Deutsche Bank Research

September 15, 2011

Stability Council: Financial inspector of Germany's Länder

- By October, the German Länder (federal states) of Berlin, Bremen, Saarland and Schleswig-Holstein must each table a restructuring programme for the upcoming five years setting out which measures they can use to reduce net borrowing and thus their budget deficit. Owing to their limited tax autonomy, the Länder will probably have to focus mainly on expenditure cuts.
- This will be the first time the Länder will be subject to the coordination and guidance of the Stability Council on the basis of pre-defined key ratios and standardised forecasts. The Stability Council is mandated to help ensure achievement of the target of structurally balanced budgets linked with Germany's new debt brake (from 2016 for the Federation and 2020 for the Länder).
- The toolbox for comparative analysis of the budget situation is not uncontroversial – this holds in particular for the threshold values for assessing the current budget situation. This is partly because of the statistical methods used, but presumably also because of political considerations.
- The establishment of the Stability Council is to be welcomed even though it has no scope to impose ultimate sanctions. More transparency and public pressure can have a positive impact on budget and fiscal policy. But the federal and the Länder governments will also have to do some experimenting with the system at first – further evaluations of the procedure can obviously not be ruled out. A key test will be the adoption of the restructuring programmes at the next meeting of the Stability Council in November.
- But all the cards in the deck will have to be reshuffled by 2020 anyway when the debt brake finally also comes into force at the Länder level; by the same time, both the Solidarity Pact II will have expired and a follow-up system for the existing Länder financial equalisation system will have to be established.

www.dbresearch.com

Author
Frank Zipfel
+49 69 910-31890
frank.zipfel@db.com

Editor
Barbara Böttcher

Technical Assistant
Angelika Greiner

Deutsche Bank Research
Frankfurt am Main
Germany
Internet: www.dbresearch.com
E-mail: marketing.dbr@db.com
Fax: +49 69 910-31877

Managing Director
Thomas Mayer

2010 saw the establishment of Germany's Stability Council, a joint body representing the Federation and the Länder with a mandate to avert serious budget problems. At the third meeting of the Council in late May 2011 it wasted no time in formally determining the existence of a looming budgetary emergency in the four Länder of Berlin, Bremen, Saarland und Schleswig-Holstein. These four states have until mid-October to devise five-year restructuring programmes mapping out how they intend to eliminate their budget imbalances. What does this mean for federal and Länder fiscal policy in practice? And how is this to be viewed against the backdrop of the new debt brakes to be installed as of 2016 and 2020, respectively? How does this approach to more sustainable financial planning and greater coordination compare with efforts at the EU level?

Abbreviations

BE	Berlin
BY	Bavaria
HB	Bremen
SH	Schleswig-Holstein
SL	Saarland
SN	Saxony
A.L.	West German Länder
N.L.	East German Länder
Länder avg.	Länder average

Apart from loose agreements in the Financial Planning Council there had in principle not been any closer coordination between the Länder themselves nor between the Länder and the Federation – let alone any type of preventive instrument potentially enabling timely remedial action in the event of budget imbalances or resultant debt accumulation – until Germany implemented its second federalism reform in 2009. The existing arrangements – besides the Financial Planning Council this refers in particular to the “old” investment-oriented debt ceiling set out in Article 115 of the Basic Law (Constitution) – ultimately had even less of an impact than the limits of the EU's Stability and Growth Pact. It now looks as if the new debt brake and the Stability Council of the Federation and the Länder will trigger a number of changes in terms of preventive and sustainable budget conduct. However, the “proof of the pudding” will probably not come until the Stability Council has ruled on the restructuring programmes and there is evidence of the degree of compliance with them and whether they lead to successful outcomes. At the end of the day, the Stability Council has no scope for ultimate direct sanctions.

How does the Stability Council function?

Stability Council: Mandated to monitor budgets and avert budgetary emergencies

As a joint body of the Federation and the Länder the Stability Council is mandated to monitor their budgets and avert serious budget problems. It is composed of the Länder finance ministers and the federal finance and economics ministers. For its resolutions to be adopted it requires the votes of 2/3 of the Länder (that is 11 Länder) and the votes of the Federation.[1.] In the case of decisions which pertain to one single state, this member is not allowed to participate in the vote. The Stability Council convenes at least twice a year (usually in May and October). It makes decisions regarding both looming budgetary emergencies and potential restructuring programmes. Furthermore, the Council discusses the progress reports on the “Aufbau Ost” reconstruction programme in the east German Länder and monitors whether the five states receiving consolidation aid actually seek to fulfil the obligations imposed upon them. All in all, the Council is considered to be the coordinator of budgetary and financial planning also with regard to the potential obligations that may arise from the Stability and Growth Pact.

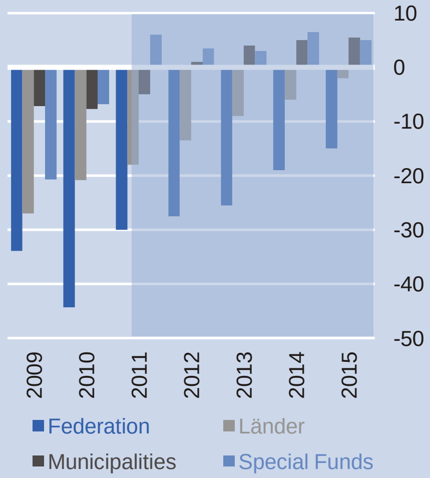
Working group advises on budgetary and financial planning of total public sector and conducts preparatory work

The groundwork for the Council’s meetings is carried out by a working group. One of its most important tasks is to provide advice on budget and financial planning. In future, such a meeting is to take place regularly every July (see graph on page 3). In November, projections of the total public-sector budget are updated on the basis of the official tax estimate prepared by the Working Party on Tax Revenue Forecasting (an advisory council at the Federal Ministry of Finance) and tabled with a breakdown by level of government. Only in cases where a looming budgetary emergency is assessed and “sanctioned” is a so-called evaluation committee set up in a separate capacity – more or less as a third body. As the process continues, this committee prepares the resolutions of the Stability Council. For one thing it starts by ascertaining whether a restructuring programme is necessary. If the Stability Council decides that this is so, the evaluation committee assists in devising such a programme and monitoring its observation. However, decisions are met solely by the Stability Council.

Evaluation committee mainly monitors restructuring procedure

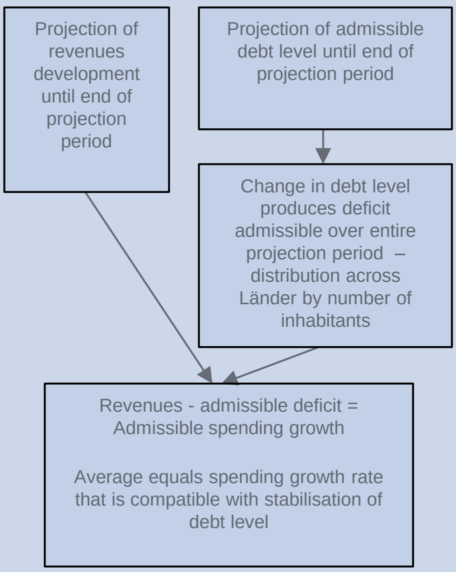
[1] For more (in German) on the following section please refer to Stability Council (2010a), Stability Council (2010b) as well as the Stabilitätsratsgesetz and the Konsolidierungshilfegesetz (Stability Council Act, Consolidation Aid Act).

Decreasing deficits estimated
EUR bn



Sources: Stability Council, DB Research

The standard projection of medium-term financial planning



Budgetary emergency and restructuring programmes – how is the budget situation reviewed?

The basis for the review of the budget situation is the stability reports that have to be submitted annually by the Federation and the Länder (usually by September at the latest in the run-up to the October meeting). In accordance with Section 3 (2) of the Stability Council Act these reports must in principle pay heed to two components of budget supervision: one is the ***monitoring*** of ***the current and short-term budget situation*** and the other is the (***projected***) ***medium-term budget development***. A state or the Federation is said to face a budgetary emergency if the pre-defined limits (threshold values) for one of the two components are not observed.

As regards the monitoring of the current and short-term budget development the Stability Council agreed at its constituent meeting in April 2010 to track four key ratios in particular: the structural financial balance, the credit financing ratio, the debt level per capita and the ratio of interest expense to tax revenue. The observation and assessment period invariably covers seven years and is broken down into two subperiods. One of these is the *current budget situation* ("actual" record of the preceding two years and the "target value" of the current year) and the other is the *financial planning period* ("target/draft value" of the following year and the items of financial planning, i.e. the four following years altogether).[2]

Assessments of the current and short-term budget development are geared to what are known as threshold values. For the Länder, at least, the related benchmark for comparison is the Länder averages (plus certain supplements) of the key ratios in the respective fiscal year and thus not absolute values. A budgetary emergency is only said to be looming if the threshold values of at least three key ratios in at least one subperiod are breached. Moreover, a key ratio is said to "ring alarm bells" as soon as the threshold value in at least two fiscal years is overstepped.[3]

Besides these four key ratios the stability reports also contain – as already discussed – a *projection of the medium-term budget development on the basis of uniform assumptions*. This is to focus on the future course of development and it extends beyond the financial planning period – covering a span of seven years.[4]

[2] This means that in the 2010 stability report of October 2010 the current budget situation was covered by the actual values for 2008 and 2009 and the target value for 2010, while the financial planning period was covered by the draft for 2011 and the financial planning for 2012 through 2014.
[3] See Overview on p. 4. Current and short-term financial planning.
[4] For more on this matter see BMF (2011) and Stability Council (2010a).

Monitoring of current and short-term budget development

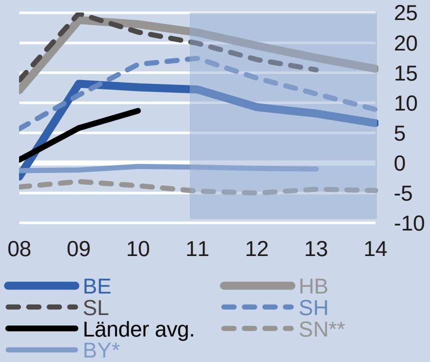
Key ratio	Explanation	Point at which threshold value is exceeded: Länder		Federation	
		Current budget situation	*Financial planning period*	*Current budget situation*	*Financial planning period*
Structural financial balance per inhabitant	The structural financial balance is the difference between revenues and expenditures adjusted for cyclical factors and financial transactions; a final decision on the cyclical adjustment procedure is still pending. An auxiliary adjustment procedure has been in use so far via a Länder comparison.	Financial balance per inhabitant more than 200 less favourable than the Länder average in the financial planning period	Threshold value of the current fiscal year plus supplement of EUR 100 (no supplement possible if tax estimate produces very good results)	Federation's debt reduction schedule is exceeded by EUR 50 per inhabitant	
Credit financing ratio	*Net borrowing to net expenditure*	Credit financing ratio more than 3 percentage points less favourable than the Länder average	Threshold value of the current fiscal year plus supplement of 4 percentage points (no supplement possible if tax estimate produces very good results)	Moving annual average of the Federation's credit financing ratio of the previous five years plus 8 percentage points	Threshold value of the current fiscal year
Debt level	*Debt level at Dec 31 in relation to population*	*Territorial states:* Debt level per inhabitant > 130% of Länder average *City-states:* Debt level per inhabitant > 220% of Länder average	Threshold value of the current fiscal year plus EUR 200 per inhabitant	Moving annual average of the Federation's debt level per inhabitant of the previous five years plus 8 percentage ponts	Threshold value of the current fiscal year
Interest-to-tax ratio	*Interest expense to tax revenue* Tax revenue less payments made in the Länder financial equalisation system and plus similar payments received, plus supplementary federal grants and compensation payments	*Territorial states:* Interest-to-tax ratio > 140% of Länder average *City-states:* Interest-to-tax ratio > 150% of Länder average	Threshold value of the current fiscal year plus 1 percentage point	Moving annual average of the Federation's debt level per inhabitant of the previous five years plus 8 percentage points	Threshold value of the current fiscal year

Current budget situation:	Actual values of the previous 2 years and target values of the current year	Financial planning period:	Target/Draft value of the subsequent fiscal year as well as financial planning items of the subsequent 3 years
Total period:	7 years		

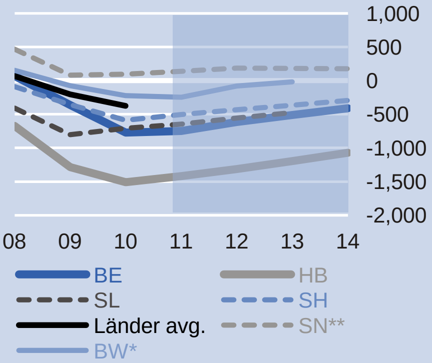
More effective budget management and coordination than before – acid test lies ahead

The procedure outlined here, consisting of an assessment of the current and short-term budget development as well as a projection for the medium term, is generally complex and not particularly transparent. It harbours various advantages and disadvantages. One advantage is that a relatively mechanistic procedure was established allowing looming budgetary emergencies to be determined largely without any latitude for political interpretation. From the Länder point of view in particular this is a new process and one that, all in all, is to be welcomed, because ultimately one aim of the Stability Council is to help the debt brake become established and function effectively also at the Länder level. A further new aspect is that the measures and procedures hammered out (though

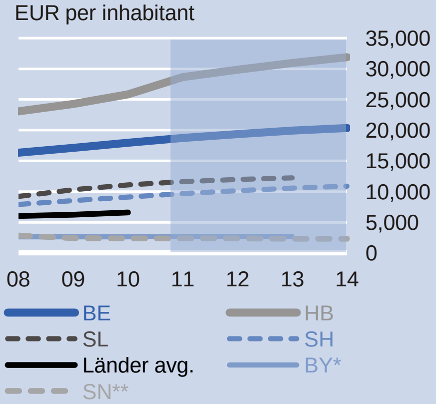
Credit financing ratio
%



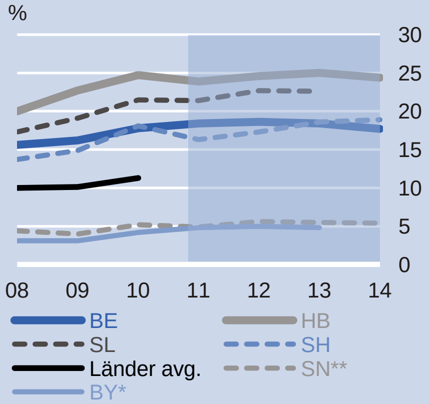
Structural financial balance
EUR per inhabitant



Debt level
EUR per inhabitant



Interest-to-tax ratio
%



*Lowest or best value in west German Länder
** Lowest or best value in east German Länder

Sources: Stability Council, DB Research

not even in the days of the Financial Planning Council did these get beyond being agreements) no longer have to be resolved unanimously and a "budget offender" is in fact barred from participating in related votes. Moreover, before the Stability Council was set up it would have been practically unthinkable that a federal state would be required to submit to a restructuring programme. All in all, this should simplify the budget policymakers' job of introducing uncomfortable and unpopular savings measures.

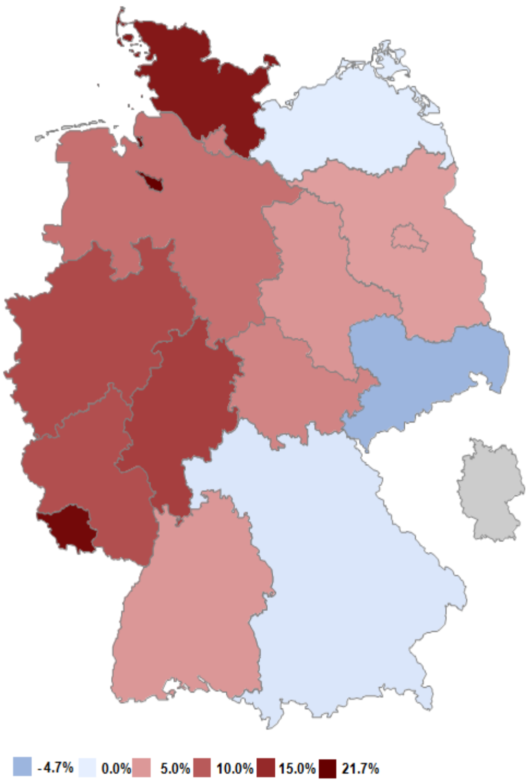
However – and this is where the biggest disadvantage is to be found – the Stability Council has no scope to impose ultimate sanctions. Once a restructuring programme or procedure has been approved it is intensively monitored by the Stability Council (the affected state is required to table a progress report every six months; if necessary, supplementary measures are to be adopted). If the restructuring procedure fails, however, it is always possible to approve yet another new programme; nonetheless, no sanction payments or similar punitive action is provided for. This means that ultimately the procedure is based on the public pressure that it can generate itself. On the other hand, however, the evaluation procedure does not automatically trigger any assistance from the Federation or the other Länder; this aid ultimately does exist indirectly though via the federal system's close financial ties (e.g. the Länder financial equalisation system). Equally, no provision is made for a certainly conceivable automatic trigger or a reverse majority (i.e. the majority of the Länder would have to decide and explain why a restructuring procedure is not necessary in spite of the data at hand).

In addition, the meaningfulness of the budget projection is limited by the multitude of assumptions made as well as by the diverse financial planning methods of the Länder – however, this is mainly due to reasons of methodology and statistics. Nonetheless, transparency about the development of individual expenditure items (or their projection) is not greeted with unrestrained enthusiasm by all politicans of the Länder either. Furthermore, the choice or exact definition of the key ratios themselves is very much the subject of controversy.[5] One good example in this context is the selection of the Länder average as a benchmark, for the deeper the Länder budgets fall into disequilibrium, the easier it becomes for the individual Land to stay within the threshold values. This suggests that the procedure is geared more towards punishing serious differences between the federal states – undesirable fiscal policies in the Länder as a group are scarcely addressed by the existing set of key ratios. Up to now, the calculation of the structural financial balance has not been in keeping with the spirit of the debt brake, since it is only a proxy value until the method has been finally established (a balance primarily adjusted for financial transactions). All in all, the choice of the key ratios leaves relatively sizeable scope for individual limits and interpretation, particularly to reflect the different starting positions of the states. This holds in particular for the projection of the medium-term development – for which the qualitative (individual) decision always comes last anyway.

The degree to which the glass seems to be half full or, rather, half empty remains to be seen. At its third meeting, in May 2011, the Stability Council acted on the proposal of the evaluation committee by making its first formal declaration of a looming budgetary emergency in four Länder (Berlin, Bremen, Saarland and Schleswig-

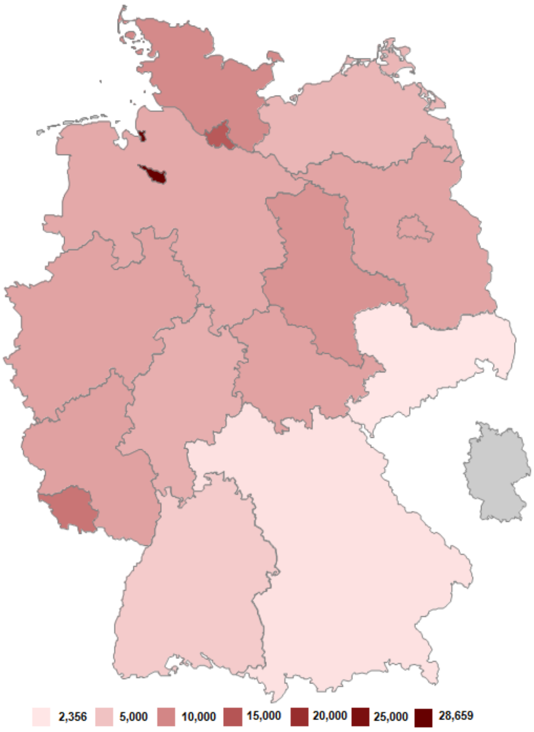
5 For a more detailed discussion see v. Deuverden and Freye (2010).

Credit financing ratio (2011)



Sources: DB Research, Stability Council

Debt level per capita (2011)
EUR per inhabitant



Sources: DB Research, Stability Council

Holstein) and compelling these Länder to devise restructuring programmes. However, the "proof of the pudding" will not come until the next meeting of the Stability Council in November, by which time Berlin, Bremen, Saarland and Schleswig-Holstein are to have tabled their restructuring programmes (deadline: October 15) and at which these are to be adopted. It then remains to be seen how extensive the measures and their impact on the budget development of these Länder may truly prove to be. During the third meeting it emerged at least tentatively that the procedure has triggered changes in the political landscape. Two Länder had – for differing reasons[6] – argued that there was no budgetary emergency on the immediate horizon; however, the Stability Council refused to accept such representations.

What could a restructuring programme look like?

Since details of how a restructuring procedure was to be carried out had not yet emerged, the Stability Council slightly elaborated on the procedure in a policy paper at its third meeting in May, even though evaluation of the restructuring procedure is to be constantly ongoing. The chief point of reference is net borrowing – it has been specified that there is to be a staggered reduction in this factor every year over a period of five years. To do so, a so-called restructuring schedule (detailing the reduction steps) has to be set up. The first stage starts in the year following agreement of the schedule. The target – i.e. the point at which the budget is deemed to be in sustainable health – for the Federation would be the structural deficit of close to zero (0.35% of GDP) dictated by the debt brake from 2016. For the Länder the target is to maintain a zero structural debt from 2020 as well as to take account of the development of the Länder average credit financing ratio – even though this last stipulation remains vague in its thrust.

Within the restructuring programme, the government is required to detail concrete measures (that can be implemented in the short term) for the following fiscal year. Above all, the measures need to show to what extent they will lead to quantifiable budget relief – less detailed measures are required initially for the remainder of the restructuring period. Thus, in principle, the restructuring programme indirectly influences the financial planning of the respective state; nonetheless, the framework legislation expressly excludes assessment of the budget structure by the Stability Council.[7] Fundamentally, measures on the expenditure side and on the income side will have equal standing in terms of consolidation potential. However, since the Stability Council Act emphasises that restructuring measures are only appropriate if they lie solely in the jurisdiction of the affected level of government, this means in practice that restructuring measures will probably focus mainly on the expenditure side owing to the limited revenue autonomy of the Länder.[8]

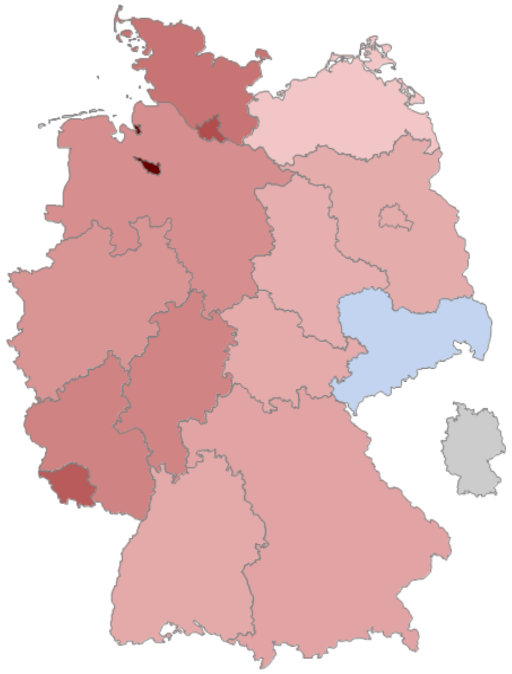
---

[6] Berlin, for example, based its argumentation on distortions caused by the booking of a special "risk protection" reserve as part of the disposal of Berliner Bank and by not factoring in extra budgets of other Länder. With the introduction of the debt brake into its constitution, Schleswig-Holstein already adopted consolidation measures to restructure the budget. While the Stability Council welcomes this measure, it does not consider it to be sufficient. The objections of both Länder were rejected. For a detailed discussion, see Stability Council (2011).

[7] For more on this matter and what follows, see Stability Council (2011), p. 3 of the policy paper.

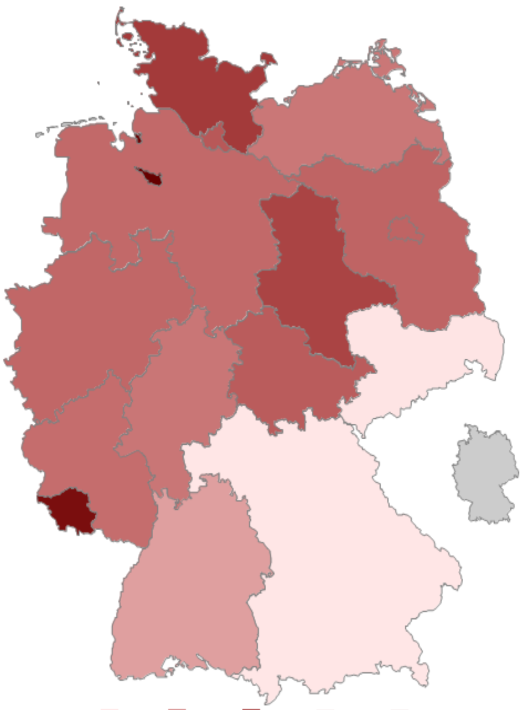
[8] The real property transfer tax imposed in several Länder is to be regarded as an exception to the rule.

Structural financial balance per capita (2011)
EUR per inhabitant



Sources: DB Research, Stability Council

Interest-to-tax ratio (2011)



Sources: DB Research, Stability Council

Even though a restructuring programme is implemented under a federal state's own direction, it must report to the Stability Council on its progress every six months (by May and October respectively, i.e. before the Stability Council's regular meetings). At this juncture a review is conducted to ascertain whether net borrowing has been reduced by the amount agreed. Every May, i.e. once a year, the Stability Council decides whether further measures are required. If the measures instigated are insufficient or if they were not implemented adequately, the Stability Council may call for the consolidation efforts to be intensified. At this point in time, however, it is still too early to see what ramifications this will have. Ultimately, this is where the lack of effective sanctions (such as fines or even, conceivably, the denial of voting rights in the Bundesrat) becomes apparent, for once the five-year period is over a new restructuring programme may be launched, but when exactly this process must end not has been specified. It is no minor issue that the mutual support between the Federation and the Länder derived from the Constitution[9] is ultimately to be seen as a sort of general limit (and thus a type of insurance against budgetary emergencies) in the face of potential financial sanctions.

Conclusion

The currently looming budgetary emergency in the four Länder comes as no surprise. After all, these Länder (and Saxony-Anhalt to boot) are already the recipients of consolidation aid totalling EUR 800 m p.a. towards lowering their structural debt before final full implementation of the debt brake has been enacted at Länder level (2020). Therefore, they have already had to tolerate stricter monitoring of their budgets. In the event that concrete restructuring plans are disregarded, they run the risk of losing this assistance. Besides, in Bremen and Saarland – but also in Berlin – persistent budget imbalances have emerged yet again. In their own stability reports, Bremen and Saarland rate their budget situation as nothing less than "extreme", even though no such rating term is to be found in the statutes of the assessment procedure.[10] Taking the values for the structural financial balance projected for the Länder in October 2010 and using them as the yardstick for budget consolidation, it emerges that except for Saxony all the Länder will have structural spending problems for years to come. However, this matter is not addressed under the existing set of regulations.

Finally, though, it has to be pointed out that despite all the problems discussed the current development is to be welcomed. For the first time ever, a preventive instrument has been established to manage and coordinate the budget and fiscal policies of the Federation and, above all, the Länder. Even though they entail no threat of ultimate sanctions semi-annual progress reports on required restructuring measures increase the pressure on affected authorities to conduct more sustainable fiscal policy. This can even help the respective state government to take uncomfortable decisions. The Länder, especially, are entering uncharted territory here (particularly in the sense of submitting to an implicit performance comparison) – in this respect, compromises and room for manoeuvre in the launch phase are understandable. The Federation and the Länder will have to do some experimenting with the system at first. Given the party

[9] Substantially, the mutual support is secured via the links of fiscal integration – e.g. the Länder financial equalisation system – and the constitutional guarantee that sufficient funds will be made available in order for duties of state to be fulfilled.

[10] See Stability Council (2011) and BMF (2011).

constellations in power there could be potentially explosive results (if, for example, in a vote the “judges” and “offenders” are of the same political hue). Moreover, the procedure will be reviewed again in a “routine check” anyway at the end of 2012. Considering that the Länder have to apply the debt brake from 2020 at the latest and allow for a planning period of seven years, this is certainly called for.

Furthermore, a new financial equalisation system has to be negotiated for the period up to 2020 – the funding from the Solidarity Pact will also have expired by then. So, from a federal fiscal standpoint, all the cards in the deck will have to be reshuffled again. In this context, preventive budget management can play a part in reducing the incentive for Länder to indulge in another generous round of largely debt-financed expenditure before 2020 in order to gain an advantage over other Länder.

Frank Zipfel (+49 69 910-31890, frank.zipfel@db.com)

References

BMF (2010). Stabilität im Bundesstaat. In Monatsbericht des BMF. May 2010, pp. 76-83.

BMF (2011). Drohende Haushaltsnotlagen in Berlin, Bremen, dem Saarland und Schleswig-Holstein. In Monatsbericht des BMF. July 2011, pp. 79-84.

Stability Council (2010a). Beschlüsse des Stabilitätsrats der 1. Sitzung vom 28. April 2010, TOP 1 (Geschäftsordnung), TOP 2 (Kennziffern zur Beurteilung der Haushaltslage), TOP 3 (Projektion mittelfristige Haushaltsentwicklung).

Stability Council (2010b). Beschlüsse des Stabilitätsrats der 2. Sitzung vom 15. Oktober 2010, TOP 2 (Einrichtung Evaluierungsausschuss).

Stability Council (2011). Beschlüsse des Stabilitätsrats der 3. Sitzung vom 23. Mai 2011, Top 2 (Feststellung Haushaltsnotlage), Top 3 (Eckpunktepapier Sanierungsverfahren), Evaluationsberichte Berlin, Bremen, Saarland und Schleswig Holstein.

Van Deuverden & Freye (2010). Schuldenbremse: Bisherige Beschlüsse stellen Schuldenbremse infrage. Pressemitteilung IWH 49/2011.

Budget management and coordination in Germany and the EU

Body		Stability Council	ECOFIN and European Commission*
Subordinate bodies		Working group and evaluation committee prepare for meetings	Economic and Financial Committee (ECOFIN) prepares for meetings
Resolution requirements		– 2/3 majority of the Länder plus 1 vote of the Federation – (No voting right for affected state)	– Qualified majority – Reverse qualified majority (in ECOFIN)
Type of budget management and monitoring		*Monitoring:* Performance comparison using key ratios with annual progress reports (stability reports). *Preventive:* Standardised projection within the reports	*Monitoring:* Member states' annual progress reports (stability and convergence programme) with criteria. *Preventive:* European semester (Commission's policy recommendations e.g. medium-term target)
Assessment criteria/monitoring		4 key ratios plus projection of spending growth rate and qualitative (individual) decision	Maastricht criteria (debt level and deficit development) as well as spending brake in cases of excessive structural deficits
Type of criteria		Relation to Länder average	Absolute limits in relation to GDP; still: monitoring of macroeconomic imbalances using certain indicators (also equipped with sanctions)
Sanction/Restructuring		If key ratios and spending growth rate are exceeded, resolution on restructuring procedure with annual reduction schedule for net borrowing and specifically agreed consolidation measures	Reduction of debt component that exceeds 60% of GDP by 1/20 of this amount per year
		No ultimate sanctions/fines	Punitive fines of 0.2% of GDP possible (to be proposed by the Commission)
Joint liability system			
	Assessment:	In principle, full liability of entire federal system for constituent parts	Since recently: de facto limited joint liability system
	Implemented via:	Federal financial relations (e.g. Länder financial equalisation system)	Transfers via EU budget (e.g. structural and cohesion funds) Bail-out mechanisms: EFSF (ESM) and EFSM ECB (Target2, SMP, ELA, liquidity operations)

*This already includes the reformed Stability and Growth Pact, which belongs to the legislative package on “economic governance” and which is currently still under negotiation between the Council and the European Parliament. The reformed Pact could be adopted in the course of the year.

Source: DB Research compilation