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Subnational Government Bailouts in Germany

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Abstract

This paper presents an investigation of subnational government bailouts in Germany. In the first part we briefly describe the system of fiscal federalism in Germany. The main part of the paper examines the bailout of two West German states. We identify the causes of the financial crisis in both states and examine the institutional settings as well as the ruling of the Constitutional Court that forced the federal government to provide bailout transfers. In addition, we investigate the impact these transfers had on the fiscal performance of both states. In a further section we provide evidence on bailouts of local governments by German states. A final section summarizes our results and presents policy conclusions.

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1. Introduction

The bailout problem is currently at the top of the research and policy agenda in Europe. Germany is an interesting case to study if only because the German government insisted on including a "no-bailout principle" in Article 104b of the Maastricht Treaty. Thus, it is of interest to study how Germany handles this problem at home. In addition, studying bailouts in existing federal states might be an important source of information for the future development of some kind of a European federal state. By a careful examination of the political as well as institutional conditions that were at work during bailout episodes, one can try to derive some knowledge of the proper design of constitutional and political institutions that reduce the probability of bailouts and thus strengthen market forces. Making a distinction between fiscal bailouts and monetary bailouts, one has to mention at the outset that the latter are of no importance in our study because in Germany no fiscal unit has access to borrowing from the central bank. Thus we exclusively examine fiscal bailouts.

Default by a subnational government can impose a negative externality upon other subnational governments or the federal government by increasing the cost of borrowing for all fiscal units. An important question that arises in the bailout literature refers to the impact of effective discipline on borrowing that is imposed by the market. These market forces can only work efficiently if subnational governments have no perceived chance of a bailout by the central government (or the central bank).[1] If a bailout occurs, it might disturb or even destroy completely market forces—increasing interest rates through higher risk premia for borrowing or even failure to find a creditor—that prevent fiscal units from overborrowing. Lane (1993) claims that an actual bailout is not necessary to destroy market discipline. Instead, the expectation of a bailout is the most important reason for the failure of market discipline. The expectation of a bailout leads to a moral hazard problem on the part of the lender as well as on the part of the borrower. Whereas the former has less incentive to monitor the borrower's performance, the borrower's incentive to run a sustainable fiscal policy is reduced. If market forces work, subnational governments that run unsustainable fiscal policies face rising interest rates that not only increase the cost of borrowing but also signal to the market, and thus the public, a risk of default and bad quality of fiscal policy. If market forces work efficiently, the other fiscal units in a federal system need not be harmed by a default of one governmental unit.

The public finance and fiscal federalism literature has left the bailout issue virtually unaddressed. Only recently have some theoretical papers investigated the issue. Wildasin (1997) presents a theoretical investigation of fiscal bailouts which suggests that large subnational governments have a higher chance to be bailed out by the central government ("too big to fail"). However, in the Wildasin model there is no public debt, either at the level of subnational governments or at the central government level. Bailouts occur because local governments strategically underprovide public goods, with nationwide externalities. Thus in this modeling framework bailouts take the form of ex-post grants. In a related paper, Qian and Roland (1999) show that fiscal competition among local governments increases the opportunity cost of bailouts because bailouts are associated with an inefficient expenditure allocation. A related study is the

[1] See Lane (1993) for other conditions that have to be fulfilled for the working of market driven borrowing restrictions.

work of Kornai (1980, 1986) which introduced the notion of a “soft budget contraint.” According to Kornai, enterprises or any organizations that expect to receive a bailout face incentive-killing soft budget constraints.

The present paper addresses the bailout issue in a case study focusing on the bailout of two West German states. In Section 2 we present a brief overview of fiscal federalism in Germany, describing the most important institutional facts and presenting some key figures. In the past there have frequently been (minor) institutional changes. Unless indicated otherwise, the institutional settings mentioned in this report refer to those valid in 1998. Section 3 presents a detailed discussion of the most important bailouts in the Federal Republic of Germany, namely the massive financial transfers to two West German states, Saarland and Bremen. Both states ran into severe financial trouble in the 1980s and turned to the Constitutional Court in order to force the federal government to support them in coping with their high public debts. Bailouts at the local level are examined in Section 4. Section 5 summarizes the results of our investigation and presents some policy conclusions.

2. Fiscal Federalism in Germany: A Short Overview

a) Basic Facts

The Federal Republic of Germany (FRG) has a political system with a pronounced federal structure which has three levels of government: federal (Bund), state (Länder) and local (Gemeindeebene). The responsibilities of each level are specified in the Basic Law (Grundgesetz). Before German unification in October 1990, there were 10 states in the former West Germany and West Berlin, which had a special status. With German unity the number of the states increased to 16 (see Map).[2] About 14,000 cities and communities are assigned to the states. Three of the states—Berlin, Hamburg and Bremen—do not have fiscal independent communities because they are in fact large cities and are called “city-states” (Stadtstaaten). To distinguish the city-states from the other states, we call the latter “non-city-states” (Flächenländer). It is rather important to distinguish between these two types of states because the budgets of the city-states also cover expenditures and revenues that are typically assigned to local authorities in the non-city states. Consequently, the expenditures of the non-city states include grants to local authorities, whereas there are no grants to local authorities in the city-states, because these states do not have fiscally independent municipalities and therefore have to run all businesses that are usually covered by communes. Consequently, fiscal data of the two types of states are not directly comparable unless the fiscal data of the non-city states are consolidated with the fiscal data of their local governments. We consequently follow this practice

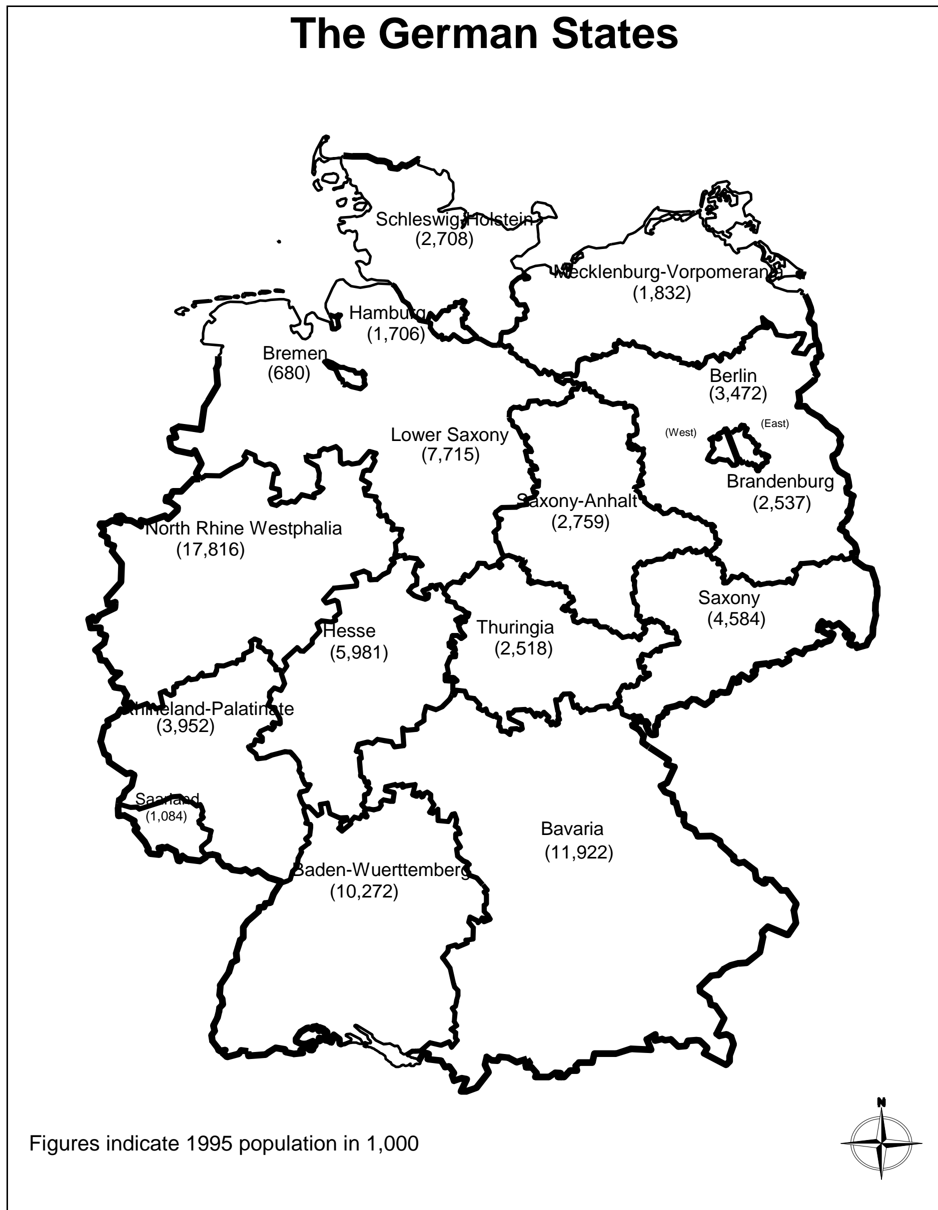
[2] The former West Germany consisted of the three city-states: Hamburg, Bremen, and Berlin (West) and the eight non-city-states: Schleswig-Holstein, Niedersachsen (Lower Saxony), Nordrhein-Westfalen (North-Rhine Westphalia), Hessen (Hesse), Rheinland-Pfalz (Rhineland Palatinate), Saarland, Baden-Württemberg, and Bayern (Bavaria). On October 3, 1990, five newly created states in East Germany, all of which are non-city-states, entered the Federal Republic of Germany. These are: Brandenburg, Mecklenburg-Vorpommern (Mecklenburg-Western Pomerania), Sachsen (Saxony), Sachsen-Anhalt (Saxony-Anhalt) and Thüringen (Thuringia). In addition, the former Berlin (West) and Berlin (East) merged to form the new city-state Berlin.

in the study; that is, if we report state data we always aggregate the budgets of all local governments and the state's budget.[3]

Table 1 presents some key data on the German states. As can be seen, the states differ quite substantially in size. The two West German states that will be the focus of Section 3, Bremen and Saarland, are the smallest states, with populations of about 0.68 and 1.08 million, respectively. Differences among the West German states in economic performance are also considerable. Whereas the two southern states, Bayern and Baden-Württemberg, had unemployment rates of less than 9% in 1997, the state Saarland had an unemployment rate of about 13.6% and the unemployment rate in Bremen was almost as high as the unemployment rate in the East German state Sachsen. We observe similar differences in per capita GDP figures. The fiscal data shown in Table 1, per capita expenditures and per capita debt, indicate dramatic interregional disparities as well. Per capita debt ranges from about 25,000 DM in Bremen to about 5,000 DM in Bayern. In addition, Table 1 shows that per capita government expenditures in the East German states exceed those of the West German state considerably.

[3] The data we will use carefully avoids double counting that could occur because states provide grants to local governments and local governments make various payments (of minor importance) to the states. These "intra-state" payments are excluded from the data on consolidated state and local government budget data.

Map 1. The Geography of the German States after German Reunification



ata on the German States 1997

	Population in 1,000	State gov. expenditures per capita in DM	State gov. debt per capita in DM	Interest payments[1] %-share	Unemploy-ment rate (percent)	Real per capita GDP in DM at 1990 prices
West German non-city states						
berg	10,375	7,290	6,580	5.49	8.7	44,410
	12,044	7,600	4,830	3.64	8.7	44,800
	5,027	8,290	9,540	7.28	10.4	52,060
	7,815	7,100	10,220	9.25	12.9	35,470
tfalen	17,948	7,800	10,440	8.24	12.2	39,090
	4,001	7,200	10,000	8.50	10.3	34,800
	1,084	7,600	13,970	12.95	13.6	36,810
tein	2,742	7,529	11,690	9.71	11.2	35,960
East German non-city states						
	2,554	9,100	9,660	5.84	18.9	20,490
orpommern	1,817	9,580	8,440	4.98	20.3	18,450
	4,546	8,560	6,310	4.40	18.4	18,840
	2,724	9,300	9,800	5.63	21.7	17,700
	2,491	8,920	8,740	5.63	19.1	17,810
City-states						
	3,459	12,110	15,330	8.00	17.3	37,170
	679	11,600	24,970	15.31	16.8	59,370
	1,708	10,790	16,750	10,45	13.0	83,500

ents as a percentage share of total expenditures.
st Berlin and the former East Berlin merged in 1990 to form the state of Berlin. Consequently, Berlin is a "mixture" of E

lculated from various sources (Federal Statistical Office, Wiesbaden, Federal Labor Agency, Nürnberg and Federal Mini

The German constitution defines the responsibilities of the different levels of government. The communes are responsible in particular for local utilities and services such as water supply, sewage and waste disposal, the construction and maintenance of local roads, etc. Local governments are also responsible for the provision of supplementary welfare benefits, especially social assistance benefits. The constitution guarantees the communities the right to manage their own affairs independently. In practice this independence is quite restricted because the local governments rely heavily on grant financing from the states governments and the vast majority of expenditures are mandatory. In addition, the states must approve all borrowing by local governments. Deficit financing can and is frequently denied by the states if it is suspected that the communes will not be able to meet the expected future financial obligations associated with borrowing. This subject will be taken up again below. The states are responsible for cultural affairs, in particular for schools and education, the administration of justice, police, universities and health services. In addition, the states and the federal government cooperate on the planning and financing of "joint tasks" such as regional economic policy, coastline preservation and agricultural policy, as well as publicly-funded research. The importance and the expenditure volume of these joint tasks has increased considerably since the passing of the 1949 Constitution, which introduced a more or less strict division of power between the federal government and the state governments. This strict separation eroded more and more, and a careful comparison of the 1949 Constitution with the current Constitution reveals that the federal government has increased its impact on the policy of the states considerably (see Blankart, 1999). Several authors, such as Blankart (1999), claim that the extension of joint tasks was associated with a centralization process because the co-financing of state projects by the federal government is accompanied by an increasing influence of the Federation on the policy of the states. In addition, Blankart also claims that there is a common pool problem by arguing that the state governments gave up part of their autonomy in order to get financial support from the federation and thus at the expense of the nation as a whole. Recently, in Germany there are tremendous political efforts to reintroduce a more strict division of power between the states and the federal government.

b) Fiscal Federalism: The Distribution of Tax Revenues among the Levels of Government

There are two important aspects of fiscal federalism in Germany: i) A pronounced fiscal equalization system that is driven by the mandate of the German constitution to achieve uniform living conditions across the regions, and ii) the almost complete lack of regional differentiation in taxation. Both issues deserve some comments.

Table 2 presents data on the sources of revenue of subnational governments in Germany. Because of the dramatic differences between the states in the former West Germany and the states in East Germany we make an East-West distinction. In addition, contrary to our general practice in this report, we supply data separately for local governments and states. As can be seen, only about 10% of the total revenue of the West German states consists of transfers from the federal government, and about 3.6% of the West German states' revenues are distributed within the fiscal equalization system to the East German states. Things are quite different in the East, where the states heavily rely upon transfers from the federal government as well as from the West German states. About 36% of their total revenues are transfers from the federal government and about 6.7% from the West German states. Looking at local governments we also observe large East-West disparities. The West German local governments receive about 30% of their total revenue as grants from the states;

in East Germany this ratio comes close to 60%. In addition, there are rather strong differences in tax financing of local governments between the two parts of Germany. In East Germany, tax revenues contribute only about 13% of total local government revenues whereas in West Germany about 36% of all local government revenues are from taxes.

Table 2. The Revenue Structure of Subnational Governments in East and West Germany, 1997

Sources of revenue:	States (excluding local governments)	Local Governments
	West German States	
Taxes	77.7%	36.4%
Fees, etc.	4.7%	21.3%
Transfers from the federal government	9.8%	~ 0.0%
Transfers from states	-3.6%	28.0%
	East German States	
Taxes	48.5%	13.2%
Fees, etc.	3.0%	14.8%
Transfers from the federal government	36.0%	1.0%
Transfers from states	6.7%	57.4%

Source: Federal Ministry of Finance, Bonn, and author's calculations.

Tax revenues in Germany are collected from two types of taxes. The majority of taxes are "joint taxes;" that is, the revenue from these taxes accrues to the federal, state and even the local level jointly according to negotiated shares, some of which are fixed in the Constitution. About 75% of all tax revenues belong to this category. Only 25% of tax revenues are derived from taxes earmarked to only one level of government. Thus, the federal government receives all revenues from the mineral oil tax, insurance tax, tobacco duties and some further taxes of minor importance. States receive taxes collected within their geographic boundaries from the motor vehicle tax, inheritance tax, and betting and lottery tax, as well as some other taxes of minor importance. The rates of these taxes, however, are fixed at the federal level. Local authorities obtain the real property tax and local excise taxes as well as most of the revenues from the local business tax.[4] Unlike the states, local governments have discretionary power in setting tax rates and can set the tax rates on local property taxes as well as the local business tax rather independently.[5] Table 3 shows the distribution of revenues from joint taxes to each level of government (vertical fiscal equalization system) in Germany in 1998 as well as the revenues collected from these taxes in 1997.

The vertical fiscal equalization system describes only the distribution of tax revenues between the different tiers of government but does not regulate the distribution of the states' share to individual states.[6] This is achieved in a horizontal fiscal equalization system. A crucial element of this distribution mechanism is an index of *fiscal capacity*. Roughly speaking, the fiscal capacity index is calculated as the sum of tax revenues of the states

[4] The local business tax is in fact a joint tax. However, neither federal nor state government has a direct influence on the setting of local business tax rates.

[5] However, local governments adjust local tax rates rather rarely and take into account competition with other local governments, see Seitz (1995).

[6] For reasons of space we do not describe the distribution of revenues from joint taxes among the local governments. This distribution is rather complicated and differs among the states.

including (approximately) 50% of the tax revenues of their local governments, with all revenue taken on a per capita basis. Whether a state is entitled to transfers from other states or has to make transfers to other states depends upon the relationship of its own fiscal capacity in comparison to the average fiscal capacity. This distribution of tax revenues among the states is achieved in a multiple-stage system:

Table 3. Distribution of Revenues out of Joint Taxes in Germany among Federal, State and Local Governments (institutional setting of 1998 and revenue data from 1997).

	Federal	States	local governments	total revenue 1997 in bill. DM[1]
Value added tax	52.5%	46.7%	2.1%	255
Income tax incl. wage tax	425%	42.5%	15.0%	249
local business tax	4.6%	16.1%	79.3%	48,6
Non-assessed taxes on Earings	50.0%	50.0%	0.0%	14,7
Interest income deduction	44.0%	44.0%	12.0%	11,4
Corporation tax	50.0%	50.0%	0.0%	33,3

1 Note: total tax revenue in Germany in 1997: 797 bill. DM.
Source: Federal Ministry of Finance, Bonn.

In a first fiscal equalization step**,** 75% of the states' share of the VAT is distributed among the states according to their population share. The remaining 25% of the VAT that accrues to the states is distributed such that financially weak states have at least 92% of the average fiscal capacity. If VAT revenues are not sufficient to reach the 92% target, the target is curtailed; if VAT revenues are high enough to reach the 92% target, the surplus is distributed according to the population share. In a second step, redistributive transfers among the states are calculated to ensure that every state attains at least 95% of the average fiscal capacity. This procedure creates a very high "marginal transfer rate" on additional tax revenues for the financially strong states. The marginal transfer rate on tax revenues collected can amount to up to 80%.

Note that both steps are confined to the level of the states. The federal government does not participate in the fiscal equalization procedure; instead, the Federal Ministry of Finance only participates as a clearing agency. Until 1994, the former West Berlin did not participate in the second stage of the fiscal equalization system because of political reasons associated with the special status of West Berlin.[7] Likewise, the new states in East Germany did not participate in the second stage of the fiscal equalization system until the end of 1994, and only partly in the first stage. Until 1994 the states in East Germany received transfers from a special (debt-financed) fund, the Germany Unity Fund, to which we will make some further reference below.

Despite the strong impact of the equalization system just described there are still large differences in per capita revenues across the states after the transfers between the states. In order to achieve a further equalization of fiscal capacity the federal government provides complementary grants (Fehlbetrags-Bundesergänzungszuweisungen) to financially weak states to ensure that every state receives a minimum of about 99.5% of the average per capita revenue. These grants from the federal government to the financially weak states are looked

[7] West Berlin was funded by the federal government in Bonn.

upon as a third stage of the German fiscal equalization system. In 1997 all East German states and Berlin, as well as 4 of the 10 West German states, received such grants. The total volume of complementary grants has been about DM 5.2 billion 1997.

In addition, the federal government provides several asymmetrical vertical transfers to the states. However, contrary to the complementary grants mentioned above, these are not designed to bring about a further reduction in fiscal disparities but to achieve other political and economic goals. There are four types of these transfers:

- Tranfers to cover the cost of political administration in small states (Sonderbedarfs-Bundes-ergänzungszuweisungen für die Kosten der politischen Führung)

These grants are provided to the small states in East and West Germany. It is argued that the per capita cost of political administration decreases with an increase in population size and therefore .small states have to bear higher per capita costs for administration. In 1997 the federal government provided about DM 1.5 billion this purpose. All East German states except Sachsen receive such transfers as well as Berlin and the three small West German states (Saarland, Bremen and Rheinland-Pfalz).

- Transition transfers to West German states (Übergangsbundesergänzungszuweisungen alte Länder)

In 1995, the East German states joined the fiscal equalization system among the states. Because of the poor economic and fiscal conditions in East Germany, all East German states receive considerable transfers from this interstate redistribution system. Correspondingly, some West German states suffered severe revenue losses as a result of the integration of the East German states into the fiscal equalization system. By providing these transfers, which will end in 2004, the federal government tries to smooth the adjustment burden of these states. In 1997, five out of the ten former West German states received such grants with a total volume of about DM 1.1 billion.

- Transition transfers to East German states (Übergangsbundesergänzungszuweisungen neue Länder)

Because of the poor economic performance and the small tax base of the East German states, as well as the need to support these states in the construction of modern infrastructure, the federal government provides transition grants to all East German states, including Berlin. These grants, like transition transfers to West German states, are to be terminated at the end of 2004; in 1997 the total volume of these grants amounted to DM 14 billion. However, the federal government promised the East German states that the extension of these grants will be negotiated before 2004.

- Consolidation transfers to Bremen and Saarland (Sanierungsbundesergänzungs-zuweisungen)

Two severely indebted West German states, Bremen and Saarland, receive financial aid for the amortization of outstanding debt. These grants will be discussed in more detail below. In 1997 the federal government paid DM 3.4 billion to both states.

Table 4 reports the transfers in stage 2 of the fiscal equalization system among the states as well as the supplementary federal grants.[8] As can be seen, only four West German states make contributions to the fiscal equalization system. The state of Hessen has to transfer about 6.5% of its resources to other states, whereas Bremen, on the other hand, receives about 4.4% of its total revenue from the fiscal equalization system. All states in East Germany, as well as Berlin, are net receivers and on average receive about 5% of their total revenues as transfers from West German states. The differences are even more striking if we look at the distributional impact of the various supplementary grants of the federal government to the states. Five of the West German states do not receive any supplementary transfers, whereas the states of Bremen and Saarland receive about a quarter of their total revenues from the federal government. In East Germany, the states receive on average about 13% of their revenues as supplementary federal transfers.

The four types of federal transfers to the states mentioned above are not an integral part of the fiscal equalization system in Germany. However, in negotiating the fiscal relations between the states and the federal government these grants play an important role. The supplementary grants by the federal government have been of crucial importance after German unification. As we already mentioned, the states in East Germany as well as Berlin did not immediately participate in the horizontal fiscal equalization system among the states after German reunification in October 1990. With the passing of a federal law in 1993 (Federal Consolidation Program), fiscal arrangements in Germany were fundamentally reorganized, and the states in East Germany, as well as Berlin, joined the equalization system in 1995. Because the tax base in East Germany was and still is rather poor, their financial requirements were met by increasing the states' share of the VAT revenues from 37% to 44%. The drop in tax revenue of the federal government was compensated by introducing an income tax surcharge of 7.5%.

[8] Apart from the various supplementary grants mentioned, all of which are unconditional grants, there are specific conditional grants from the federal government to the states, such as support for regional and agricultural policy. However, these grants require projects to be co-financed by the states.

Table 4. Distributional Impact of Transfers among the States and Supplementary Transfers from the Federal Government to the States

	Transfers from (+) and contributions to (-) fiscal equalization among the states in 1997[1)]		Supplementary federal transfers to the states in 1997[2)]	
	mill. DM	% of total revenues	mill. DM	% of total revenues
West German States				
Baden-Württemberg	- 2,410	- 3.27	0	0
Bayern	- 3,102	- 3.56	0	0
Hessen	- 3,148	- 6.47	0	0
Niedersachsen	+ 672	+ 1.27	1,414	2.68
Nordrhein-Westfalen	- 3,059	- 2.34	0	0
Rheinland-Pfalz	+ 296	+ 1.11	1,037	3.90
Saarland	+ 204	+ 2.34	2,016	23.09
Schleswig-Hostein	-5	- 0.03	346	1.82
Bremen	+ 350	+ 4.44	2,100	26.65
Hamburg	- 273	- 1.62	0	0
East German States (including Berlin)				
Brandenburg	+ 986	4.73	2,618	12.57
Mecklenburg-Vorpommern	+ 843	5.40	1,976	12.65
Sachsen	+ 1,918	5.02	4,492	11.76
Sachsen-Anhalt	+ 1,175	5.39	2,870	13.16
Thüringen	+ 1,123	5.63	2,627	13.18
Berlin	+ 4,432	13.90	3,725	11.68

1. Without redistribution of VAT among the states. Thus, only transfers at the second stage of the fiscal equalization system among the states are included.
2. Supplementary federal transfers comprise the above mentioned federal grants: i) complementary transfers to financially weak states, ii) transfers to cover the cost of political administration in small states, iii) transition transfers to East German states, iv) transition transfers to West German states, and v) consolidation transfers to Bremen and Saarland.

The financial equalization system in Germany produces rather strange incentives because states that run a “sound” fiscal policy leading to a rise in the tax base lose a considerable share of any additional tax revenue. This kills incentives to run a proper economic policy. Consequently, the system has come under attack by politicians and economists who criticize the almost complete lack of incentives to run a policy that increases the tax base (see, for example, Homburg, 1994). While the fiscal equalization system among the states does not change the ranking of the fiscal power of the states, the numerous supplementary federal transfers change this ranking dramatically so that fiscally weak states can and do end up “richer” than the fiscally strong states. In fact, per capita revenues of “poor” states can exceed per capita revenues of “rich” states after all transfer payments in the fiscal equalization system and supplementary transfers from the federal government to the fiscally weak states. This is the case for all states in East Germany but the ranking is also distorted if one considers the West German states only.

c) Tax Policy in Germany at the Subnational Level

Some remarks must also be made on tax policy in Germany. The states have virtually no power to set tax rates, despite the fact that about 80% of the West German states' total revenues come from taxes; tax rates are set by the federal government. However, the federal government has to pass a law if rates of joint taxes or rates of taxes that are earmarked to the states are changed; the states participate in the legislative process through voting in the Upper Chamber, the Bundesrat. Thus, the states can jointly influence tax policy but none of the states can fix tax rates individually. In addition, the states and the federal government also negotiate the distribution of tax revenues from shared taxes between the two levels of government.

Unlike the states, the local governments can decide—more or less independently—on the rates of local taxes, and there are quite large differences in local tax rates across communes. However, the revenue from these local taxes amounts to only about 8.3% of total tax revenues in Germany. Thus, the regional differentiation in taxation that is brought about by local taxation is rather modest.

d) Restrictions on Borrowing

Borrowing restrictions on subnational government are an important issue. Ter-Minassian and Craig (1997) argue that high subnational public debt is a symptom of an inappropriate design of intergovernmental fiscal relations and/or a lack of adequate controls and limits on subnational borrowing. Ter-Minassian and Craig mention four types of controls that can be imposed on subnational governments:

1. reliance on market discipline,
2. cooperation of the different tiers of government in the design and implementation of debt controls,
3. rules based controls, and
4. administrative controls.

As we will show below, the first control mechanism is virtually eliminated by the construction of German fiscal federalism. A special institution, the Financial Planning Council (Finanzplanungsrat), introduced in Section 51 of the Law on Budgetary Principles for Federation and States, has the task of coordinating the financial planning of all tiers of government. The Council is composed of representatives of the federal, state, and local governments. Especially since the introduction of the Maastricht Treaty, the Council gives recommendations for expenditure growth and budget deficits. However, because of the independence of federal and state budgeting the agreements negotiated in the Council are not binding. Rules-based controls are introduced in the Federal Constitution as well as in the Constitutions of all states. Administrative controls are at work at local government borrowing.

According to Article 115 of the German Constitution, federal government borrowing is restricted by the "golden rule": that is, government borrowing cannot exceed the amount spent on investment. Similar rules hold at the state level. In 1969 a federal law was passed which makes it possible to exceed the constitutional limit in case of "disturbances of general economic equilibrium." The federal constitution as well as the constitutions of all states were

adjusted in 1969 to take this exceptional case into account. Local government borrowing is also restricted to the financing of investment outlays, and it is additionally controlled by state governments, which especially investigate local governments' ability to meet projected debt service.[9]

As a matter of fact, all levels of governments are quite innovative in developing procedures to circumvent debt restrictions. These practices include reclassifying current expenditures as capital (investment) expenditures, setting up entities whose operations are kept off-budget, and using innovative debt instruments such as private-public partnership in running and financing infrastructure projects.[10] Thus, for example, the massive transfers that were necessary to pay for East Germany's integration into the Federal Republic were financed almost completely through off-budget funds, especially the German Unity Fund, which made it possible to avoid constitutional borrowing restrictions.

3. The Bremen and Saarland Case

a) *The Fiscal and Economic Crisis in the States of Saarland and Bremen and the Ruling of the Federal Constitutional Court*

In 1988 the states of Saarland and Bremen turned to the Federal Constitutional Court to force the federal government to support both states in coping with their high public debts. Both states claimed that their high debts were caused by negative economic developments not under the control of the state governments—the crisis in the ship-building industry in Bremen and the crisis in the iron, steel and coal industry in Saarland—and that the tremendous fiscal burden associated with high public debt made it impossible for the states to fulfill their constitutional duties. In addition, both states argued that they were forced to violate the requirements of Article 115 of the Constitution,[11] which limits the annual budget deficit to the volume of investment spending. Both states also claimed that if they had to cope with the fiscal burden by themselves, they would have to introduce such severe expenditure cuts, associated with dramatic reductions in the supply of public services, that they would run counter to another requirement of the German Constitution, namely the equalization of living conditions throughout Germany. Furthermore, both states put forward that the majority of state expenditures, such as welfare payments, are fixed by federal law. Significant spending cuts would thus counter federal legislation.

It took the Court four years to arrive at a decision. In 1992, the Federal Constitutional Court, in a very important ruling, supported the claims of both states. The Court argued that the German Constitution, especially the principles of the fiscal federalism system set out in Articles 104-107 of the Constitution, aims at establishing fiscal homogeneity and equalization

[9] For an international comparison of subnational government borrowing restrictions, see Ter-Minassian and Craig (1997).

[10] That does not mean that we believe public-private partnership to be a bad thing. The problem is that it is usually difficult to judge who has to carry the burden of a potential default. For example, in the state of Brandenburg a state-controlled bank arranged the construction of large-scale apartment buildings by private companies. When one of the major private investors ran into financial trouble, medium-sized local companies turned to the state of Brandenburg and asked for financial support because of the indirect involvement of the state in the project. Political pressure, particularly in a state election year, resulted in a (partial) bailout of private debt by the state government.

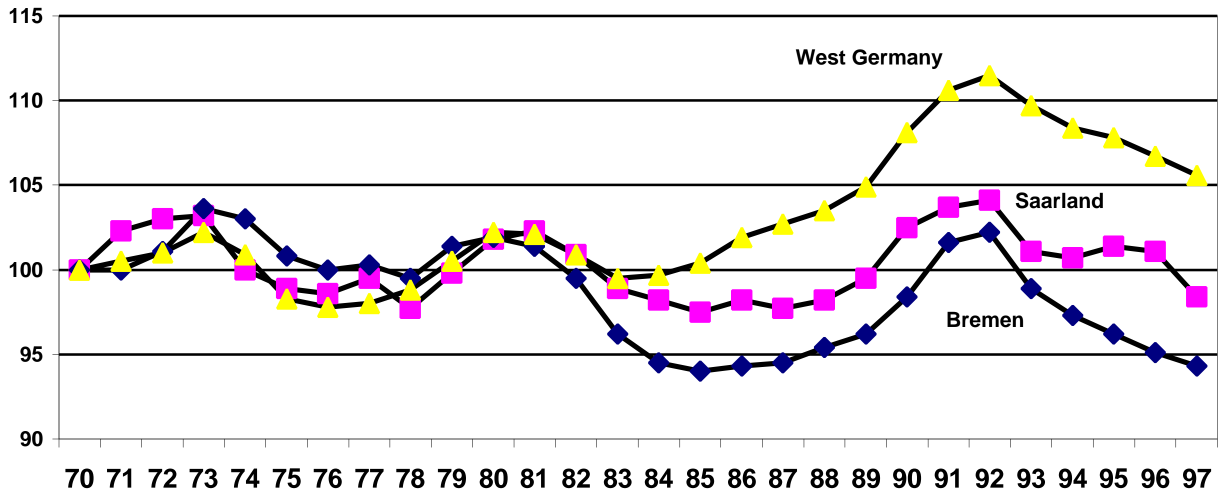
[11] In the Constitution of both states there are deficit financing restrictions similar to those in Article 115 of the Federal Constitution.

of living standards throughout Germany. These objectives can only be achieved by mutual support from the states to the federal government, from the federal government to the states and among the states. Thus, the Court stressed the solidarity principle of the German federal system and concluded that if states (or the federal government) experience "extreme budgetary hardship"—as was claimed by Saarland and Bremen—they were entitled to financial support from all other members of the federation.

The Constitutional Court as well as the two states put forward three arguments to support the claim that there was an extreme budgetary hardship: i) the poor performance of the two states' economies, ii) the far-above-average indebtedness of the two states, and iii) the unusually high ratio of interest payments to total expenditures, which limited the state's ability to pay off the debt without significant cuts in the supply of public goods and services that are enforced upon the states by constitutional law. We examine these facts in some detail.

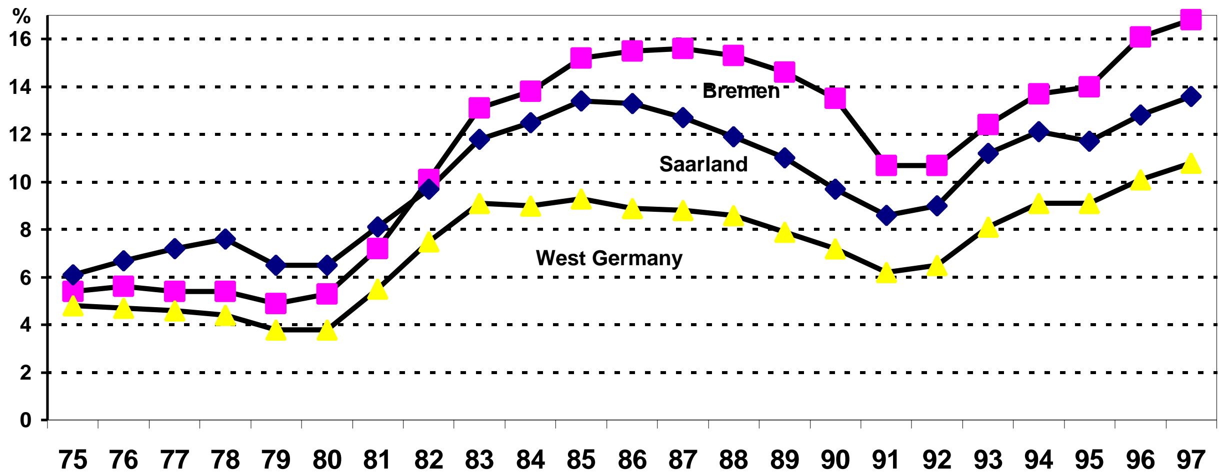
Figure 1 shows a normalized employment series. Starting in the early 1980s, employment in Saarland and, especially, Bremen fell considerably below the West German average. The poor labor market performance of both states is even more visible if we look at the unemployment rates depicted in Figure 2. After 1975 no other West German state had an unemployment rate that exceeded that of Saarland or Bremen. Recently, the unemployment rate in Bremen even approached that of the East German states Thüringen and Sachsen. The reason for their poor economic development was that both were dominated by one or two industries: shipbuilding in Bremen and iron, steel and coal in Saarland. With the deep recession after the first oil price shock in 1973/1974 both industries suffered tremendous losses in employment. None of the jobs lost in these industries, moreover, could be regained after the initial recession was over. Because both states are rather small—see Table 1 above—there was no sufficient compensating labor demand from other industries with more favorable growth performance that could have absorbed the unemployed from the old industries. The unemployment performance would have been even worse if there had not been severe migration out of these two states. In the period 1975 to 1995 Bremen lost about 6.1% and Saarland about 2.5% of its population, whereas other West German states experienced population growth of about 7.5%.

Figure 1. Employment in Saarland, Bremen, and West Germany
Normalized series 1970 = 100



Source: Federal Statistical Office, Wiesbaden and calculations by the author.

Figure 2. Unemployment rates in Saarland, Bremen, and West Germany



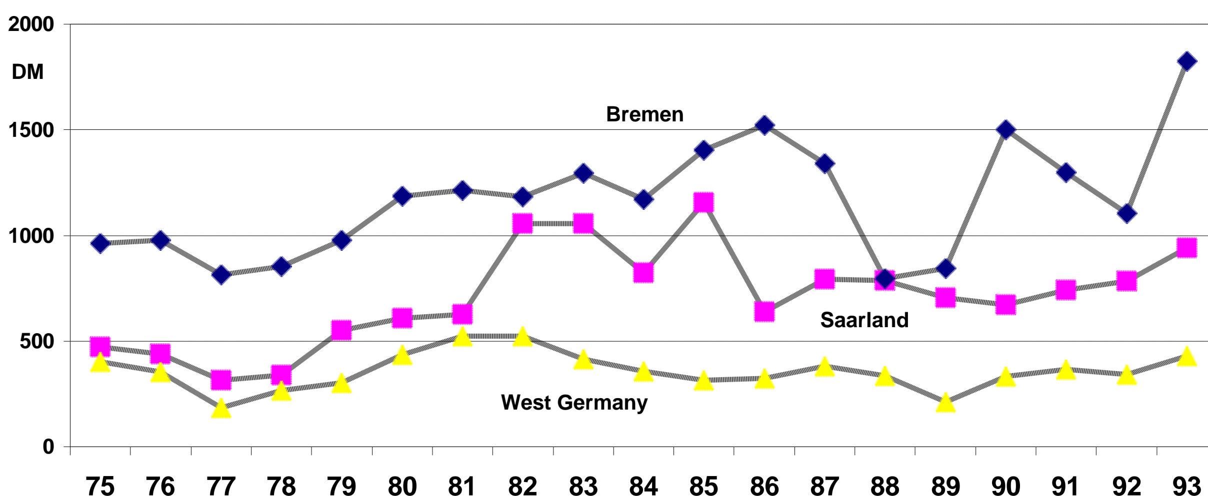
Source: Federal Statistical Office, Wiesbaden.

Table 5. Per Capita Debt and Interest Payments of the German States in 1988 and 1992

	Per capita debt in DM		Interest payments as a percentage of total expenditures, %	
	1988	1992	1988	1992
Bremen	19,150	24,050	14.62	15.38
Saarland	11,650	14,730	13.06	14.71
Hamburg	10,760	12,164	9.61	8.93
Nordrhein-Westfalen	7,780	8,510	9.35	8.77
Schleswig-Holstein	7,710	9,120	8.84	9.07
Niedersachsen	7,260	8,180	8.73	8,23
Rheinland-Pfalz	7,150	7,960	8.97	8.55
Hessen	7,030	7,920	6.81	7.00
Baden-Württemberg	4,980	5,730	5.35	5.32
Bayern	3,820	4,100	4.71	4.36

Source: Federal Ministry of Finance and calculations by the author.

Figure 3. Per Capita Deficit in DM of Saarland and Bremen and All West German States



Source: Federal Statistical Office, Wiesbaden and calculations by the author.

Next we examine debt and interest payment data. Table 5 presents the consolidated data of state and local government per capita debt and the ratio of interest payments to total expenditures for each West German state[12] in 1988 (the year both states turned to the Constitutional Court) and 1992 (the year of the ruling of the Constitutional Court).[13] This information was of considerable importance in the arguments of the Constitutional Court as well as the two states.[14] In Saarland and Bremen, both fiscal indicator were well above the

[12] In fact, the Constitutional Court relied on the ratio of interest payments and “adjusted” tax revenues and not total expenditures. For the ease of discussion we neglect this point.

[13] Berlin is not taken into account in this table. In 1988 there was only West Berlin that belonged to the Federal Republic and in 1992 West Berlin and East Berlin were already merged to form the new city-state Berlin. Therefore, data on Berlin cannot be compared to that of the other West and East German states.

[14] Kitterer (1994) presents a detailed analytical investigation of the financial indicators used in the case before the Constitutional Court.

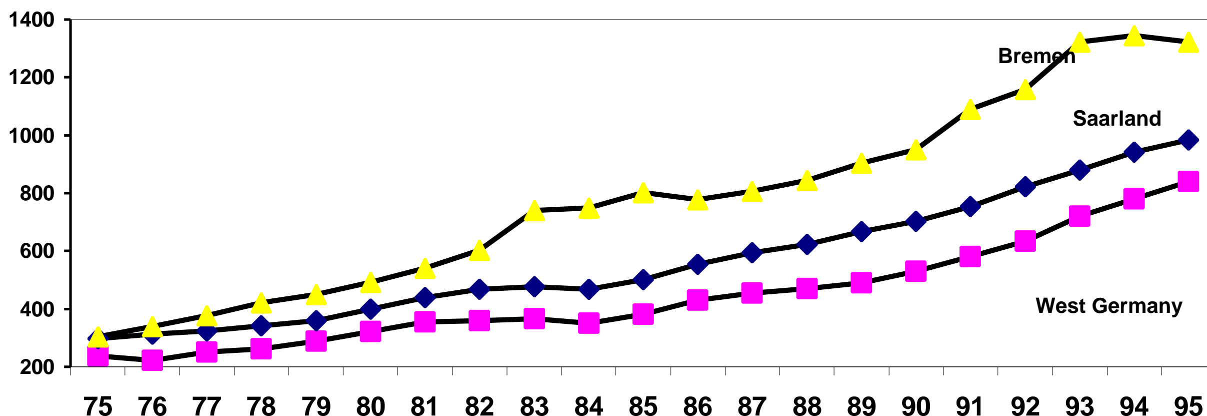
West German average and above the corresponding figures of all other West German states in 1988 and 1992. The Court was convinced that the data indicated "severe budgetary hardship" and followed the arguments of the two states. The Court even presented an estimate of the resources necessary to support the two states. For Saarland the Court presented an estimate of about DM 7.6 billion, and for Bremen an estimate of DM 8.5 billion. According to the ruling of the Court, these transfers would be necessary to bring both states fiscally in line with the average of the West German states.[15]

Finally, we look at some further fiscal data in order to see which type of expenditures was responsible for the poor fiscal performance of the two states. Because of the strong equalizing impact of the fiscal equalization system in Germany, below average revenues in Bremen and Saarland cannot have contributed to the high public debt. This was also indirectly admitted by the two states, because this point was never raised before the Court. Figure 3 presents the per capita deficits of the two states as well as the average per capita deficit of the West German states. The time series indicate that Bremen was permanently running significantly above-average deficits in the period from 1975 to 1993, with the exception of 1988 and 1989. In Saarland deficits started to be considerably above average in the period 1982 to 1985 and decreased slightly in the period from 1986 to 1993, while still staying above the West German average. The comparison suggests that Saarland ran into fiscal troubles because of "transitory" problems, whereas in the case of Bremen an inspection of the time series suggests a "permanent" fiscal crisis. This conclusion is also supported by the facts presented in Figures 4 and 5. Figure 4 shows the time series of per capita welfare payments.[16] As can be seen from comparing Figure 1 and Figure 4, welfare payments started to explode, especially in Bremen, with the deterioration of employment at the beginning of the eighties. In Saarland welfare payments also exceeded the West German average; this change, however, is far less dynamic than in Bremen. **Figure 5** examines another important type of expenditure that is generally held responsible for the fiscal imbalance in the two states, namely investment subsidies paid by the two states to private firms. In the period from 1981 to 1983, Saarland tried to keep the local iron and steel industry alive by providing tremendous financial support. However, despite these massive transfers, the downturn of this industry could not be prevented. In Bremen public support for dying industries started in the mid-1980s, as Bremen tried to prevent the local shipbuilding industry from total collapse. This policy turned out to be ineffective, too. We also inspected personnel expenditures of both states. Personnel expenditure growth in Saarland since 1975 closely kept in line to the other West German states. In the case of Bremen we observe an above average growth rate of personnel expenditures, but this growth rate does not differ significantly from that of the other city-state, Hamburg.

[15] However, the written rule does not permit the reader to follow the calculations of the Court, which resulted in these estimates.

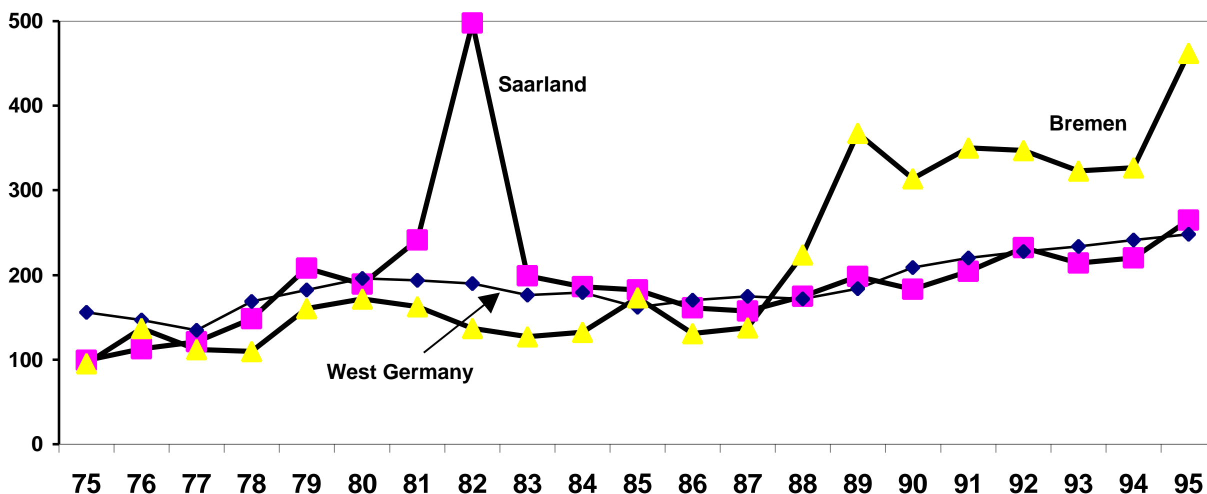
[16] In Germany, there is a specific welfare system, called social assistance, which provides transfer payments to people with insufficient income. The majority of people receiving these welfare payments are the elderly, asylum seekers, and unemployed persons who have no claims on the unemployment insurance system, as well as single parents. In fact, the local governments are responsible for these welfare payments. However, because we consider consolidated budgets of state and local governments, this distinction does not matter. For an investigation of the financing of social assistance expenditures in Germany see Seitz and Kurz (1999).

Figure 4. Welfare Transfer Payments (in DM per capita)



Source: Federal Statistical Office, Wiesbaden and calculations by the author.

Figure 5. Investment Subsidies to Private Firms (in DM per capita).



Source: Federal Statistical Office, Wiesbaden and calculations by the author.

It should also be mentioned that both states used considerable resources, as well as "marketing activities" to document their position of fiscal stress and obtain the support of other states as well as that of trade unions, the local private economy, and others. The states' activities included preparing voluminous reports and even publishing books.

Five arguments were put forward by the Constitutional Court to justify the need for special transfers to overcome the fiscal crisis in the two states: i) both states had violated Article 115 of the German Constitution for 15 consecutive years, ii) the public debt of both states exceeded the expenditure volume by a factor greater than 2, iii) interest payments in both states had increased by more than 300% since 1980, compared to an increase of about 180% in the other West German states, iv) the ratio of interest payments to total revenues exceeded the West German average considerably and, finally v) both states seemed unable to cope with the debt burden on their own and, thus, the federation as a whole was obliged to support them.

In 1993 the federal government made a contract with Saarland and Bremen which promised both annual payments until 1998 to reduce the financial burden of the high debt.[17] Bremen received annual transfers of DM 1.8 billion, whereas Saarland received transfers of DM 1.6 billion. DM. These transfers are quite significant: in Saarland, bailout payments amounted to about 18% of total annual expenditures and in Bremen to about 22.5%. Contrary to the usual practice in the case of bailouts of local governments, on which we report below, neither state has to repay the money it received. Restrictions nonetheless applied. Both states made a commitment to limit (primary) expenditure growth to a maximum of 3% per year; this limit was reduced to 2% in 1997. According to the contract, the payments had to be used for the reduction of public debt, and the savings in interest payments had to be used either for a further reduction of public debt or for additional infrastructure investment. In addition, Bremen and Saarland had to present regular reports on the progress of their fiscal consolidation program to the federal government as well as the other states. Thus both states had and still have to "justify" their fiscal policies. This may have influenced their policies, because every decision was closely monitored. The contract further specified that in 1997 an intensive evaluation of the financial status of both states should be made to bring about a decision about the necessity of support beyond 1998. However, in 1997 and 1998 no decision on this subject could be achieved and the issue could not be settled before spring 1999.[18] The new contract between the federal government and Saarland and Bremen on the prolongation of the bailout over the period 1999 to 2004 introduced two novelties: i) bailout transfers are decreasing over time and ii) further transfers beyond the year 2004 are excluded. The latter restriction was completely lacking in the 1993 contract. On the contrary, the 1993 contract explicitly mentioned the possibility of further transfers after the year 1998. Table 6 reports the bailout transfers to both states in the period from 1994 to 1998.

Table 6. Bailout-Transfers to Bremen and Saarland in mill. DM (in DM per capita)

	1994-1998 per year	1999	2000	2001	2002	2003	2004	Total 1994 – 2004
Saarland	1,600 (1.500)	1,200 (1,230)	1,050 (990)	900 (850)	750 (700)	600 (560)	500 (470)	13,000 (12,210)
Bremen	1,800 (2,650)	1,800 (2,650)	1,600 (2,360)	1,400 (2,060)	1,200 (1,770)	1,000 (1,470)	700 (1,030)	16,700 (24,630)

For comparison: Total expenditures (per capita expenditures) 1998: Saarland: DM 8,300 million (DM 7,800) Bremen: DM 7,900 million (DM 11,650 DM).
Source: Federal Ministry of Finance, Bonn.

b) Results of the Bailout

One of the main objectives of the bailout transfers was the reduction of the debt in both states to about DM 11.5 billion at the end of 1998.[19] This target was missed considerably: At the end

[17] It should be mentioned that both states received special transfers from the federal government to cope with their already high public debt in the period 1987 to 1993. However, these transfers were quite modest: Saarland received about DM 75 million annually, while Bremen received about DM 50 million per year.
[18] A probable reason for this might be the fact that in 1998 there were federal elections and the prime minister of Saarland was one of the leading opponents of Chancellor Kohl.
[19] The debt of both states was about the same in 1992. At the end of 1992 Bremen had a debt of about DM 16.4 billion (DM 24,200 per capita). In Saarland the state debt amounted in 1992 to about DM 13.4 billion (12,590 DM per capita) and the debt of the local government sector in Saarland amounted to about DM 2.5 billion (DM 2,350 per capita). Thus total public debt in the state of Saarland in 1992 amounted to about DM 15.9 billion (DM 14,950 per capita).

of 1998 the per capita debt of Bremen was about DM 16,600 (virtually identical to the 1992 figure) and about DM 16,650 in Saarland (virtually identical to its 1991 figure). Therefore it seems to be important to look more closely at the fiscal performance of both states in the 1994-1998 period when they received such considerable bailout transfers.

As Table 7 shows, both states kept the growth rate of primary expenditures below the average of 7.4 percent of the other West German states. However, a detailed investigation of fiscal data of each individual state reveals that some West German states even kept primary expenditure growth below that of these two states. For example, Hessen increased primary expenditure in the period 1994 to 1998 by an average of only 3.7%. This suggests that neither state ran a very tough or restrictive fiscal policy.

Table 7. Primary Expenditure Growth Rates in %

	Saarland	Bremen	Average of the other West German states
1994	0.1	-0.5	1.5
1995	2.2	2.4	3.0
1996	2.5	1.1	0.9
1997	-1.6	1.6	-0.9
1998	0.9	0.9	2.1
1994 – 1998	4.1	5.7	7.4[1]

1 Behind this average figure a wide spread of expenditure growth rates is hidden, ranging form 3.7% in Hessen to 9.8% in Niedersachsen.
Source: Authors' calculations based on data supplied by the Federal Ministry of Finance, Bonn.

In order to examine the usage of the "consolidation grants" we compare the actual debt performance in the period 1994 to 1998 with hypothetical debt figures. We achieve this by running two simulation experiments using a dynamic budget constraint model for the period 1994 to 1998:

The set-up of our model is very simple: Public debt, B, evolves according to:

(1) $B_t = B_{t-1} + (E_t - R_t)$

with R denoting revenue. Total expenditure, E, is determined by:

(2) $E_t = P_t + r_t B_{t-1}$

with r_t denoting the "effective" interest rate,[20] and P is primary expenditure, which evolves according to:

(3) $P_t = P_{t-1}(1+\pi_t)$

with π_t denoting the growth rate.

Simulation 1 assumes that both states adjusted primary expenditure growth according to the formula:

π_t = Min(3%; growth rate of primary expenditures in the other West German states) for t = 1994, 1995, 1996

(4)

π_t = Min(2%; growth rate of primary expenditures in the other

[20] We calculated an "effective" interest rate by dividing interest payments in period t by the value of debt at the end of period t-1.

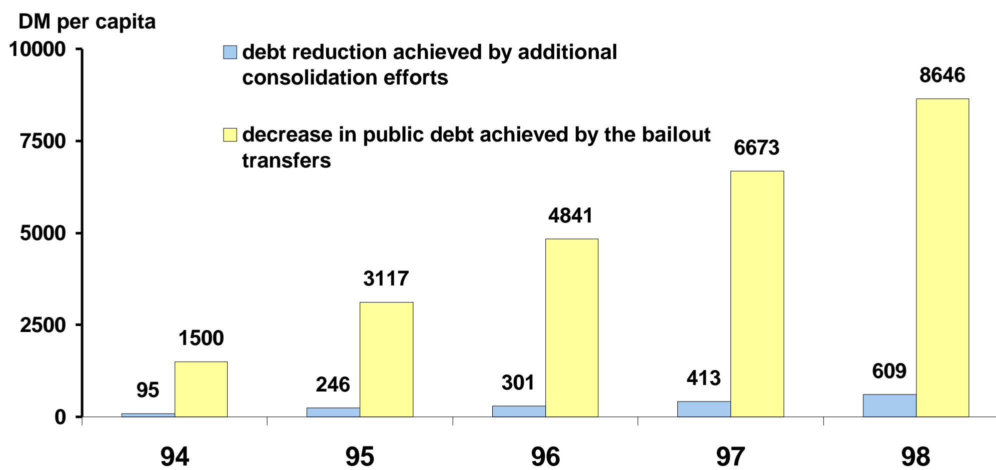
West German states) for t = 1997, 1998.

The scenario defined by equation (4) corresponds to the commitment of both states in the 1993 contract with the federal government. Solving equations (1) to (4) yields an estimate of the stock of public debt, which we denote as B_t^I. The debt series B_t^I indicates the public debt the states Saarland and Bremen would have accumulated if their expenditure policy in the period 1994 to 1998 had obeyed the rules fixed by the consolidation contract with the federal government. If B_t^I exceeds the actual public B_t we can conclude that primary expenditure growth in the two states was more restrictive than requested by the consolidation contract. As we will see below, this has been indeed the case for both states.

In Simulation 2 we examine how much debt both states would have accumulated by the end of 1998 if there had not been a bailout and if both states had followed the same expenditure policy as they actually did in the period 1994 to 1998. We achieve this by setting π_t equal to the actual figure and cutting the revenues, R, by the bailout transfers.[21] From this simulation experiment we get an estimate of a public capital stock, which will be denoted as B_t^{II}. The difference B_t^{II} - B_t is the reduction in public debt achieved by the bailout transfers.

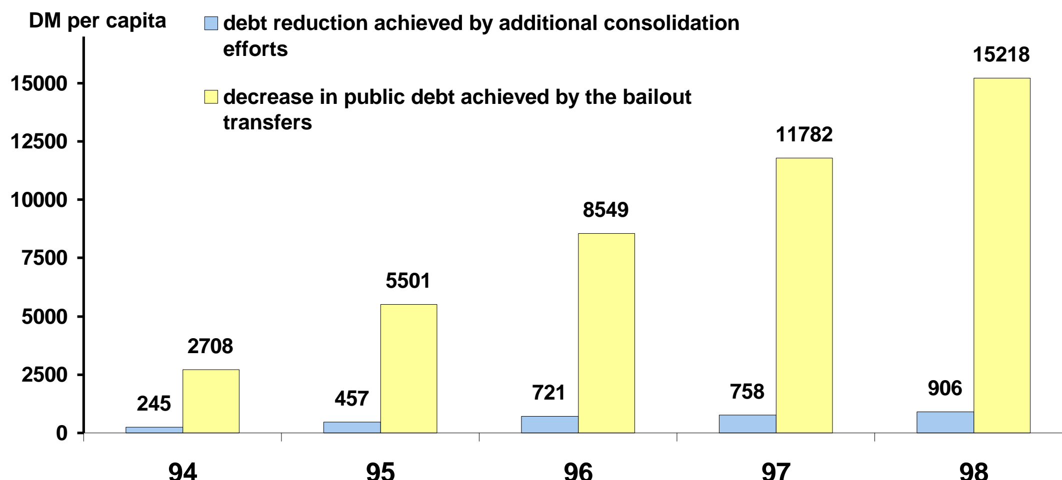
The objectives of the two simulations are obvious: Simulation 1 evaluates the "additional consolidation efforts" of both states achieved by running a more restrictive expenditure policy as requested by the consolidation contract. Simulation 2 estimates the effects of the bailout transfers on public debt. Thus B_t^{II} is the public debt which the bailed-out states would have accumulated if they had not have received bailout transfers. As a matter of course, both simulation experiments rely upon the assumption that the bailout transfers did not significantly affect expenditure behavior. However, one should expect that if the Constitutional Court had denied bailout transfers, both states would have adjusted their fiscal policy dramatically. The pressure on both states to run a very restrictive expenditure policy has been considerably reduced by the transfers.

Figure 6a. Debt Performance of Saarland



[21] In Simulation 1 total revenues, R, are identical to the actual revenue figures.

Figure 6b. Debt Performance of Bremen



Source: see text.

Figure 6 presents the results of our estimates. The series labeled "debt reduction achieved by additional consolidation efforts" depicts the time series B_t^I - B_t in per capita terms, whereas the series "decrease in public debt achieved by the bailout transfers" is the time series B_t^{II} - B_t in per capita terms. As we already mentioned in discussing Table 7 above, both states kept their expenditure growth slightly below the restrictions set out in the consolidation contract—see equation (4)—and thus made more consolidation efforts than the federal government in fact requested them to do. However, the additional consolidation efforts were extremely small. The state of Saarland achieved by additional consolidation efforts a reduction of the per capita debt of about DM 600 and Bremen a reduction of about DM 900. In neither state did these reductions exceed 4% of per capita debt in 1993. Examining the series "decrease in public debt achieved by the bailout transfers" shows that if there had not been a bailout, per capita debt in Saarland would have increased by about DM 8,650 in the period 1994 to 1998, which is an increase of about 54% as compared to 1993. In Bremen, per capita debt would have increased by about DM 15,200 DM until the end of 1998, which corresponds to an increase of about 60% as compared to 1993.[22] During the same period, the other West German states increased their public debt by about 17%, which is dramatically less than the theoretical increase in the two bailed-out states.

Our simulations indicate, however, that bailout transfers to both states were used for debt reduction and not misused to finance additional primary expenditures. It should also be pointed out that, despite these massive transfers, the reduction of the interest payment ratio, defined as interest payments divided by total expenditures, is rather modest. Saarland reduced this ratio from 14.8% in 1993 to 12.8% in 1998, and Bremen from 15.8% in 1993 to about 14.2% in 1998. In the same period, the other West German states reduced the interest payment ratio by about 0.4% despite their increase in public debt. This was due to the significant drop in interest rates in this period.

[22] However, as we already mentioned, one should strongly suspect that both states would have run a quite different fiscal policy in this period if they had not received such generous bailout transfers!

It is interesting to note that virtually all states and the Federal Ministry of Finance did not consider federal support to be a success. However, nevertheless virtually all states and the Federal Ministry of Finance supported its extension in spring 1999. Insiders and political observers note that this consent was due to the fact that Saarland is governed by a SPD-majority government, whereas in Bremen there is a grand coalition of SPD and CDU. Thus the two major parties in Germany were involved in governing one if not both of the states enjoying bailouts.[23]

Using our simple model, set out in equations (1) – (4) above, we can make an estimate of the evolution of the public debt in the two states until 2004. However, we need some assumptions about the growth of total revenue—net of bailout transfers—as well as primary expenditures. We assume that primary expenditures grow annually by 1% in both states and that the interest rate from 1999 to 2004 will be equal to the interest rate in 1997.[24] With respect to revenue growth—net of bailout grants—we assume in an optimistic scenario an annual growth rate of 2.5%, compared to 1.5% in an alternative, pessimistic scenario.[25] Table 8 presents our simulation results that are based upon the scheduled bailout transfers as shown in Table 6. In the pessimistic case, both states will accumulate further debts until 2004, about 12% compared to 1998 in the case of Saarland and about 16% in the case of Bremen. In the optimistic scenario, Saarland will have about the same level of debt in 2004 as in 1998, whereas Bremen will increase the public debt by about 7%. Thus, in the optimistic scenario one should expect that the debt-GDP ratio of both states declines moderately until the year 2004. However, if both States want to stick to their promise to reduce the absolute level of debt, they have to increase their efforts to keep primary expenditure growth below the assumed 1% growth rate, even if revenue growth is favorable. Expenditure cuts are even more unavoidable if revenue growth remains below the assumed growth rate of 2.5% in the optimistic scenario. If revenue growth is closer to the pessimistic scenario, the debt-GDP ratio in both states is expected to increase until the year 2004.

Table 8. Simulation of Changes in Public Debt in Saarland and Bremen 1999-2004 as Compared to Debt in 1998 (in mill. DM)

	Saarland		Bremen	
	Pessimistic	Optimistic	Pessimistic	Optimistic
1999	+2	-69	-43	-105
2000	+119	-100	+86	-106
2001	+360	-95	+399	+2
2002	+730	-55	+906	+222
2003	+1,239	+19	+1,620	+557
2004	+1,844	+74	+2,654	+1,112
Change 1998-2004:				
in %:	+11.8	+0.4%	+ 16.0%	+6.8%
in DM per capita	+ 1,733	+ 70	+ 3,914	+ 1,640

[23] The SPD (Social Democratic Party) and the CDU (Christian Democratic Party) are the two dominant parties in Germany, and no government can be formed at either the state or federal level without the participation of at least one of these two parties. On average, both parties receive about 40% of the votes.

[24] The latter implies that we assume that the historic low interest rates in 1998 will slightly increase to the 1997 level.

[25] Note that we assume a restrictive fiscal policy at the state level in the near future, both in the pessimistic as well as in the optimistic scenario.

Source: See text.

Apart from the transfers from the federal government, the West German states also provided indirect bailout transfers to Saarland and Bremen that were virtually unnoticed by the public. As mentioned in Section 2, the East German states received transfers in the period from 1991 to 1994 from the German Unity Fund, which was almost completely debt-financed. The West German states and the federal government reached an agreement about sharing the financial burden associated with servicing the debt of the German Unity Fund. Because in 1991 Bremen and Saarland had already turned to the Constitutional Court and claimed to be unable to service their portion of the debt of the German Unity Fund, the West German states agreed to cover a considerable part of the payments that the two states would have made otherwise. These payments are a form of hidden bailout to Saarland and Bremen by the other West German states. Table 9 reports the total payments to the German Unity Fund in the period from 1991 to 1997 by all states. Both Saarland and Bremen made per capita contributions that are only about 50% of those of the other West German states. However, one has to take into account that the contributions of the West German states are differentiated according to their financial capacity and thus not all differences can be identified as (indirect) bailout payments. We estimate that about 40% to 50% of the difference between the per capita payments of Saarland and Bremen and the average of the other West German states can be classified as an indirect bailout, in which case Saarland received "transfers" (saved expenditures) of about DM 200 million, and "transfers" of about DM 100 million.

Table 9. Contributions of the West German States to the Financing of the German Unity Fund (in mill. DM).

	Bremen	Saarland	other West German States	total of the West German States
1991	0	0	965	965
1992	0	0	2,462	2,462
1993	58	85	8,517	8,660
1994	103	149	13,003	13,255
1995	24	31	6,573	6,628
1996	26	34	6,788	6,848
1997	28	38	7,783	6,849
1991-1997:				
total, mill. DM	239	337	45,090	45,666
per capita, DM	350	310	730	710

Source: Federal Ministry of Finance.

c) Response to the Bailout by the Market

The ruling of the Constitutional Court signals to the financial market a high chance of bailout of risky borrowers, improving their credit quality. That is exactly what happened in Germany. Recently, leading credit-rating agencies[26] monitored the debt and debt-servicing capacity of state governments. In fact there are indeed minor differences in risk premiums on states'

[26] In fact, some states, such as the East German state Sachsen-Anhalt, requested credit-rating agencies to rate their debt-servicing capacity.

bonds. Insiders observe that Bavaria receives, on average, a five basis point reduction in interest rates compared to the East German state Sachsen-Anhalt. In March 1999, the international rating agency Fitch IBCA (London) rated all German states and reached the conclusion that there are no differences in the default risk of the states. Thus they evaluated all states with the best possible ranking: triple A (AAA).[27] In a detailed press release Fitch IBCA mentioned three arguments for this rating: i) the close federal linkages in German federalism (Politikverflechtung), ii) the principle of federal solidarity (Prinzip der Bündnistreue) set out in the German Constitution and in the 1992 ruling of the Federal Constitutional Court, and iii) the fiscal equalization system (Länderfinanzausgleichssystem) in Germany.[28]

With respect to the close federal linkages, the rating agency claimed that despite the fact that in the German Constitution there are exclusive powers of the federal government and the states, the political reality in Germany is characterized by close interdependence of decision making and interweaving of power between the federal level and the state level. Reference is also made to Article 106 of the German Constitution, which demands fiscal homogeneity and equalization of living conditions. Reference is additionally made to fiscal federalism principles as set forth in Articles 104-107 in the German Constitution, which demands the balance of resources between the two levels of government as well as a balancing of resources between fiscally strong and weak states.

Based upon the ruling of the Constitutional Court in 1992, the rating agency argues that the German constitution enforces upon the federal government and the states a bailout in case of default. Consequently, all states carry the same risk and any state can rely upon support from other states as well as the federal government and, as a matter of course, the federal government can in turn rely upon support from the states in case of fiscal problems. With respect to the fiscal equalization principle, the rating agency points out that the tax sharing and transfer system has an equalization effect across all states and claims that this establishes a “preventive framework designed to prevent the states from falling into financial difficulties.”[29]

One should expect that both the decision of the Constitutional Court and the response of the markets, as documented in the Fitch IBCA report, will have a long-run and permanent effect upon fiscal federalism in Germany. Other candidates for a bailout are already standing in line, most notably Berlin. In 1991 Berlin had a per capita debt of about DM 4,000 (in comparison to DM 12,400 in Hamburg) which increased dramatically to about DM 17,000 per capita in 1998 (in comparison to DM 16,500 in Hamburg).

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[27] It would be more interesting to compare credit ratings before and after the ruling of the Constitutional Court in 1992. However, we are not aware of any credit rating of German states before 1992.

[28] The following exposition rests upon a press release of Fitch IBCA, London, dated March 25, 1999.

[29] While the former point is undoubtedly correct, the latter conclusion does not correspond to the rules of the game in the fiscal equalization system. To begin with, the fiscal equalization system does not take expenditures or debt and deficits into account. In addition, the specific grants paid to Saarland and Bremen as described above are not part of the fiscal equalization system and one should expect that every state government that would make reference to the solidarity principle and request financial support—or even the federal government—would probably have to turn to the Constitutional Court again.

4. Bailouts of Local Governments in Germany

Having examined the two important bailout cases at the state level, we briefly review bailouts of local governments. Table 10 reports the per capita debts of the states, separated by state and local government level, for the non-city-states in West and East Germany in 1998. Two important conclusions can be drawn. First, per capita debts of the states are considerably higher than per capita debts of the local governments. Second, both local and state governments in East Germany have per capita debts very close to the West German average, despite the short history of the East German states.[30]

Table 10. Per capita debt of state and local governments in Germany 1998 in DM

	Total per capita debt in DM	
	State	Local governments
West German non-city-states		
Baden-Württemberg	5,290	1,430
Bayern	3,010	1,980
Hessen	6,920	2,790
Niedersachsen	8,270	2,170
Nordrhein-Westfalen	8,000	2,760
Rheinland-Pfalz	8,440	1,990
Saarland	11,530	1,980
Schleswig-Holstein	10,480	1,560
East German non-city-states		
Brandenburg	8,910	1,360
Mecklenburg-Vorpommern	7,190	2,110
Sachsen	4,230	2,390
Sachsen-Anhalt	8,520	2,210
Thüringen	7,240	2,350

Source: Federal Statistical Office, Wiesbaden.

The influential ruling of the Federal Constitutional Court in 1992 never mentioned local governments. From the constitutional point of view the communes are part of the states and the states even have the right to dissolve communes. During the 1960s and 1970s significant organizational reforms reduced the number of municipalities in West Germany from about 20,000 to about 10,000. All states in East Germany also started such reforms. A further difference between states and communes is the strong control states have over local governments, whereas the federal government has virtually no command over the states. State governments review and authorize the borrowing of local governments. However, the states have to rely on the completeness and seriousness of all information provided and they would hardly be able to identify cheating or suppression of relevant information. It happens quite frequently that the states refuse local governments' borrowing. A typical reason for such a refusal arises if the states believe that a commune will not be able to service its debt in the future.

[30] See Seitz (1999) for a detailed investigation of fiscal policy and public debts in East German states.

Table 11. Bailout Funds in German States for Local Governments

	Volume of money provided by special fu for grants to communes in "fiscal hardshi
Baden-Württemberg	average annual volume of 2 – 5 millior
Brandenburg	1998: about 30 mill
Bayern	1998: about 16 Mill
Mecklenburg-Vorpommern	1998: about 15 Mill
Hessen	1998: about 50 Mill
Rheinland-Pfalz	1998: about 110 Mill
Sachsen-Anhalt	1997: about 80 Mill
Sachsen	1997: about 14 Mill
Thüringen	1997: about 30 Mill

Note: The other non-city states (Nordrhein-Westfalen, Niedersachsen, Schleswig-Holstein) did not present detailed reports. However, further investigations revealed that these states too have similar funds.
Source: Bericht des Arbeitskreises Kommunalfinanzen der States (Report of the regular workshop on local public finance of the states), dated August 12, 1998.

Despite rather strict state control it happens occasionally that communes are close to default, and these cases are much more frequent in East Germany. All states claim to follow the principle that no commune will be bailed out. In reality, however, every state practices some form of bailouts. Recently a group of experts from the ministries of finance of the German states discussed the subject of financial support of local governments in default in order to achieve some consent among the state governments about how to cope with this problem. The report prepared by this group revealed that all non-city states have special funds to support communes in default. However, as Table 11 reveals, the amount of money involved is rather small, never exceeding DM 30 per capita. In addition, the usual case seems to be that the bailout is a loan, which is required to be repaid. All states ask the communes to present consolidation schedules and report regularly on the consolidation's progress. Most states provide the possibility that the loan does not have to be repaid if local governments stick to the consolidation program to which they made a commitment when they apply for the transfers. Some states, such as the East German state Sachsen, finance these funds by reducing regular grants to all local governments in their territory, which means that the burden is distributed across all communes.

A crucial point that arises in bailouts of local governments is associated with the monitoring of local government borrowing by the states, which we have mentioned above: in the event of severe financial trouble, communes turn to the state government and ask for financial support. This request is very often backed by the argument that the initial borrowing had been monitored, controlled and approved by the state government. Thus, if the local government cannot service the debt, local governments claim that the state is at least partially responsible for the default. To the best of our knowledge, up to the present, no local government has turned to a State Constitutional Court on this subject in order to get a final decision. The usual practice seems to be that the issue is settled in negotiations and states provide bailout transfers.

Finally, we examine in greater detail local government bailouts in East Germany in the period immediately after German unification. During this period the federal system had to be

implemented at both the state and local level, and a lack of experience made it very difficult to handle financial issues without tensions in East Germany. Thus, for example, in the East German state of Brandenburg, which has a population of about 2.5 million, the communes received about DM 500 million from a special "bailout fund" in 1991 and 1992, which was about 5% of total revenues of local governments. These payments declined to about DM 40 million in 1995 (see Table 12). In addition, Table 12 reports the repayments of the communes, which on average amount to about 25% of the funds received. Similar evidence can also be reported for the other East German states.

Table 12. Bailout Payments and Repayments in the East German State Brandenburg (in mill. DM).

	Bailout payments	Repayments
1991	Approx. 500	Approx. 0
1992	485	105
1993	72	96
1994	140	14
1995	40	8
1996	41	8
1997	38	14
1998	104	11

Source: Ministry of Finance of Brandenburg.

This evidence from East Germany suggests that in transitional periods, such as periods after the introduction of a federal system or in periods after fundamental changes in the federal system, significant bailouts might be very hard, if not impossible, to avoid. Lack of experience both by communes (adjusting expenditures to available resources) as well as by states (adjusting grants to the financial needs of subnational governments) might be identified as the major reason. In fact, the German federal government had a similar experience: in the period 1991 to 1994 the amount of money scheduled to be provided to the East German States via the German Unity Fund had to be increased several times in order to meet the financial requirements of the newly implemented states in the East of Germany.

5. Conclusions

This paper has examined bailouts of subnational governments in Germany. The focus has been on the Saarland and Bremen case, the two smallest (West) German states that received and still receive considerable bailout transfers from the federal government. We argued that the federal government was in fact forced by the Constitutional Court to bail out these two states. However, taking political reality in Germany into account, one should suspect that a bailout would have also occurred—probably to a much smaller extent—if both states had not appealed to the court. We also documented the strong impact the ruling of the Constitutional Court had on enforcing the federal government to provide bailout transfers to the two states and we argued that the ruling of the Court created strong expectations in financial markets that German states have a very high chance of receiving a bailout from the federation as a whole.

In a study of the fiscal crisis of Philadelphia, Inman (1995) mentions four important factors that can push a city or any subnational government to severe financial problems:

1) unfavorable economic developments in the local economy because of temporary or structural problems,
2) unfavorable demographics (such as an inflow of poor families or an outflow of middle-income and rich families),
3) unfavorable federal public policies (reduction of aid to state or local governments or the introduction of new legally mandated expenditures, such as increasing standards or introducing new laws that create additional expenditure obligations) and
4) local politics.

The arguments put forward in our discussion of the Saarland and Bremen case provided plenty of evidence that factors 1, 2 and 4 contributed significantly to the fiscal crisis in both states. With respect to the third factor, unfavorable federal public policies, we could not obtain any evidence that the federal government introduced policy changes that specifically affected both states. However, one has to mention that due to the high unemployment in both states federal mandated social assistance expenditures were and still are far above the West German average; thus factor 3 might additionally have been of some importance in the Bremen and Saarland case.

The ruling of the Federal Constitutional Court has established firm expectations of bailouts of any fiscal unit in the Federal Republic. This has destroyed any market-induced discipline of borrowers and creditors. This shortcoming can only be overcome by imposing hard constitutional restrictions on borrowing by all tiers of government. The current German Constitution does not currently impose such hard restrictions on borrowing because there is always the "emergency exit" of declaring the general economic equilibrium to be disturbed. In addition, the Saarland and Bremen case revealed that nobody really cared at the state level when the constitutional mandate of adhering to the "golden rule" was violated for more than 15 consecutive years. Nor did the Maastricht guidelines of a 3% deficit quota and 60% debt-GDP ratio solve this problem, especially in a federal state such as Germany. The distribution of the Maastricht guidelines among the different tiers of government as well as among the individual states and local governments is still an unresolved issue.

An inspection of expenditure data of the two bailed-out states revealed that both states made tremendous (investment) transfers to private companies. This suggests that a considerable portion of the bailout transfers are in fact "delayed" subsidies by the federal government, and thus the taxpayer, to private firms. In addition, we have shown that both states, especially Bremen, had to make far above average welfare transfer payments, which also contributed to the accumulation of public debt. Thus welfare payments, designed to be covered by the region, were partly deficit financed and with a proper time lag financed by the federal government and thus taxpayers all over the nation.

An important fact seems to be that both states are small. Bremen has a population of about 680,000 and Saarland about 1,060,000. Small size is important for several reasons:

(1) To begin with, small regions usually have an industry structure that is less diverse than that of large regions. If demand and supply shocks are not perfectly correlated across industries, in small regions there is a smaller chance that, if an industry with a significant employment share is hit by negative demand and/or supply shocks, there are other industries of significant size that can absorb these shocks. Both bailed-out states were dominated in 1970 by large old industry sectors: shipbuilding in Bremen, and the iron and steel industry, as well as coal mining, in Saarland. All sectors mentioned were

immediately and severely hit by the deep recession following the first oil price shock, and none of these industries regained employment during or after those years.

(2) A second important issue associated with small size is that policymakers in small states are much closer (in terms of distance) to the public and to everyday life problems than in large regions. In addition, they have to care and are involved in "solving" small problems. Thus the closing of a company with 100 jobs in Saarland or Bremen, with a population of less than 1 million, is much more significant than the closing of an identical company in the state of Nordrhein-Westfalen with a population of 18 million.

(3) A third reason is related to the cost of a bailout. Supporting small states like Saarland and Bremen is "cheap." If similar transfers had been made to Nordrhein-Westfalen, the federal government would have had to make annual payments of about DM 27 billion, which is about 6% of federal expenditure. Such tremendous transfers could never have been borne by the federal government, and thus all other states in Germany would have had to make significant contributions to finance these transfers. Thus, big states simply cannot be bailed out to the same extent as small states.

(4) A fourth reason, that has been put forward by Homburg (1993), is specifically German. All states have votes in the Bundesrat, and small states are over-represented in terms of ballots per one million inhabitants. Both Bremen (population: 680,000) and Saarland (population: 1,080,000) have 3 votes in the Bundesrat, while Nordrhein-Westfalen, with a population of 17 million, has only 6 votes. Because the federal government can pass most laws only with the consent of the Bundesrat, it is much cheaper to "buy" the votes of two small states than the votes of population-rich Nordrhein-Westfalen.

The facts mentioned above provide arguments that support the conclusion that smaller states have a higher chance of receiving a bailout and can therefore free-ride on the federation as a whole. However, our conclusion that smallness seems to be important is considerably influenced by the German experience. We mentioned in the introduction the conflicting conclusion of Wildasin (1997), who shows in a theoretical model that larger subnational governments have a higher chance of receiving a bailout. Indeed, several arguments can also be put forward to support the notion "too big to fail." Thus, one should expect that a large region with a considerable share of the population and thus voting power can put more pressure on central governments to provide a bailout. In addition, high public debt of large subnational governments might have a nonmarginal impact on interest rates and risk premium, and the externalities on the other fiscal entities of the nation might provide an incentive to provide a bailout. Landon and Smith (1999) present some evidence for Canada that suggests that there are significant inter-jurisdictional government debt spillover effects on creditworthiness and interest rates.

Apart from the case of the two German states, we also briefly examined bailouts of local governments by state governments. The evidence presented suggests that minor bailouts occur throughout all German states. However, local governments are more closely monitored and controlled in their borrowing behavior and thus the state governments can usually intervene before local governments amass debt that they are unable to serve. The evidence presented on East Germany suggests that introducing a fiscal federalism system, or achieving

major reforms of a fiscal federalism system, might be associated with transitional periods in which bailouts might occur as a result of planning errors or lack of experience.

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