is for this reason that the Federal Minister of Finance cannot issue any instructions with regard to the budgetary policies of the Länder and cannot demand accountability. This has become especially important since the introduction of the EMU as annual borrowings and general government debt in relation to GDP are now subject to permanent monitoring by the European Commission.

In the Financial Planning Council, the Federation and the Länder have concluded agreements in the course of the medium-term financial planning on how expenditure may be reduced or expenditure growth limited up to 2006. Borrowing from the EU provisions, this arrangement is called the "national stability pact". This national stability pact was to be extended within the framework of the Federalism Commission by a clear rule governing how EU legal sanctions are to be apportioned between the Federation and the Länder in the event of a breach of the European Stability and Growth Pact. Monetary penalties were to be divided between the Länder based on two criteria: the Bundesländer which caused them, and the number of inhabitants. As this proposal was part of an overall reform package, on which ultimately the Federalism Commission could not agree, it has not been implemented. The need for regulation remains.

Notes

1. See the Basic Law for the Federal Republic of Germany, Article 106(9).
2. See Article 109(1) of the Basic Law.
3. See Articles 109 and 115 of the Basic Law.
4. The Länder constitutions contain similar provisions.
5. See the Law to Promote Economic Stability and Growth, section 1. The law came into force in 1967.
6. See the Treaty establishing the European Community, Article 104.
7. See the Resolution of the European Council on the Stability and Growth Pact, *Official Journal of the European Communities* C236 of 2 August 1997, and Article 104 of the Treaty establishing the European Community. In cases of excessive deficit, Member States may be required to deposit a non-interest bearing deposit with the EU or to pay a fine.
8. See the Law on Budgetary Principles, section 51a (in effect as of 1 July 2002).
9. Participants in the "tax revenue estimates" working group are: representatives of the Federal Ministry of Finance, representatives from the finance ministries of the 16 Länder, representatives of the central associations of local authorities, the Federal Statistical Office, economic research institutes, the German Council of Economic Experts and the German Bundesbank.
10. See Federal Ministry of Finance, *FMF Monthly Report*, January 2003, p. 42.

11. See the decision of 21 March 2002 of the Financial Planning Council.

12. Ibid.

13. See Article 114(1) of the GG, and sections 37 to 41 of the HGrG.

14. The European System of National and Regional Accounts 1995 is an internationally compatible accounting framework for a systematic description of a total economy. First published in 1970, it represents the central framework reference for the economic and social statistics of the European Union and its Member States. See ESA 95, Chapter 1.01.

15. The Council will in all probability agree a change before the end of the year so that the two annual notifications from 2006 on will be sent one month later.

16. See Article 114(2) of the GG, and sections 42 to 47 of the HGrG.

17. See Article 104 of the Treaty establishing the European Community.

18. See Bundesrat-Drucksache 750/03 of 17 October 2003.

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