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GERMAN PUBLIC FINANCES: RECENT EXPERIENCES AND FUTURE CHALLENGES

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German Public Finances:

Recent Experiences and Future Challenges

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Abstract

German public finances are currently subject to considerable changes in the macro-economic environment and this is probably only the beginning of more far-reaching developments in the future. Like many other European countries, Germany, on the one hand, faces the fiscal problems emerging from an ageing population, which will put upward pressure on social security expenditures. On the other hand, the public will reject an increase of the already high tax burden and an increasingly globalized economy and further European integration may put an additional limit on the government's capability to raise additional revenues. Finally, German governments will have to show whether they are able to meet these conflicting challenges in the future within the fiscal framework set by the Maastricht Treaty and the Stability and Growth Pact. Therefore, continued debt accumulation does not seem to be a viable option to circumvent the ageing problem and the limit on taxation. Thus we see three challenges for German public finances in the future.

In this paper, we develop the recent history of German fiscal policy as a background to judging how fit Germany is to meet these challenges. Our main focus is on the government's fiscal strategies and the gradual erosion of the institutions that secured Germany's fiscal stability in the past.

Germany left the Golden Sixties with very sound public finances, reflecting the cautious and conservative fiscal management of the successive governments until 1969. This rosy picture changed dramatically over the next ten years. Government spending first increased when the Federal Government started to use fiscal policy for demand management. The result was a huge expansion in public sector wages and purchases, and even more so in transfer programs. These expansions proved to be irreversible later on. The role of the pension system in cushioning cyclical fluctuations and siphoning off unemployed, which became important from the early 1970s onwards, was never reversed. The Kohl government, which came to power in 1981, addressed the expansion of public sector deficits and debts and achieved at least a temporary stabilization of the debt ratio. However, the same government also started a practice of circumventing the ordinary budget process to finance new government programs. Particularly after re-unification, it used a variety of off-budget funds and decision-making channels outside the budget process to finance the financial consequences of German unification. An important consequence of these practices was the considerable weakening of the institutional position of Germany's finance minister in the budget process. The government no longer found the political will to address the need for cutting back public expenditures.

We retrace the major lines of these developments. Our review shows that, following the initial expansion of the state in the late 1960s and early 1970s, Germany's fiscal institutions gradually deteriorated. Quite apart from the financial aspects of a reform of German public finances in the future, of which the recent Social Security reform is just the beginning, a major challenge for the future is to strengthen the institutional arrangements. There is as yet not much reason to believe that policy-makers have understood this challenge.

I. Introduction

German public finances are currently subject to considerable changes in the macro-economic environment and this is probably only the beginning of more far-reaching developments in the future. Like many other European countries, Germany, on the one hand, faces the fiscal problems emerging from an ageing population, which will put upward pressure on social security expenditures. Public finances in some European countries are better prepared to face this challenge than others. The country's demographic structure and current debt level puts Germany in an intermediate position, where the additional demand on public monies will be considerable compared to the current situation. On the other hand, the public will reject an increase of the already high tax burden and an increasingly globalized economy and further European integration may put an additional limit on the government's capability to raise additional revenues. Although tax competition is not yet a serious encroachment on the tax generating capacity, the mobility of capital may be felt even more in the future, when not only equity investment but also firms become more indifferent about their investment sites in an increasingly homogenous region and the mobility of labor, which is currently as very low levels, raises. Finally, German governments will have to show whether they are able to meet these conflicting challenges in the future within the fiscal framework set by the Maastricht Treaty and the Stability and Growth Pact. Even though it is not clear yet, whether European governments will always be willing to stick to the 'letter of the law', international organizations, peer governments in Europe and capital market participants will be more sensitive to any gross violation of these statutes and put additional pressure on governments to correct fiscal policy, particularly if they emerge from long-term misalignments. Therefore, continued debt accumulation does not seem to be a viable option to circumvent the ageing problem and the limit on taxation.

Thus we see three challenges for German public finances in the future. In this paper, we develop the recent history of German fiscal policy as a background to judging how fit Germany is to meet these challenges. Our main focus is on the government's fiscal strategies and the gradual erosion of the institutions that secured Germany's fiscal stability in the past.

Germany left the Golden Sixties with very sound public finances, reflecting the cautious and conservative fiscal management of the successive governments until 1969. General government expenditures stood at 35 percent of GDP in the mid-60s, and general government debt remained virtually constant at 17 percent of GDP throughout the decade. The government was still a net recipient of interest payments during that decade, and thus it was able to achieve primary surpluses despite the incipient increase in the expenditure rate in the second half of the 1960s. This rosy picture changed dramatically over the next ten years. Government spending first increased when the Federal Government started to use fiscal policy for demand managements. The Brandt administration, which took power in 1969 on the slogan "Mehr Demokratie wagen" (dare more democracy), equated more democracy with a

larger public sector. The result was a huge expansion in public sector wages and purchases, and even more so in transfer programs. These expansions proved to be irreversible later on. The Kohl government, which came to power in 1981, addressed the expansion of public sector deficits and debts and achieved at least a temporary stabilization of the debt ratio. However, the same government also started a practice of circumventing the ordinary budget process to finance new government programs, thus hiding the financial consequences of its actions from public criticism and the control of the finance ministry. In the 1980s, this tendency manifested itself mainly in the abuse of Germany's Social Security system to address problems of labor market policy.

In the early 1990s, the Kohl government used a variety of off-budget funds to finance the financial consequences of German unification. An important consequence of these practices was the considerable weakening of the institutional position of Germany's finance minister in the budget process. The government no longer found the political will to address the need for cutting back public expenditures. A visible indication of the country's fiscal troubles is the fact that the Kohl government managed to meet the deficit criterion for entry to EMU only by taking recourse to some one-time accounting changes (see von Hagen and Strauch 1999).

Below, we retrace the major lines of these developments. Our review shows that, following the initial expansion of the state in the late 1960s and early 1970s, Germany's fiscal institutions gradually deteriorated. Quite apart from the financial aspects of a reform of German public finances in the future, of which the recent Social Security reform is just the beginning, a major challenge for the future is to strengthen the institutional arrangements. There is as yet not much reason to believe that the new government has understood this challenge.

I.1. Ageing Population

Graph 1 describes the main demographic trends in Germany. As in other industrialized countries, Germany's population will shrink over the coming decades. Population size will fall from close to 82 million in 2000 to 75 million in 2030 and further to 64 million in 2050.[1] At the same time, the number of elderly people above the age of 65 as compared to younger people between 20 and 64 (the elderly coefficient (65)) will increase from 27 percent in 2000 to almost 50 percent in 2030 and 56 percent in 2050. Looking at the share of elderly above 60, which is the current average retirement age, the ageing of the society looks even more dramatic. Here the old-age ratio will increase from 43 percent in 2000 to almost 75 percent in 2030 and somewhat more than 80 percent in 2050. This shift is the result of low fertility rates and higher life expectancy. Individual life expectancy is projected to rise by 1.5 years until 2030.

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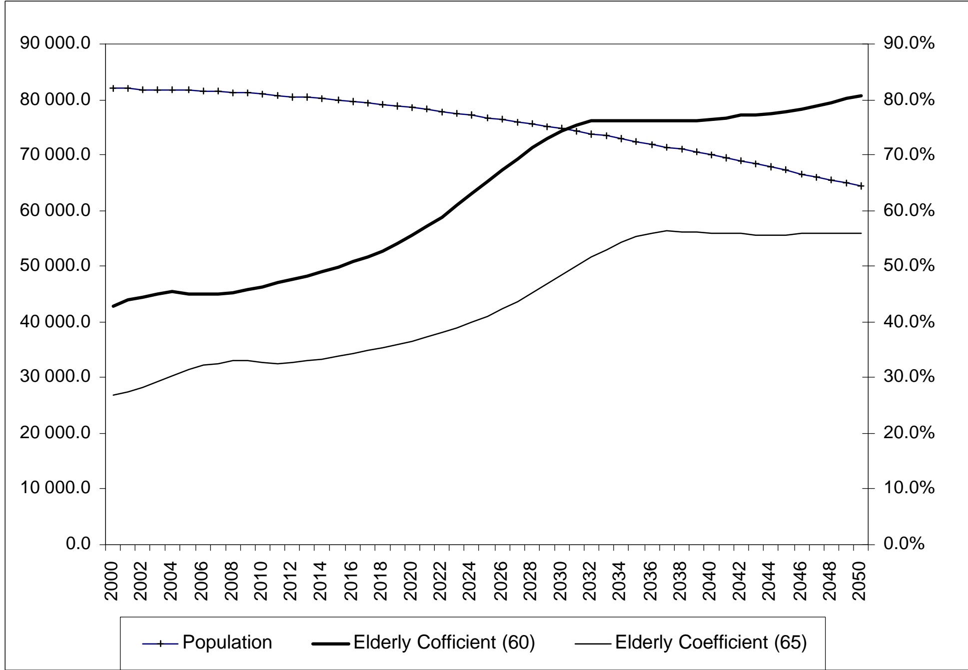
[1] Figures are taken from of the ninth coordinated official population projection, which is published by the Federal Statistical Office. This scenario assumes net immigration of 100000 persons per year. With a yearly net immigration of 200000 people, the population size would be close to 70 million in 2050.

Graph 1: Demographic Development until 2050



Ageing will affect above all three social security schemes - pensions, health and social care - due to the direct link to demographic changes. This is most obvious for pensions. Since the working population will have to finance pension payments for a larger share of the society, the recently reformed pension law foresees that contribution rates will have to increase by more than three percentage points until 2030. In addition, the reform also strengthens private fully-funded pension schemes, as supplements to the public pay-as-you-go system. These additional savings required from households as well as the general taxes, such as the recently installed environmental tax, needed to cover pension payments, are not included in this amount. However, a comparative study on future pension liabilities finds that pension expenditures will grow by 4.3 percentage points of GDP. If this estimate is correct, the planned rate increase will not be sufficient to cover the additional expenditure. This is a middle position compared to other European countries where the expected additional future burden ranges from zero in the United Kingdom to 8.3 percent in Spain (European Commission 2000a). In the pension reform, the government introduces a progressive curtailment of the pension payments, which will however not fall below 67% of the net earning for the 'standard pension'. Important options to cut expenditures, through a higher standard pension age, larger discounts for early retirement or a general shift from wage to price indexation, have not been considered. Given the strong political resistance that, for example, a temporary two-year adoption of price indexation has met recently, it remains unclear whether this or future governments will recur to these policy instruments to lower pension expenditures.

The relation of ageing to social care and to health expenditures is not as straight forward. Although health expenditures per person are by far higher for elderly, it is unclear whether this relates to mortality

or to morbidity[2]. Therefore an increasing life expectancy probably does not have the same effect on this social security scheme. Long-term projections of health care expenditures in fact find that rising expenditures will largely result from technological progress, while ageing plays only a minor role in comparison. Breyer and Ulrich (2000) estimate that contribution rates will increase by between two and three percentage points until 2040, i.e. contributions will grow from currently 13.6 to about 16 percent. Until now, most reforms in the health care sector have been piecemeal no conclusive concept dealing with this problem has been presented.[3] By comparison, technological progress will more forcefully add the upward pressure producing a contribution rate of 23 percent.

Estimates for the social care insurance system indicate the contribution rates will rise from currently 1.7 percent to 2.5 or 3 percent until 2030. In 2040 they are projected to stay between 2.8 and 3.4 percent, depending on the share of services or transfers provided by the scheme. (Schmaehl 1999) However, these simulations assume a dynamic evolution of costs per patient in line with the average income of members. Although this may be considered a plausible assumption, this dynamism is neither stipulated by law, nor does it correspond to actual developments during the short history of the scheme. To sum up, although these estimates are subject to large error bands and necessarily rest on assumptions which may be questioned, they certainly indicate that the ageing of the German population will produce a significant spending pressure.

Combining the various projections, one could assume that total contribution rates will have to rise between five and eight percent until 2030 without any policy reform. The total contribution rate then will come close to 50 percent, given that unemployment insurance contributions will be held constant.

I.2. Taxation

Comparing the German tax system with other industrialized countries we see that within Europe Germany maintains again a medium position, with an overall tax burden higher than Portugal, Spain and particularly Ireland, but also much lower than the Nordic countries. However, compared to the US, where now a tax reduction is debated, the tax burden is considerably higher. Whereas overall current revenues amount to 31 percent of GDP in the US, it stays at 44.5 percent in Germany.

A recent comparative study (Boeri et al. 2000) analyzed the attitude of Germans with regard to the size of the welfare state and the current tax burden. It finds that the vast majority of citizens either want to maintain the current situation (59.1%) or reduce transfers and taxes (26.9%). Only a small minority of

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[2] According to the morbidity argument, health care costs for the elderly are strongly concentrated in the last 6 months of their lives and, therefore, not strongly dependent on age.

[3] Recently the Council of Economic Advisors of the Ministry of Health presented an encompassing report on the German health care system. However, the main concern of this report is the relatively poor quality of services in the German system, despite being one of the most expensive among industrialized countries. It does not focus particularly on the ageing problem. (see SVR Gesundheit 2001)

14 percent would favor a further expansion of taxes and transfers. The further analysis of respondents revealed that the individual judgment is largely related to personal characteristics. It is generally the older people with lower income, the unemployed, and union members who favor larger governments, while younger and wealthier people, if they are in work and less dependent on public transfers, are more inclined to demand a smaller state. An implication of these findings is that future governments may find additional support for raising public revenues in the future, when a larger share of the population becomes more pension dependent. But the current distribution of preferences still would have to shift substantially to affect the median voter. Moreover, raising public revenues should also lead to mounting political conflict about the role of the state or more migration. According to the survey particularly younger and wealthier employees or self-employed, which are typically more mobile than poorer sections of the population, would be inclined to either confront the governments policy or, if it materializes, to leave the country.

Table 1. Tax Structure and Rates in Industrialised Countries in 1999

Country	Total current revenues (percent of GDP)	Maximum Personal Income Tax Rates	Corporate Income Tax Rates
Austria	47.7	50	34
Belgium	47.2	55	41
Denmark	55.1	58	34
Finland	48.9	56	28
France	50.4	54	41
Germany	44.5	53	57
Greece	42.1	45	40-35
Ireland	33.6	46	32/10
Italy	46.4	51	41/31
Luxembourg	47.3	47	37
Netherlands	43.7	60	35
Portugal	39.3	40	37
Spain	38.5	56	35
Sweden	57.9	55	28
United Kingdom	40.4	40	31
Switzerland	-	26	22
United States	31.0	40	36

Source: Baker and McKenzie (1999) Survey of the Effective Tax Burden in the European Union; The Global Competitivness Report 2000

Moreover, there is now ample empirical evidence that business is sensitive to changes in tax rates even in the short run. For multinational firms, higher tax rates induce increased use of 'strategic tax planning', i.e. tax avoidance practices and affect decisions on the allocation of foreign investment (see Hines 1999) Higher labor taxation, i.e. payroll taxes and social security contributions, in addition reduces business investment activity (Alesina et al. 1999). Future initiatives to raise public receipts

through instruments of direct taxation, thus, may run the risk of slowing investment activity and ultimately growth.

To assess the German position with regard to personal and corporate income taxation, Table 1 presents the maximum personal income tax rates as well as the effective corporate income tax rates for industrialized countries. In 1999, Germany had rather high tax rates in both areas in comparison to other countries. The top marginal personal income tax rate was 53 percent and the corporate income tax rate 57 percent.[4] This situation has recently changed due to a tax reform approved under the current government. The reform reduces the top marginal personal income tax rate to 51 percent in 2000, to 48.5 percent in 2001 and subsequently to 48.5 percent in 2003 and 42 percent in 2005. The statutory tax rate for corporate income taxation has been reduced from 40 percent for retained earnings and 30 percent for dividends to generally 25 percent in 2001. This measure is partly financed by a broadening of the tax base. (see Finanzbericht 2000, 2001) These tax changes are an attempt of the current government to enhance the competitiveness of the German economy and reduce the distortionary effect high income taxation.

Unfortunately, Germany is not the only country currently adopting such measures. The general direction of reform is broadly in line with similar reforms in other European countries. As a result, the current and anticipated further reforms may not do much to change Germany's relative position in international taxation and, therefore, it is unclear that they will succeed strongly in attracting tax payers from abroad as the government hopes. At the same time, it is unlikely that the internaitonal trend towards lower taxes will end soon. This puts an important constraint on future policies to increase taxes again in Germany. Such policies would also probably meet considerably domestic opposition. Under these circumstances, any future increase in tax revenues hinges on the development of the taxable base. The current government assumes that the short-term reduction of revenues will soon be canceled out by the positive supply side effect and, as a consequence, higher growth rate. But the insights gained through simulations with a macro-economic model for European countries indicate that this expectation may be overoptimistic, since tax reductions have positive growth effects, but they do not suffice to be 'self-financing' (European Commission 2000). Alternatively, German governments could hope to be among the winners in the competition game, attracting foreign investment and labor from other countries to be able to expand taxes in the long-run. Whether they will succeed will to a considerable extent also depend on developments in other policy areas, in particular the future evolution of labor market institutions. Given the governments' relatively weak record in labor market liberalization during recent decades, this seems to be a rather shaky foundation of future fiscal planning.

If German governments, however, will not be able to either reduce the significant additional spending to be expected from the ageing of the population, as indicated in the previous sub-section, or to raise a

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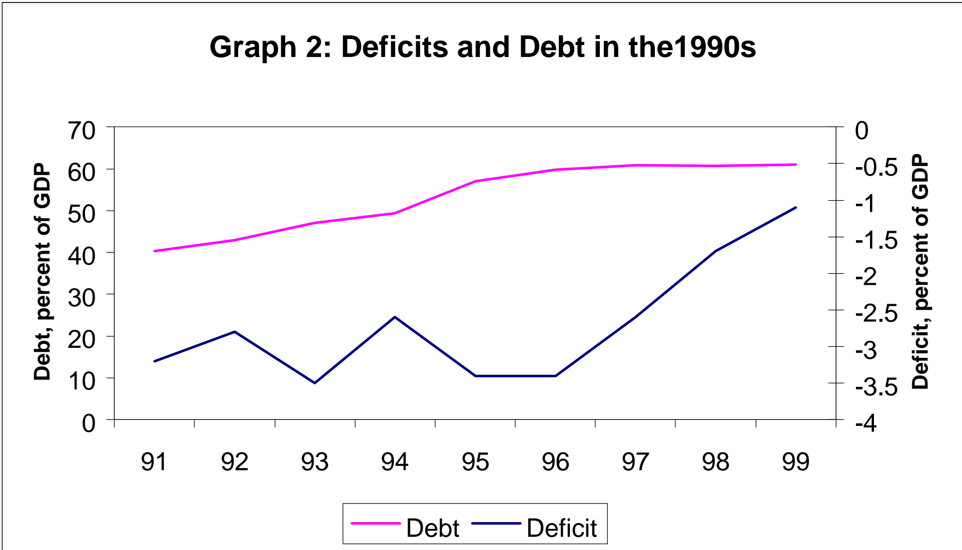
[4] This figure comprises the statutory corporate income tax rate as well as surcharges, local business taxes etc.

corresponding amount of additional revenues, as argued in this sub-section, they necessarily will run into conflict with the requirements set forth in the Stability and Growth Pact and the Maastricht Treaty.

I.3. Fiscal Policy Under European Strictures

Shortly after the completion of the formal reunification process, the European Integration process leading to Stage III of the European Monetary Union became a prevailing issue for fiscal policy making. The introduction of a set of formal convergence criteria into the Maastricht Treaty should lead to a convergence of European economies before they would create a single currency area. The fiscal criteria in particular were written into the Treaty upon the insistence of the German government. It is an irony of the Maastricht process that the very country that insisted on the need for entry criteria constraining fiscal policy proved unable to meet them except by resorting to budgetary accounting gimmicks in the last minute. More importantly, however, this episode presents a 'test case' for the capacity of German governments to cope with spending pressures, on the one hand, and to stick to a fiscal rule restraining the budget balance, on the other hand.



The Kohl government proved unable to implement a clear strategy to cope with this challenge. For the first six years of the 1990s, Germany's public sector deficit hovered around three percent, often violating the three-percent limit of the Maastricht Treaty. The government had to resort to last-minute measures in 1996 and 1997 to meet the deficit criterion for EMU entry, and this included changes in the accounting rules (see von Hagen and Strauch, 1999, for details.) At the same time, the debt level kept creeping upwards during the 1990s with a visible jump in the middle of the decade due to the inclusion of the liabilities of off-budget entities in the official figures. During the initial phase, when the reunification process was sparked off, political opportunism was the driving forces behind this failure. Budgeting institutions were weakened under the Kohl government, undermining the orderly functioning of budgeting and fiscal planning.

II. Historical Evolution and Causes of Public Debt and Deficits

While the previous section provided a picture of the future potential problems arising for German public finances, the following part will look into the past and trace the evolution of public deficits and debt from the 1960s onwards in order to detect the causes of unsustainable fiscal situations. Table 2 illustrates the fiscal picture of Germany in the 1960s. It is characterized by actual and primary surpluses, low levels of debt and, by European standards, a relatively moderate government spending rate – lower than that of Scandinavian countries, though higher than that of Britain, for example.[5] On the revenue side, social security contributions stood at 10 percent of GDP, roughly the same as direct taxes.

Table 2: Deficits and Debt in Germany, 1960-2000

Year	1960	1965	1970	1975	1980	1985	1990	1995	2000
Deficit	*3.0*	*-0.6*	*0.2*	*-5.5*	*-2.8*	*-1.1*	*-2.0*	*-3.2*	*-1.2*
Primary Deficit	*1.8*	*-1.9*	*-1.1*	*-6.2*	*-1.6*	*1.1*	*-0.1*	*-0.1*	*1.8*
Debt	*17.2*	*16.8*	*17.5*	*23.1*	*30.2*	*41.6*	*42.0*	*59.1*	*63.5*
Expenditures	*31.2*	*35.3*	*37.2*	*47.1*	*46.5*	*45.6*	*43.8*	*46.3*	*45.1*
Transfers and Subsidies	15.6	16.5	17.6	23.0	21.1	21.0	21.5	22.0	22.5
(Social Security Benefits)	12.6	13.0	13.0	17.2	16.6	16.0	15.2	18.1	18.7
Wage Compensation	6.6	7.5	8.5	11.1	10.7	10.3	9.5	9.0	8.2
Purchases	6.6	7.5	7.0	9.1	9.2	9.4	8.5	10.8	10.6
Investment	3.2	4.5	4.5	3.8	3.5	2.3	2.3	2.3	1.8
Interest Payments	-1.2	-1.3	-1.3	-0.7	1.2	2.2	1.9	3.1	3.0
Revenues	*34.2*	*34.7*	*37.4*	*41.6*	*43.7*	*44.5*	*41.8*	*43.1*	*43.9*
Direct Taxes	9.0	9.7	10.5	11.6	12.3	12.2	10.7	11.2	11.8
Social Security Contributions	10.0	10.3	12.2	15.8	16.4	17.0	16.3	18.8	18.5
Indirect Taxes	13.4	13.2	12.8	12.3	12.8	12.3	12.1	11.4	12.3

Source: OECD Economic Outlook No. 68 dataset

Three economic factors contributed to the stability of the country's public finances in the two decades after World War II. First, public finances had benefited from the 'economic miracle' leading to buoyant revenues despite some drastic tax cuts. Second, a legal and the fiscal instruments for a business-cycle oriented cyclical management of public finances did not yet exist and there were no firm legal foundations for an anti-cyclical policy stance. (Kitterer, 1999). Thus, fiscal policy was largely passive

[5] Notice that social welfare expenditures in Germany are largely net payments, i.e. they are disbursed free of tax. This contrasts with many others, as for example the Scandinavian countries, where benefits are subject to taxation. Thus the figures mentioned here probably somewhat understate the dynamism of German tax and

with regard to cyclical movements. Third, the distinction between an ordinary and an extraordinary budget, which was eventually removed in the fiscal reform of 1969, limited deficit spending to financing specific projects, basically for investment purposes. Fourth, unemployment spending was minor due to the low unemployment rate and the social security system was not yet fully developed. The basic foundations of the current social security system had already been laid during the 1950s and 1960s, but the system had not yet reached its final degree of coverage and largesse.

This situation changed drastically in the early 1970s, when the government started to use fiscal policy as a tool for active demand management. The budget balance fell from as small suplus of 0.2 percent of GDP in 1970 to a deficit of 5.5 percent of GDP in 1975. At the same time, the primary deficit deteriorated from 1.1 percent of DGP to 6.2 percent of GDP. This development was caused by a 10 percentage point increase of expenditures, which rose to 47.1 percent in 1975, mostly due to an expansion of transfer payments. The ratio of transfers and subsidies to GDP rose by 5.4 percentage points of which 4.2 percentage points are explained by higher social security benefits. Thus the increase of total revenues from 37.4 percent of GDP to 41.6 percent of GDP only sufficed to finance the increase of social security benefits, but not the rest.

The Stability and Growth Act, which was enacted in 1967 as a response to the economic downturn, obliged the Federal and Länder authorities to 'have due regard to the requirements of overall economic equilibrium', during the budget process. Moreover, the Social Democratic government of Willy Brandt, which came to power in 1969, put forward a broad redistributive agenda. As a consequence, fiscal policy became considerably more expansive during the economic crisis of the early 1970s, and this development was not fully reversed in subsequent years, when the economy fared better. Stabilization policy is illustrated in Table 3 which depicts the fiscal impulses, measured as the change of the primary cyclically-adjusted primary budget balance as a share of potential output for the years 1966 until 1979. Until 1969, fiscal policy did not show an expansionary tendency. In contrast, fiscal policy became much more expansive thereafter, increasing the cyclically adjusted primary deficit every year between 1970s and 1976, most significantly during the recession in 1974/5. Importantly, however, the initial fiscal loosening already occurred when the economy was still growing above trend. Fiscal policy was, therefore, procyclical, fuelling the boom rather than counteracting the bust. In 1971 and 1972, the Ministers of Finance, Moeller and Schiller, both resigned after pleading for expenditure cuts and a more restrictive fiscal stance, but finding no support in cabinet nor from the Chancellor. In 1972, Schiller's successor Schmidt, in contrast, argued that fighting the inflationary boom could not justify to cut back or postpone government spending on programs of high social value. (von Hagen 1999)

Table 3. Fiscal Stabilization Policy, 1966-79

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expenditure developments relative to other countries.

	Real Growth Rate	Fiscal Impulse (% of Potential Output)		Real Growth Rate	Fiscal Impulse
1966	2.8	-	1973	4.8	0.75
1967	-0.3	0.04	1974	0.2	1.43
1968	5.5	0.00	1975	-1.3	3.21
1969	7.5	-0.70	1976	5.3	1.01
1970	5.0	1.46	1977	2.8	-.10
1971	3.1	2.17	1978	3.0	1.16
1972	4.3	1.19	1979	4.2	2.17

One channel of government expansion, combining both solicital targets of redistribution and anti-cyclical demand management, was the expansion of government wage consumption. On the one hand, the state increased public employment. After the growth of public employment had virtually stagnated in the late 1960s, it rose by more than four percent per year from 1970 to 1973. During the first oil crisis, it was somewhat reduced to slightly above three percent and to around two percent from the mid-1970s until 1979. On the other hand, the government accommodated high wage pressures from public sector unions. During these years public sector unions still had wage leadership. They pursued an aggressive policy by pushing public sector wages hikes to double-digit numbers. Their strategy was supported by the Brandt government, which, at the end of the 1960s, had given them an explicit guarantee of full-employment through the absorption of labor force in the public sector. Public sector wages rose by 13 percent in 1970 and by 15 percent in 1971. In 1974 public employees again achieved a collective agreement above 12 percent. (Kitterer 1999:184) This development was largely beyond the influence of the minister of finance, since collective bargaining for the public sector is traditionally conducted between the unions and a delegation of federal and Länder governments, represented by the ministers of the interior, and representatives of local government associations.

A second channel of government expansion was the rise in public transfer programs. As mentioned above, the increase in social security expenditures explains roughly 40 percent of the overall increase of public spending. In the early 1970s, this development reflected partly the impact of high inflation and high wage settlements on indexed social security payments. But it was also generated by discretionary changes in health care and, above all, pension legislation. Pensioners became fully included in the health care system only in 1967 and hospital and ambulant financing was made more generous in the early 1970s. (Frerich & Frey 1996:77). Pension payments expanded, due to a more permissive regulation for early retirement enacted in 1972, as will be explained in more detail below.

In 1983, Kohl came to power on an electoral platform promising to bringing public finances in order and reducing unemployment. (see Hellwig and Neumann, 1987) During the early years, his government

pursued a more stability oriented fiscal policy.[6] The Kohl government was moderately successful on the first account, but less so on the second one. It improved the primary balance so as to stabilize of the debt level by producing a primary surplus from 1983 onwards. The initial consolidation effort was achieved by reducing social security benefits from 17.3 percent of GDP in 1982 to 16.3 percent in 1984, although this development was also strongly supported by an economic upswing. Thereafter benefits remained virtually stable at around 16 percent until 1989. The growth of public wage payments was also halted, primarily by low wage increases during the initial years. This policy slowed down the growth rate of public debt, which stabilized at 42 percent of GDP after 1985. But the adjustment effort already started to vanish from 1985 onwards, despite relatively favorable macro-economic conditions, re-emerging only in 1989 by a surprisingly high surplus producing a short-term upward spark in the deficit curve. Nonetheless, the primary spending level grew in line with the economy, without any major shift in the relative importance of individual spending categories.

But this moderate fiscal stance was immediately abandoned with German unification and the inception of the economic transition process. Again, the subsequent deterioration of the fiscal balance was entirely spending driven. The expenditure level rose from 34.8 percent of GDP to 46.3 percent of GDP between 1990 and 1995. Looking at general government figures, we find that above all transfers and subsidies and government purchases, which according to German accounting definitions also include health care services (such as medicine etc.), contributed to the spending growth. They increased from 15.2 percent of GDP in 1990 to 19.2 percent of GDP in 1996 and 1997. The fiscal balance hovered around minus three percent until 1997, but this reflects not the entire unification induced expansion, because large amounts of transfers were drawn from special funds and only later, in 1995, properly integrated into the government accounts. When these and other liabilities finally were integrated into the system in 1995, public debt jumped from 42.0 in 1990 to 59.1 percent of GDP.

From 1997 onwards, the German government again has achieved a consolidation by and large stabilizing the debt level. Seizing the opportunity provided by the favorable macro-economic environment, public deficits were reduced to 1.1 percent of GDP in 1999, a primary surplus was achieved again and debt stabilized close to 64 percent of GDP. The improvement of the fiscal balance was primarily based on expenditure reductions, which were cut from 47.3 percent of GDP in 1996 to 45.6 percent of GDP in 1999.

III. Expansion of the Welfare State and Spending Pressures

The previous section showed that there are two decisive episodes when the expansion of the German welfare state gave rise to large public deficits and increasing debt burdens, the early 1970s and the early

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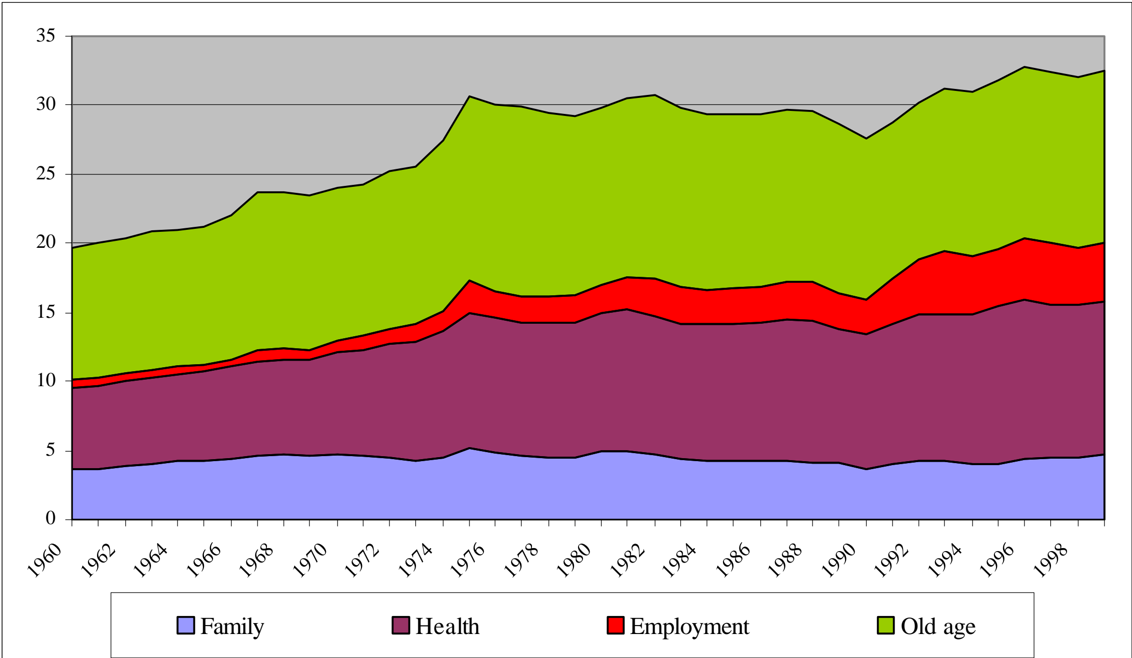
[6] The change in fiscal policy actually had already started before in the final years of the outgoing Social Democratic government under Chancellor Schmidt, however, without stabilizing or even reducing the spending levels effectively.

1990s after re-unification. A closer look at these developments reveals that during the 1970s and 1980s successive governments, Social Democrats as well as the Kohl government, were willing to exploit a previously healthy social security system to avoid hard solutions to Germany's growing unemployment problems. In the 1990s, the flawed integration of the East German labor market created a sizable clientele which threatens to remain dependent not only on the pension system but also on other transfer schemes in the long-run.

III.1. The Labor Market Role of Early Retirement

Graph 3 shows the historical evolution of the social budget in Germany and a break-down of expenditures into different functional categories. The social budget includes services and transfers from the state and para-statal insurance systems and other resource flows related to temporary and permanent losses of income.

Graph 3: Social Budget of Germany, 1960-99 (in % of GDP)



Note: The chart omits other services and transfers, such as compensation for special political events etc. However, this category is minor adding about 1.5 percentage points of GDP to the total social budget. Only between 1970 and 1981 did these expenditures grow above two percentage points of GDP.
Source: BMA (2001)

Graph 3 clearly indicates that, in the 1970s, a major part of the increase of public transfers to households through the social security system was produced by enlarging role of public pensions.[7] The

[7] Health expenditures rose by a comparable amount from 1972 onwards until the end 1970s, but this was among others the effect of the expansion of membership (to all pensioners etc.) taken during the late 1960s. (see Frerich & Frey 1996)

German public pension system is among the oldest formal social security systems in Europe. It was introduced by Bismarck in the late 19th century. However, it obtained its current form only through several reforms from 1957 onwards. In contrast to the original system, which provided retired workers with not much more than a basic insurance, public pensions from the 1960s on have been designed to extend the standard of living that was achieved during an individual's work life into retirement by tying pension payments to the level of individual earnings. In addition, pension payments are indexed to wage developments in order to let pensioners share the benefit of productivity growth.[8] In the 1960s and 1970s the German system evolved into one of the most generous pension systems in the world in terms of both its replacement rate and its early retirement provisions. When the more generous benefits had exhausted the savings from the years of the economic miracle, the government converted the partly funded into a full pay-as-you-go system in 1969.[9]

During the first decade after 1957 pension payments increased, mainly because coverage was broadened and replacement ratios were raised due to changes in the accounting of work time. Some expenditure-reducing and contribution-raising measures were implemented to alleviate financial problems of the pension insurance. The coalition of Social Democrats and Liberals, which assumed power in 1969, prepared and approved a major pension reform in 1972. The reform (a) opened the public insurance system to the entire working population, including the self-employed, and gave these groups incentives to enter the system, (b) introduced a virtual minimum-wage to compute pensions, which was above the level of low-income earners, and (c) determined a fixed date to adjust pensions payments annually, and (d) introduced the opportunity to retire at ages below the previous minimum age without a corresponding adjustment of benefits. The permissible retirement age was lowered to 63 for workers with a long service life and to 60 for women, older disabled and unemployed.[10] Combined with the economic downturn of the first oil price shock, inflationary pressure on wages, and concomitantly double digit pension adjustment rates, these measures produced the large rise of pension payments of the mid-1970s (Frerich and Frey 1996:228). Since the reform propelled considerable deficits and ate up reserves, governments started to implement consolidating measures from 1977 onwards.

However, the long-term consequences of the reform were not reversed. Furthermore, the government increasingly used the pension system as an instrument of labor market policy. When unemployment rose from 0.6 percent in 1970 to four percent in 1975, the government proposed to address the issue by sending older workers into early retirement. This idea of siphoning off unemployed workers had already

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[8] See Hockerts (1990) and Hermann (1990) for the reform of 1957 and the development thereafter. Morever see Gruber and Wise (1999) for a description of other European and non-European pension systems.

[9] From then on the reserve funds had only the function of a liquidity reserve. The reserve requirements of the pension insurance funds was drastically reduced to the amount of aggregate pension payments in one quarter. (Hermann 1990:114)

[10] See Hermann (1990) and Boersch-Supan and Schnabel (1999) for a more detailed description and discussion of these regulations.

emerged in the 1960s as a solution to the structural problems of the mining sector. When the problem reappeared on a larger scale in the 1970s, the notion among policy makers was that early retirement would allow to reduce the labor supply and that this would help to bring younger people into work. During the initial years, the regulation for employees with long service years was used as a pathway to early retirement, while in the second half of the 1970s the disability rule emerged as the most important channel. (see Boersch-Supan and Schnabel 1999: 169-171) The increasing role of the unemployment regulation of the pension system in pulling male unemployed, in particular, out of the labor market is clearly illustrated in Table 5. Between 1975 and 1980, the share of pensions going to male unemployed entering the pension system already increased from 3.7 percent to 8.4 percent. It rose from 0.7 percent to 1.6 percent for females.

In line with this development, the more generous early retirement regulation produced a drastic reduction of the participation rate during the 1970s, above all for male workers. The rate for the cohort between 60 and 65 fell most dramatically from 74.7 percent in 1970s to 58.3 percent in 1975 and 44.2 percent in 1980. The decline in the active participation rates of other cohorts in the labor market was less dramatic, but still sizable. The rate for elderly above 65 fell from 21 to 7.4 percent during this time period and the rate for the group between 55 and under 60 from by 7 percentage points. At the same time, we see a reduction in the average age for male and female workers receiving pensions due to limited employability. The average age fell from 66.3 in 1975 to 54.7 for males between 1975 and 1980 and from 59.2 to 57.7 for females within these five years. (Tables 4 and 5.)

The 1980s were still marked by almost continuous attempts of the Kohl government to fill and reduce the financing needs of the pension insurance system propelled by this enlargement of coverage. However, it was not able to forcefully redress the previous developments and, therefore, effectively expanded the labor-market role of the pension system. Fiscal stabilization was achieved through short-term and piecemeal changes, including pre-dated contribution hikes and delayed pension adjustments as well as reduction of benefits. Among other things, the eligibility conditions for rehabilitation measures and inability pensions were tightened, the formula for pension adjustments was changed and survivor pensions modified. The basis for pension adjustments became the wage development of the last year, rather than the average of the previous three years, which had been the rule before. Given the decline in (wage) inflation at the time, this downsized pension adjustments. (Frerich and Frey 1996:230-1)

The employment policy of the government was largely unsuccessful, as indicated by an increase in the unemployment rate from 4.5 percent in 1981 to close to 8 percent in 1984. In view of this, the Kohl government took additional measures giving employees incentives for early retirement or shifting to part-time work. The Preretirement Act (*Vorruhestandsgesetz*) was passed in 1984 and the Law on Part-Time Work for Elderly (*Altersteilzeitgesetz*) in 1988. The financing associated with both measures came from the Labor Office (*Bundesanstalt fuer Arbeit*) and therefore did not have an immediate

impact on the pension system. The early retirement arrangement was restricted until 1988.[11] (Hermann 1990:136).

Nevertheless, the share of unemployed among newly incoming male pensioners increased to 13.7 percent until 1990 and the overall share of pensions going to previously unemployed more than doubled from 4.8 percent in 1980 to 10.7 percent in 1990. (see Table 5) At the same time, the participation rate of male workers was further reduced to 35 percent for the cohort between 60 and 65. (see Table 4)

Table 4. Participation Rates of Male Persons in West Germany

	Age 55- under 60	Age 60 – under 65	Over 65
1970	89.1	74.7	21.0
1975	85.7	58.3	11.0
1980	82.3	44.2	7.4
1985	79.1	33.0	5.4
1990	81.1	35.0	5.3
1995	79.0	33.0	4.6
1999	78.6	33.7	5.0

Source: Federal Statistical Office

Table 5. Trends in the German Social Security System

	Average Age of New Pensioners Receiving Pensions for Reduced Employability		Share of Pensions for Unemployment In all new Pensions (%) (West Germany)		Share of Pensions for Unemployment in all new Pensions (%) East Germany		Share of Pensions for Unemployment in all Pensions (%)	
	Male	Female	Male	Female	Male	Female	West	East
1975	56.3	59.2	3.7	0.7			3.5	
1980	54.7	57.7	8.4	1.6			4.8	
1985	54.8	54.3	11.9	1.1			7.9	
1990	53.9	52.6	13.7	1.8			10.7	
1995	53.5	51.4	24.2	3.4	60.2	6.4	8.7	10.2
1999	52.9	50.8	26.9	2.1	54.5	1.8	14.4	31.4

Source: Verband der Rentenversicherer

A more comprehensive pension reform was finally approved in the late 1980s. In 1989 parliament passed the Pension Reform Act 1992, which introduced the following changes to the pension system: a) Federal subsidies to the pension system were indexed and thereby made automatic, b) modification of the relevant contribution period and more generous arrangements concerning the work biography of women, c) changing the indexation of pensions from gross to net wage developments, and discount factors for early retirement, d) rise of the general retirement age. (Frerich & Frey 1996: 255-6) But even

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[11] The number of unemployed leaving the labor market via the special arrangement included in the pension legislation, which allows them to receive old-age pensions from 60 onwards, amounted to 100 000 persons per year at the time. It was higher than the number of unemployed making use of the temporary early retirement scheme (Hermann 1990:136), Enterprises largely used the generous unemployment regulation as a vehicle to lay off workers before 60, via a negotiated agreement, which then 'transferred' them automatically

this reform did not change accessibility of the pension system and therefore its labor market role, because the law envisaged a slow change of the regular retirement age for unemployed and female employees from 60 to 65 to start only in 2001. The legal retirement age for workers complying with the minimum contribution period, similarly should be raised from 63 to 65. (Heine 1990:164)[12] These regulations did not imply that these groups of the workforce could not retire earlier, but rather that they their payments would be subject to some discount. The *Law for the Promotion of Growth and Employment* further reduced the generosity of pension payments. In particular, it speeded up the amount of discount for early retirement age. These regulations were again somewhat tighened in the pension reform act adopted in 1997, which was to become effective in 1999. Several measures of this reform act were however revoked by the new government in 1998. The recent pension reform of the current government, mainly planned to strengthen a new, fully funded private component of the pension system, leaves the regulations of the Law for the Promotion of Growth and Employment basically unchanged, which implies that the option to retire is still left to unemployed and participants of part-time programs at the age of 60.

Despite these changes, the share of new pensions going to male unemployed using this channel to leave the labor market increased to 24 percent in 1995 and 26.9 percent in 1999 in West-Germany. For females this ratio increased from 1.8 percent in 1990 to 3.4 percent in 1995 to then level down again towards the end of the decade. For the new Laender, the role of the pension system was even much more important. As will be shown in more detail below, aside from the creation of a publicly financed secondary labor market, it was one of the major instruments of the Kohl government to cope with the high levels of structural unemployment in the East. Here the share of new pensions going to unemployed lies at 60.2 percent in 1995 and 54.5 percent in 1999.

III.2 Transfers and the East German Labor Market after Unification

German unification implied the extension of West Germany's social security and assistance institutions to East Germany and the inclusion of East Germany into the federal grant system. German fiscal federalism establishes a system of horizontal and vertical resource flows between different layers of government, complemented by centralized pensions and unemployment insurance administered by independent federal agencies. As illustrated in Graph 2, the full inclusion of the new Laender into the system led to an overall increase of transfers, particularly however of unemployment related benefits. The following section will more closely analyze how the strong raise of unemployment benefits marking the 1990s emerged.

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into the pension system at the retirement age for unemployed. (Boersch-Supan and Schnabel 1999:154)

[12] However, the government was obliged to show in its pension report from 1997 onwards how this regulation might affect the labor market and the budgetary position in order to then assess the appropriateness of the regulation (Heine 1990:164)

Table 6 reports the transfer flows paid to East Germany by the various parts of German government.[13] Total gross transfers rose from DM 142 billions in 1991 to DM 196 billions in 1999. The federal government's share in these transfer flows increased over time. The table also reports the functional distribution of these transfers. The largest share are transfers to private households. Social security payments rose from peaked at 54 pecent of a total gross transfers in 1992/3. A large part of these expenditures were payments from the federal government, which were channeled through the social security system to overcome its financing shortages in the East (see Table 7). Moreover, the federal government directly paid for social security benefits under early retirement schemes and unemployment support. Current subsidies to East German enterprises are the third largest transfer category amounting to 3.6 billion in 1991 and 11 billion in 1999.[14] Importantly, transfers to finance public investment amount to much less than transfer payments to individuals. This is a clear refutation of the tax-smoothing interpretation of German fiscal policy after unification.

Table 6. Public Gross Transfers to East Germany, 1991-1999 (in Bill. DM)

	1991	1992	1993	1994	1995	1996	1997	1998	1999
Federal Budget	75	89	115	115	136	139	131	132	141.3
"German Unity" Fund	31	24	15	5	-	-	-	-	
EU	4	5	5	6	7	7	7	7	7
Social Insurance (net)	19	34	23	30	33	31	35	32	36
Länder and Local Governments in West-Germany	5	5	11	15	11	11	11	11	11
Treuhand	9	14	23	24	-	-	-	-	-
Total	**142**	**172**	**192**	**194**	**187**	**188**	**184**	**182**	**196**
Of which (percent)									
Social Security Benefits	45.4	54.0	54.0	53.8	49.4	50.3	50.0	49.4	51.7
Subsidies to Firms	2.5	4.8	7.6	7.5	8	6.9	6.3	6.3	5.8
Infrastructure Investment	12.3	9.9	8.6	10.0	13.1	13.1	13.1	12.8	12.5
Block Grants	28.1	22.4	20.1	19.5	23.8	24.3	24.8	25.6	24.4
not classifiable	11.7	9	9.6	9	5.7	5.4	5.8	5.8	5.6

Note: IWH (2000:14)

Federal support to the social insurance system would have been even larger without the transfers from within the system to East Germany. Table 7 indicates that around 18 percent of all revenues spent on social benefits in the new Laender are paid through intra-insurance transfers to this region. Although social security and unemployment insurance have no explicit geographical dimension, these schemes became channels of massive regional income distribution (Czada, 1995)

[13] The table reports gross transfers. Although net transfers would have been more appropriate, they are hard to compute and the data were not available to the authors. See Deutsche Bundesbank (1996) for the problems in measuring West/East transfers.

[14] Unclassified spending includes wage compensation for public employees and other transfers.

In addition, Table 7 gives evidence to the continuously high level of dependency on social benefits. Social expenditure in comparison to the regional GDP of the new Laender amounts to somewhat more than 55 percent in recent years. Thus, it has remained fairly unchanged from 1994 onwards. By comparison, social benefits in the old Laender stay at a level of 30 percent of GDP. Regarding the distribution of benefits, the strongest difference between the two regions occurs in employment related expenditures. In the new Laender, this functional category accounts for roughly one forth of all social benefit spending, or close to 14 percent of regional GDP, while it remained at around 10 percent in the Western Laender during recent years.

Table 7. Social Expenditures in the new Laender (as share of regional BIP) and West-East Transfers within the Social Insurance System

	1991	1992	1993	1994	1995	1996	1997	1998	1999
Family	7.5	7.6	6.6	5.6	5.6	5.8	5.9	5.9	6.2
Health	16.3	17.6	16.2	16.3	16.1	16.2	15.6	15.5	15.5
Employment	18.4	21	18.9	15.4	14.1	14.1	13.6	13.8	13.6
Old age	15.1	16.8	15.8	15.9	17.5	18	18.2	18.9	19
Others	1.7	1.4	1.4	1.3	1.2	1.3	1.7	1.7	0
Total	**58.1**	**64.7**	**58.9**	**54.6**	**54.6**	**55.3**	**54.6**	**55.8**	**56.0**
West-East-Transfers (as share of total financing)	18.8	23.9	24.1	19.3	17.9	19	18.7	18.8	17.9

The immediate transfer of West-German social insurance institutions, including generous unemployment and early retirement benefits, was a decisive factor in creating a labor market crisis, reflected in a level of registered unemployment close to 20 percent. The previous decision on a 1:1 conversion rate for the East German Mark to the Deutschmark had already created large social insurance entitlements. Then, the transfer of the insurance system defined the rules of wage bargaining in East Germany. It allowed West German employers and labor unions to fend off the competition of low-wage workers from East Germany. To do so, employers associations and unions in 1991 agreed on a stepwise adjustment of East German wages to Western levels. Several industries - most importantly the steel industry - envisaged to have the same wage levels in East and West Germany by 1994 (SVR 1992:107-110). Moreover, unions striving for a very rapid adjustment of wages signed contracts only for less than a year to facilitate re-negotiations and a quick upward move of wages. The result of this was that wages grew stronger than productivity and labor was priced out of the market (see Table 8). But high wage levels also secured high unemployment benefits, which left the unemployed better off staying in the East than moving to West Germany to find employment. (Sinn 1995, von Hagen, 1998).[15]

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[15] Theoretical models emphasize the role of unemployment benefits for the level of structural unemployment (see among others Driffill & Miller 1998). Empirical findings strongly confirm that high replacement rates in combination with their "long-term" duration causes high levels of structural

Table 8. The Labor Market in East Germany, 1991-1999

	1991	1992	1993	1994	1995	1996	1997	1998	1999
Unemployment rate	10.3	14.8	15.8	16.0	14.9	16.7	19.5	19.5	19.0
Participation rate	51.7	48.0	47.1	48.0	48.1	48.0	48.2	48.4	48.6
Wage Index	53.5	70.4	83.9	91.8	100.0	104.9	107.5	110.1	114.2
Productivity	49.7	65.9	79.9	92.7	100.0	104.0	105.9	108.0	111.1
Active Labour Market Measures									
Employees in part-time work	1616	370	181	97	71	71	50	-	-
Employees in job-creation schemes	183	388	260	280	312	278	235	314	348
Employees in training schemes	169	425	345	241	243	230	177	147	141
Employees in early retirement- or transitional old-aged schemes	554	811	853	650	374	186	58	-	-

Note: SVR (2000), Deutsche Bundesbank (1998), Autorengemeinschaft (1998). Figures are in thousands or in percent. Participation ratio –data from 1995 onwards from Arbeitsgruppe VGR der Laender

The federal government responded to the rise in unemployment with an unprecedented level of labor market interventions. In fact, German Unification marks the beginning of a "new era" of labor market policy in the country. Table 8 reports the number of participants in different labor market schemes and the unemployment rate for East Germany. Between 183.000 and 388.000 employees, or two to five percent of the German labor force, participated in public works programs from 1991 to 1999. A similar number of employees were enrolled in training programs. This number fell to 141.000 in 1999 after a peak of 428.000 in 1992. Early retirement and provisional retirement schemes were a third, important kind of labor market policy during the early years of transition. The number of beneficiaries in these programs increased from 554.000 in 1991 to 853.000 in 1993 and then leveled off to 58.000 in 1997, among others, by transferring these people to the regular pension and disability schemes. At the peak, some eleven percent of the total labor force benefited from these programs. An even larger number of individuals were included programs supporting part-time work during the initial stage of the transition process. In 1991, 1.6 million employees received such transfers, or 19.6 percent of the labor force, but the number was continuously and forcefully reduced during the subsequent years to 50 thousand recipients in 1997. The total full-time work equivalent of these measures amounted to almost 20 percent of the labor force in 1991 and to approximately 11 percent in more recent years. Taken together, these policies created what became known as a "secondary labor market" in Germany.

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unemployment, above all if no effective active labor market policies are in place bringing people back to work (see Nickell 1997, Siebert 1997).

IV. Fiscal Policy Under the Maastricht Constraint and the Stability and Growth Pact

Within the Maastricht process the German government started to set forth medium term fiscal policy goals in its Convergence and Stability Programmes. The first German Convergence Programme, released in October 1991, referred to the re-unification process as a major break in German public finances for obvious reasons. Despite the financing requirements related to the transition process, however, the convergence programme envisaged a fiscal consolidation, which would reduce the deficit from five percent in 1991 to 2.5 percent of GNP in 1995. This projection was still based on the ill-founded assumption that the re-unification would be a self-financing process. The fiscal adjustment was to be based on restrained expenditure growth, especially at the federal level.[16] Apart from a more general constraint on public employment and wage spending, savings were to be made in policy areas related to the separation of Germany - such as special transfers to Berlin - and defence spending.

Table 9. Deficits and Debt Targets in Stability and Convergence Programmes and Actual Developments

Year	1991	1992	1993	1994	1995	1996	1997	1998	1999
CP 91	-5	-4.5	-4	-3	-2.5				
CP 93			-4	-3.5	-2 to -3	-1 to -2	>-1		
CP 97							-2.9	-2.5	-2
CP 99									-2
Actual (BMF)	-3.1	-2.6	-3.2	-2.4	-3.3	-3.4	-2.7	-2	-1.4
Actual (EC)	-2.9	-2.5	-3.2	-2.5	-3.3	-3.4	-2.6	-1.7	-1.6
CP 93			48.5	53.5	60 to 63	59 to 62	57 to 60		
CP 97							61.5	61 to 62	61 to 62
CP 99									61
Actual	40.32	43.02	46.95	49.26	56.95	59.69	60.82	60.67	61.1

Note: Actual figures are ESA 79 until 1998.

The updated Convergence Programme, presented in October 1993, a recognised that the economic transition of the new Länder would be more difficult and protracted than initially planned. Moreover, it argued that the international economic downturn was responsible for the deviation from the envisaged consolidation path. Yet, it reiterated the governments willingness to engage in a fiscal consolidation, based on revenue and expenditure measures, and listed several initiatives already taken or close to being approved. In addition, it pointed out the need to take some action improving the conditions for economic growth and mentioned several initiatives taken in that direction. The revised Convergence Programme submitted in December 1996[17] puts a stronger emphasis on the later aspect. Expenditures respectively

[16] The programme states that the average rate of nominal expenditure growth should be 2.3 percent at the federal level and around three percent for general government. Since nominal GNP growth was expected to be close to seven percent, this should lead to a reduction of the overall spending level (Convergence Programme 1991:7)

[17] Since the revised programme did not include the most recent developments and forecasts, an update was presented in February 1997.

the reduction of the tax burden and fiscal consolidation become equally important elements of a twofold strategy. The first Stability Programme reconfirms this approach and specifics that public expenditures on average should not grow by more than two percent between 1998 and 2002.

In line with the Convergence Programme, the government undertook some steps to improve the fiscal balance on the revenue side of the budget. Most importantly, a 'solidarity surcharge' on personal and corporate income was introduced in 1991. The surcharge of 7.5 percent of the tax liability was implemented as a temporary measure until June 1992. Moreover, the tax rate on mineral oil and other excise duties increased (Convergence Programme October 1991) and social security contribution rates rose. The total rate rose from 35.65 percent in 1990 to 36.1 percent in 1991 and to 36.7 percent in 1992. At the same time, the rates of pension and health care contributions were reduced, but this development was quickly reversed in 1992 leading to the overall increase. Nonetheless, revenue-reducing measures were adopted to promote investment in former Eastern Germany. In 1992 the government ruled that the investment allowances scheme for investments in the new Länder should be extended and remain in effect until the end of 1996.[18]

Then financing efforts became more pronounced with the *Federal Consolidation Programme* and the *Savings, Consolidation and Growth Programme* approved in 1993 and implemented until 1995. The first programme set an end to the financing arrangements installed for the transition of the Eastern Länder and integrated them fully into the federal transfer system from 1995 onwards. In 1994 the mineral oil tax was increased and tax concessions granted to owner-occupied old buildings are reduced. (OECD Economic Survey 1995:158) In 1995 the 'solidarity surcharge' was re-introduced at a rate of 7.5 percent, the insurance tax was aligned with the VAT tax rate, i.e. it increased from 12 to 15 percent, the wealth tax doubled from 0.5 to one percent for many assets and, at the same time, the wealth tax allowance was increased from DEM 70000 to 120000 (Convergence Programme October 1993, OECD Economic Survey 1996:181) To improve business conditions, the *Investment Location Law* envisaged a reduction of corporate taxes on retained profits from 50 percent to 45 percent and on dividends from 36 percent to 30 percent, becoming effective from 1994 onwards. In addition, the top rate of taxes on business income was reduced from 53 to 47 percent. These reductions were to be financed through the replacement of the declining-balance depreciation by the linear depreciation on company buildings and the closure of several tax loopholes and tax simplifications reducing evasion (Convergence Programme October 1993, OECD Economic Survey 1995:158)

The major provisions of the 1997 tax law, again, were more directed towards the improvement of investment conditions. In particular, the wealth tax was abolished and the inheritance and gift taxes were restructured. The personal exemption level increased and tax brackets were reduced from four to three. (Convergence Programme December 1996). Employment in private households was promoted by

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[18] see OECD Economic Survey (1993:127) for details.

special tax allowances and extended depreciation allowances are introduced for newly founded enterprises. Finally, the real estate purchase tax increased. (OECD Economic Survey 1998:158)
Over the entire time period, social security contributions were almost continuously extended to finance the persistent deficits of the social security system in the Eastern Länder. (see Table 10) The only exception was the reduction of pension contributions from 19.2 percent in 1994 to 18.6 percent in 1995. But this decision was immediately reversed in 1996. Moreover, the government introduced a new Social Care Insurance Scheme (*Pflegeversicherung*) in 1995, which contributed further to the fiscal burden.

Table 10: Social Insurance Contribution Rates

Year	Total	Pension	Unemploy-ment	Sickness	Social Care
1970	26.5	17.0	1.3	8.2	
1980	32.4	18.0	3.0	11.4	
1990	35.6	18.7	4.3	12.6	
1991	36.7	17.1	6.8	12.2	
1992	36.7	17.7	6.3	12.7	
1993	37.4	17.5	6.5	13.4	
1994	38.9	19.2	6.5	13.2	
1995	39.3	18.6	6.5	13.2	1.0
1996	40.9	19.2	6.5	13.5	1.7
1997	42.0	20.3	6.5	13.5	1.7
1998	42.1	20.3	6.5	13.6	1.7
1999	42.1/41.3	20.3/19.5	6.5	13.6	1.7

Source: SVR (1996), Deutsche Bundesbank

In 1998, the outgoing government finally reduced the solidarity tax surcharge by two percentage points to 5.5 percent, abolished the business capital tax and increased the basic income tax allowance. Moreover, the VAT rate rose by one percentage point to 16 percent in April 1998 to cover the increasing government transfers to the pension system (OECD Economic Survey 1999:150). In 1999, the tax reform law, which updated the valuation of company pension reserves, and the tax relief law came into force. The latter lowers statutory income tax rates and reduces the tax burden for households. The corresponding revenue shortfall was to be compensated by broadening the tax base for income from business activities. (OECD Economic Survey 1999:176) The government, later on, enacted legislation extending the obligation to pay social security contributions to casual employment and to "apparently self-employed" persons. Moreover, higher taxes on energy were introduced, the proceeds of which were utilised to lower pension contribution rates by 0.8 percentage points (see IMF Staff Country Report November 1999)
On the expenditure side of the budget, the government initially maintained its expansionary fiscal stance. This is not immediately evident from budget figures, because the post-unification period was marked by the creation of several special funds and semi-governmental entities. Table 11 reports the

debt level for these funds from 1990 to 1997. While the federal government's debt rose by 3 percent of GDP in the wake of unification, the combined debt of the German Unity Fund, the ERP fund and the *Erblastentilgungsfonds* rose quickly to 12 pecent of GDP. *Treuhand*, the East German privatisation agency, alone incurred an impressive debt of over 6 percent of GDP. But the major part of this debt stock was not related to liabilities inherited from old East German enterprises. A large part of the debt was accumulated due to the privatisation-related expenditures, which were equivalent to 46 percent of the federal transfers to the East in the last two years of the Treuhand's existence. In short, large parts of the financial support given to East Germany, simply were not included in government spending until finally the stock of liabilities was ascribed to the federal government, which caused the reported debt level to jump 10 percentage points in 1995.[19]

Table 11: Public Debt in the 1990s (as percentage share of GDP)

year	General Government	Federal Government	Länder Government	Local Government	German Unity Fund	Kreditab-wicklungs-fonds	Erblastentil-gungsfonds	Treuhand
1991	40.0	20.0	12.0	4.8	0.8	1.1	-	1.3
1992	42.6	19.4	12.3	4.9	1.7	0.9	-	3.4
1993	46.6	21.2	13.4	5.3	2.4	2.9	-	5.2
1994	49.0	21.0	13.9	5.5	2.7	3.1	-	6.0
1995	56.7	21.5	14.5	5.6	2.6	3.0	-	-
1996	59.4	23.4	15.6	5.6	2.5	-	9.3	-
1997	60.5	24.7	16.2	5.5	2.3	-	9.3	-
1998	60.3	25.3	16.5	5.3	2.2	-	8.8	-
1999	60.5	36.0	16.5	5.2	2.1	-	8.1	-

Note: Debt data from Deutsche Bundesbank database, GDP data from Arbeitskreis VGR der Laender database. Note that the components do not necessarily add up to the total amount of general government debt, because some elements are missing. Debt figures for total government here differ somewhat from those mentioned in Table 2 because a different accounting concept is used by the Deutsche Bundesbank.

Apart from this complication, only a few initiatives were taken to reduce public transfers, which had been the most important source of public spending growth after unification. The enactment of the Federal Consolidation Programme went one step into this direction by lowering the replacement rate for unemployed. Until 1994, the rate was 68% for an unemployed person with at least one child and 63% for a childless unemployed. In the Consolidation Act these rates were lowered to 67% respectively 60 percent. The duration of unemployment insurance payments varies from one year for people up to the age of 45 to 32 months for workers above 57. When the insurance payments expire, they are replaced by unemployment aid. Unemployment aid is paid indefinitely until the age of 65, although beneficiaries have to apply again after one year. The replacement rate was also lowered in 1994 from 58 percent to 56 percent for unemployed with children and from 57 percent to 53 percent for childless persons. (BMA 1998, Steffen 1995).

[19] For a more detailed account see von Hagen & Strauch (1999).

In 1996 and 1997, several measures accompanied the above-mentioned pension reform initiatives. As a compensatory tool for the rise of the retirement age, the labor office introduced a programme compensating wage losses for elder workers switching to a part-time position if they are replaced by previously unemployed or newly graduated apprentices. Moreover, the growth of social assistance expenditures was restrained by a modest increase of the standard rates and a reduction of at least 25 percent if a recipient rejected acceptable work. Social assistance providers could instead support employment by granting wage subsidies (OECD Economic Survey 1997:157)

In 1997, health care benefits were restricted and co-payments increased. The *Law for the Promotion of Growth and Employment* not only reduced the generosity of pension payments but also curbed the increase of unemployment benefits in 1997. Wage subsidies were reduced and job search controls for recipients of unemployment benefits strengthened. (OECD Economic Survey 1998:158-159)

The new government which took office in late 1998, reversed several initiatives which the previous government had taken. Job search controls were eased again by removing the reporting obligation of recipients and redundancy payments will no longer be credited against unemployment benefits, which had been the case since 1997. Moreover, a benefit ceiling for repeatedly unemployed was dropped with the intention to increase the incentives for unemployed to accept lower-paid jobs. The government also revoked parts of the health care reform previously introduced. In particular, it removed or reduced co-payments for medicines and other services and the possibility for health funds to provide rebates or reimburse patients, rather than paying the health provider directly was abolished. Payments to the new Länder health funds out of the risk equalisation fund, temporarily established in 1998, were extended indefinitely. (OECD Economic Survey 1999:73).

Table 12 summarizes Germany's fiscal developments in the 1990s. Cyclically adjusted budget figures indicate that the consolidation achieved from the early 1990s onwards was clearly revenue based. The strongly rising level of social security contributions provided the major financing source. From 1992 to 1999 social security contributions increased 2.4 percentage points of GDP, reaching a peak of close to 20 percent of GDP in 1997 and declining slightly afterwards. The changing economic circumstances somewhat lower this difference for actual social security contributions, so that they do not have the same impact on the actual deficit. By comparison, cyclically adjusted direct tax receipts rose only one percentage point of GDP due to the counter-veiling initiatives mentioned above. Overall the cyclically adjusted revenue level rose from 42.4 percent of GDP in 1991 to 46.7 percent of GDP in 1999. The change of 4.4 percentage points even exceeds the improvement of the primary adjusted budget balance.

At the same time, the initiatives to cut public spending, as envisaged by the convergence programmes proofed relatively ineffective. Because of the special fund arrangements, it is hard to judge the expenditure development before 1994/5, when the activities of the Treuhand phased out and the new

Länder where integrated into the federal financing system.[20] Looking at the evolution of public spending from 1994 onwards shows that the policy measures addressing transfers and subsidies did not reduced the spending level. Expenditures in this spending category only modestly declined relative to GDP in 1997/8, but over the entire period increased by 0.8 percentage points. Looking at actual transfer payments leads to a similar conclusion. As a consequence, budget developments fell short of their targets specified in the Convergence Programmes during the mid-1990s. (see Table 9) The contribution of expenditures to fiscal consolidation after 1994 is primarily related to restraints in wage payments and investment. Thus, revenues and short-term measures targeting public investment remain the primary source of consolidation even if we look at the second half of the 1990s only.

Table 12: German Fiscal Trends in the 1990s

Year	1989 (1)	1991 (2)	1994 (3)	1999 (4)	Dif. (2)-(1)	Dif. (4)-(2)	Dif. (4)-(3)
Debt	39.9	40.1	49.2	62.6	0.2	22.5	13.4
Surplus	0.1	-2.9	-2.5	-1.6	-3.0	1.3	0.8
Primary Surplus	**2.7**	**-1.9**	**0.4**	**2.2**	**-4.6**	**4.1**	**1.9**
Revenues	**44.1**	**42.2**	**45.5**	**46.7**	**-1.9**	**4.4**	**1.2**
Direct Taxes	12.8	11.0	10.9	12.0	-1.8	1.0	1.1
Indirect Taxes	12.1	10.9	11.9	12.1	-1.2	1.3	0.2
Soc. Securitiy Contr.	16.6	16.9	18.7	19.3	0.2	2.4	0.6
Primary Expenditures	**41.4**	**44.2**	**45.1**	**44.4**	**2.7**	**0.3**	**-0.7**
Transfers and Subsidies	20.5	20.6	21.9	22.7	0.2	2.1	0.8
Wage Payments	9.7	9.0	9.0	8.4	-0.7	-0.6	-0.7
Purchases	8.8	10.2	10.7	10.6	1.4	0.4	0.0
Investment	2.3	2.6	2.6	1.8	0.3	-0.8	-0.8

V. Institutional Deterioration

Decisions to spend other people's money are at the heart of fiscal policy. Political economy research shows that good budgeting institutions are critical to keep political interests producing fiscal profligacy in check and to keep spending and deficit biases small.[21] Germany's budgeting institutions at the federal level traditionally ranked among the strongest in European comparison (von Hagen 1992). Important characteristics of the traditional German budget process were the comprehensiveness of the

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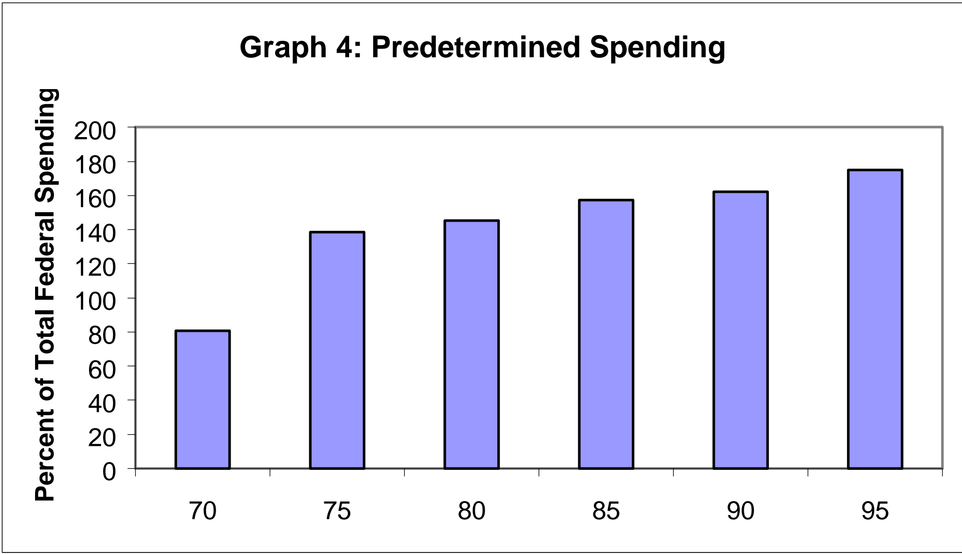
[20] It is not possible for the authors to assign the expenditures of the Treuhand to particular spending categories. However, the overall amount of spending rose from 27.4 billion in 1991 to 41.2 billion in 1992 and subsequently to 46.6 billion in 1993 and 1994, i.e. the spending to GDP ratio was reduced only slightly in 1994. (Von Hagen & Strauch 1999: Tab. 4.7)

[21] For a review of this literature, see von Hagen (1998), and Alesina and Perotti (1997).

budget, i.e., the rule to make decision with financial implications within the framework of the budget process, the relatively strong position of the finance minister relative to the other members of cabinet, based on his constitutional right to veto spending decisions, and the binding force of the budget law, i.e., the fact that supplementary budgets and in-year changes were rare. A significant aspect of the large fiscal expansions of the past 35 years is that they came with policies that circumvented and eroded this structure. In overview, the institutional deterioration is a significant part in explaining the mis-alignments of German public finances.



In the context of the fiscal trends described in the earlier parts of this paper, the weakening of Germany's budgeting institutions is visible in three developments. The first is the loss of political influence of the finance minister in the late 1960s and early 1970s. As indicated above, two finance ministers under Chancelor Brandt, Möller and Schiller, resigned from office when they realized that they did not have the political support of the chancellor for their attempts to reign in spending. In both instances, the ministers argued that the stance of fiscal policy was too expansionary for an economy enjoying full employment and suffering high inflation rates. In both instances, their demands for more spending discipline were overruled by arguments of other political priorities and exigencies.

The second development is more long-term. Starting in the 1970s, a critical observation in the development of German public finances is the rising share of personnel expenditures and transfers, and, beginning in the late 1970s, interest expenditures, in total spending at the federal level. This is significant, because the political decisions over such spending are largely taken outside the annual budget process, where the finance minister has much less control. At the same time, transfers and personnel spending are, to a large extent, predetermined relative to the annual budget process, i.e., there is little that can be done in that context to control spending on these items. Graph 4 illustrates the process by showing the ratio of predetermined expenditures in this sense (spending of the social insurances, interest expenditures and wage expenditures) as a ratio of total federal government spending from 1970 to 1995. This ratio has roughly doubled over the 25 years under consideration. The German

finance ministry lost significant amounts of control over federal policies that determine public spending at the federal level through these developments. A similar phenomenon is the increased use of tax expenditures in favor of business investment during the 1990s. The large number of tax exemptions and special rules made tax revenues increasingly unpredictable during the 1990s and weakened the link between economic developments and tax revenues, thus undermining the finance ministry's ability to plan and manage public finances consistently.

The third, important development in this context is the erosion of the German budget process due to German unification. The initial phase of German unification brought the most far-reaching institutional weakening in Germany's public finances. The most important factor at the onset of the unification process were its stunning dynamics. It was only a year from the Leipzig mass demonstrations to the political unification of Germany in October 1990. As a consequence, some critical decisions were taken under immense time pressure. In addition, the process was largely led by political and electoral considerations. The decomposition of the political system in the former GDR started at the beginning of the electoral campaign for the West German federal elections in 1990. Earlier in 1989, electoral expectations for the governing coalition looked rather bleak. The Christian and Liberal Democrats were trailing behind the Social Democrats in public opinion polls from the Fall of 1989 to the Spring of 1990. (Schwinn 1997:55) Working towards rapid Unification strongly improved the position of the government parties; probably Chancellor Kohl was aware of that when he proposed his 10-point program for a confederation of the two parts of Germany in November 1989. While the government had been in a defensive position before, the prospect of Unification immediately changed its strategic position. Moreover, rapid Unification under favorable terms promised a new electorate for the governing parties. Therefore, short term electoral reasoning became a major determinant for the speed and the terms of agreements on the Economic, Monetary and Social Union between the West and the East German governments. In other words, the astonishing pace of the transition was not entirely exogenous for political decision-makers in the West. Later in the course of 1990, when it became obvious that the unification costs were likely higher than initially estimated, the government could not change the political agenda any more without a tremendous loss of credibility. Thus, unsustainable financial arrangements driven by electoral opportunism were carried forward into the Reunification Treaty.

While initially, the re-unification stage was largely marked by a lack of guiding institutions in a rapidly evolving political transition, the further process was still characterized by a weakening of budgeting institutions. The increased use of special funds by the federal government to finance German Unification is the first, most obvious phenomenon in this regard. Table 11 gives a break-up of the development of

Germany's public debt after 1989.[22] While the federal government's debt only rose by three percent of GDP in the wake of Unification, the combined debt of the German Unity Fund, the ERP fund and the "Erblastentilgungsfond" rose quickly to 12 percent of GDP, or almost half of the federal government's official debt.

Significantly, the use of such funds implied that the decisions over a large part of the transfers paid to East Germany were not subject to the scrutiny of legislative control. The control of the otherwise powerful budget committee in Parliament was largely circumvented by the fact the special funds did not appear in the budget. As a result, the committee's control powers became only effective when the changes in fiscal stocks and flows finally began to have an impact on the federal budget. A second phenomenon is the increased use of tax expenditures indicated above. While the budgetary effect of tax expenditures is the same as that of explicit subsidy payments, they are harder to control in the budget process, because they do not appear as an expense in the budget law.

Treuhand is a particularly significant case as regards the loss of financial controls in the German government. *De jure*, it was an independent federal agency under the supervision of the Ministry of Finance and subject to the scrutiny of a special parliamentary committee. *De facto* the Ministry of Finance exercised partial control, at best, over its activities. Nor was the Treuhand Committee in parliament able to exercise financial control, although it was vested with the formal authority to do so. A conflict between the Treuhand and the Committee in 1993 illustrates the point. In June 1993, Treuhand demanded an expansion of its credit limit by eight billion DM to finance some measures settled in the negotiations for the Consolidation and Solidarity Pact between the Federal Government and the Länder. When the Committee approved seven billion DM, Treuhand threatened to limit its commitments to public work agencies. The Committee was eventually forced to concede to Treuhand to avoid risking the consolidation package (Czada 1994a:35).

A second indication of the institutional deterioration is the increasing loss of influence of the Ministry of Finance over the financial decisions involved in German unification. During the initial unification process the Ministry of Finance lost fiscal control due to its own framing of the first Treaty on the social, economic and monetary union. In the Treaty the West German government made financial commitments to its Eastern counterpart without having the legal authority and instruments to control the usage of the corresponding funds. The Ministry's unlucky role during this stage of the Unification process, later on, may have further undermined its political position[23] which was generally weak due to Kohl's inclination to concentrate power in the Chancellor's office (Bundeskanzleramt). In fact, a Task Force on Reconstruction in the Chancellor's Office instead of Ministry of Finance participated in most

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[22] See Boss & Rosenschon (1996) and Kilian (1993) for a description of the different funds and their functions.

[23] See the biographic essay of Wolfgang Schäuble, head of the Chancellor's Office. He presents an episode where he employed this argument to counter Waigel's assertion that the Unification Treaty

important decisions concerning the reconstruction of the East German Länder.

Moreover, a variety of informal decision making forums sprang up under Chancellor Kohl's government. One example are the "round tables" involving representatives of the parties in parliament, social groups, and the Chancellor's Office to discuss issues such as labor market policies (Czada 1994b). Ultimately, the agreements reached at these "round tables" had financial implications, which, as it seems, were often not fully considered by the participants, but which were later presented as unchangeable. The most important of these coordination circles was the "Ludewig Round Table", where governors of the new Länder or their delegates, a representative of Treuhand, and State Secretary Ludewig, acting as the representative of the Chancellor's office, discussed transition issues and policies, such as public work programs and investment subsidies. This informal circle also took definite decisions and drafted fiscally relevant laws. Among other decisions, it set the eligibility criteria for public guarantees of private debts incurred by firms in Eastern Germany (Czada 1994a:41). In addition, the contacts emerging from these meetings were often used to furnish financing strategies rescuing single enterprises in East Germany. (Czada 1994b: 257)

A third indication of the institutional deterioration is the increased "ad-hoccery" of the fiscal measures, within or outside the pre-established setting of the budget process. Particularly prevalent in the early years of the 1990s, was the Chancellor's tendency to promise financial aid to special interests and groups complaining of being particularly hurt by the transformation process. At the time, the German press was musing about the standard "Chancellor billion" that anyone complaining seemed to be able to obtain. Moreover, while German governments between 1952 and 1980 had resorted to supplementary budgets only four times, the Kohl government presented seven supplementary budgets between 1990 and 1997 (Sturm, 1998). Budget freezes and the last-minute revisions of the budget proposal in December 1994 are similar signs of weakening budget management (ibid.). These incidents show that the Kohl government's fiscal policy increasingly become one of reactive budgeting rather than a consistent budgetary strategy.

Evidently, the Kohl government did not use the opportunity of the Maastricht process to strengthen Germany's budgetary institutions, as a number of other EMU member states did (von Hagen et al., 2000). When the time of reckoning finally came in 1997, the government had resort to one-off measures and accounting adjustments to meet the very fiscal criteria it had verbally touted for so long to persuade the German public of the benefits of EMU.[24]

bears "unpredictable financial risks" (Schäuble 1993:121-122).

[24] While the European Commission recognized that 20 basis points of Germany's deficit improvement were due to one-time measures, a German institute put this number to 40 basis points. Given the official ratio of 2.7 percent, an 'honest' fiscal account would have caused a violation of the deficit criterion (DIW 1998).

VI. Conclusion

We have argued that future German governments are likely to face three, largely conflicting challenges for fiscal policy making. First, the ageing of the population probably will lead to substantial pressures for increased public spending, if no significant reforms are undertaken. Second, we consider it unlikely that future governments will be able to raise the level of public revenues significantly above the current one, and they may be even forced to lower the tax burden due to mounting competition for mobile factors with other countries. Third, they will not have the option of 'borrowing their way out of the ageing challenge' if they do not want to overtly violate the fiscal rules set in the Stability and Growth Pact. Obviously it is hard to say how governments will actually meet these challenges. If the revenue restriction actually turns out to be binding, ideally the government would lower expenditures accordingly. But instead, some 'compromise' lowering expenditures and maintaining a moderate deficit could as well be an outcome. In any case, policy-makers will have to strike a precarious balance between these different challenges and substantial reform may be necessary to avoid major mis-alignments of public finances.

Our analysis of Germany's recent experience traced the evolution of deficits and debt in Germany to detect episodes and underlying causes of such fiscal mis-alignments. We detected two crucial episodes giving rise to the existing current debt burden in Germany – the early 1970s and the 1990s after re-unification. In the early 1970s it was the willingness of policy-makers to engage in active demand management coupled with the thrust for redistribution, which produced the large deficits. The resulting rise in expenditures was then perpetuated by the willingness of further governments to extend the insurance provided by the welfare state and to cushion short-term cyclical effects through the pension system or other measures siphoning off unemployed. As similar phenomenon emerged after reunification, the main difference being that now unemployed were largely pulled into the 'secondary labour market' giving rise to substantial increase of pubic spending in the labor market. The rather short-sighted introduction of the measure was the background for a wage policy ultimately leading to the persistence of structural weaknesses in the new Laender. These structural problems, and with them the transfer dependency of the population, will still persist for a considerable period of time. Thus the first lesson to be drawn from the German case is in line with the political economy literature on fiscal reforms arguing that fiscal consolidations are more persistent when they focus on transfers and wage payments. Here we found that the opposite holds similarly: Expansions of the welfare state are hard to reverse, first, because it creates new dependent constituencies, and second, because it entails the 'temptation' for governments to use these instruments for short-term purposes.

The last point is related to the second element which our analysis has stressed. In both episodes essential policy decisions where taken outside the regular budget process, and thus the Minister of Finance had little say on how the money is spend. This is generally the case for social legislation creating

entitlements. In the German context it also holds for wage settlements. The period after reunification was marked by several factors weakening existing budget institutions: short-term institutional vacuum, creation of special funds, interventionism of the Chancellor. The short-term vacuum characterizing the immediate transition period in 1989/90 will certainly not be repeated and also the transition related special funds will not be relevant for the future. However, other weaknesses complicating fiscal policy making remain. Above all the federal structure of the state still complicates a ‘unitary’ fiscal policy since major areas of authority still rest with the Laender governments. Until now, coordination between Länder and the Federal Government is quite loose and Länder have resisted initiatives to formalize an internal stability pact (see Wendorff 2001). Moreover, although the heyday of interventionism by the Chancellor is over, it can be considered a legacy of the centralisation under the Kohl cabinet that has not yet completely vanished. Some crucial areas, such as the policy towards the new Laender as well as labor market policies remain ‘Chefsache’ in the hands of the Chancellor. By now the party leadership has again become more important in formulating policy reactions to short-term demands and push them either directly or via the Chancellor. The influence of the Chancellor as head of government as well as the ruling party can certainly be considered normal and even valuable for the democratic functioning of the government system. However, this is not to say that they should be allowed to intervene in budgetary matters through short-term policy initiatives. Here one would have to create institutional safeguards foreclosing these initiatives. In short, an important ingredient for Germany’s capacity to meat the challenges of future public finances is the revival, creation or maintenance of strong budget institutions.

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