Current Issues

International topics

# Deutsche Bank Research

February 5, 2008

# Improving the quality of public finances – the road ahead

## A workshop report

**Over the past 25 years, many OECD countries have knocked their public finances into shape,** eliminating deficits, trimming their debt levels and improving the quality of their fiscal policies.

**So far, Germany has not secured entry into the club of successful consolidation countries.** Successes achieved here and there could not be sustained for any length of time and, most importantly, across the economic cycle.

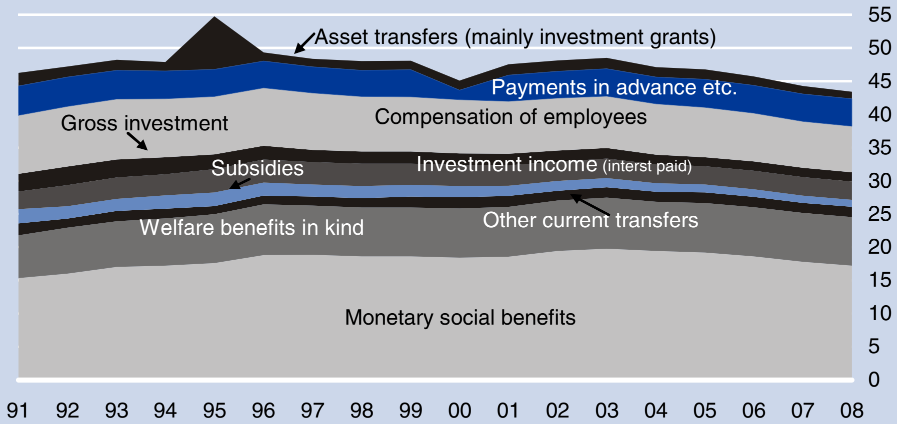
**The level and structure of expenditure need to be reviewed for their growth impact.** Better indicators and methods are needed. Excessive debt calls for further spending cuts.

**Funding of the welfare state should be reorganised.** While there is no such thing as the perfect revenue structure, more funding for public services should come from taxes. Population ageing and shrinkage make fuller funding of the welfare systems absolutely vital.

**Germany's institutional fiscal policy framework needs overhauling.** Circumspect planning and more centralised management by government and parliament are the most pressing issues.

*Featuring an article, by invitation, from Dr. Christian Kastrop of the Federal Ministry of Finance on the **Quality of public finances – a comprehensive fiscal policy strategy for the future.***

**Government spending in Germany**
in % of GDP




Source: DIW

www.dbresearch.com

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# Introduction

**Scant reliable knowledge on fiscal consolidation**

Even though the task of restoring fiscal balance in public budgets and making public finances conducive to growth was by no means new, up to the mid-1990s practically no resilient game plans or reliable knowledge on how to do so existed in either political or academic circles. Since then, scientific studies have been published mapping out at least the basics of successful consolidation policy. And since that time governments and parliaments of quite different political stripe have made efforts in both good and bad times to bring public finances into line, often with quite respectable results. The Council of Ministers[1] and European Commission also addressed the issue with reform of the Stability and Growth Pact. Moreover, the European Union is currently putting in place the statistical pre-requisites for meaningful economic classification of government activity that will make more nuanced empirical analysis possible in the first place.

**Fresh insights now available**

In March 2007, Deutsche Bank Research and the Federal Ministry of Finance hosted a workshop with experts from a variety of different institutions on improving the quality of fiscal consolidation. This essay on the fundamental issues is based on the contributions and discussions at that event, which are documented on our website (http://www.dbresearch.com). However, we bear sole responsibility for the presentation and accentuation of the contents in this paper.

## What do we know about fiscal consolidation?

**Conditions for successful consolidation**

Since the first series of papers by the researchers Alberto Alesina and Roberto Perotti[2] and subsequent studies[3] on the issues raised in them, research has come up with some solid findings on the outlook for success, the importance of revenues and expenditure in fiscal adjustment, the baseline conditions and the political institutional framework conditions for the consolidation of government finances in established OECD countries.

**Comprehensive reforms, spending cuts and institutional changes point the way**

Experience shows that governments and parliaments are particularly successful in bringing public budgets into line when they submit a comprehensive, ambitious programme, focus on spending cutbacks and at the same time address institutional reform of government activity in general and fiscal policy in particular. As a rule such bold political approaches garner greater public support than half-hearted measures, particularly since the chances of the economy's growing robustly notwithstanding consolidation are surprisingly good.

### *There are spending cuts and spending cuts…*

**Welfare benefits are trimmed...**

Normally, in successful cases government transfers to households and the corporate sector (subsidies) are reduced and a particularly tight reign placed on welfare spending. The education system is typically spared, for which there are good reasons: improving the working population's average level of education is arguably one of the major determinants of growth, and social spending on education is closely related to this.[4]

Interestingly, countries with rather more social-democratic leanings have done well in coming to grips with serious budget deficits in the

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1 ECOFIN (2005).
2 Alesina and Perotti (1995a, b, c).
3 Wagschal (2006), Hauptmeier, Heipertz, Schuknecht (2006), Schuknecht and Tanzi (2005), Afonso, Ebert, Schuknecht and Thöne (2005), Perotti (2004) and Tanzi and Schuknecht (2000) provide a good overview.
4 See in particular Afonso et al. (2005), Bergheim (2005a, b).

**... but spending on education spared**

medium term and remaining politically successful despite slashing social transfers.[5] Wagschal argues that stemming the tide of welfare and health expenditure – significant budget items – as well as general administrative expenses over roughly a decade determines the success or failure of consolidation. The welfare states of Northern Europe, which are typically funded very heavily by taxation rather than contributions, were thus better able to reduce their spending than the contribution-based mainland European Bismarckian-style welfare states. Where retirement provision, the health service and even labour market policy operate within their own self-contained financial regimes and citizens have a vested right to benefits, it is more difficult to implement adjustments.

**Tax-funded welfare states better able to consolidate**

**Switching to indirect taxation is typical**

Spending cuts are frequently also made in the government payroll, i.e. reductions in staff and pay restraint, along with reductions in the defence budget. To a certain extent tax increases also regularly form part of the austerity package, whereas social contributions should ideally not be raised. Structural shifts in the tax system that boost the relative importance of sales taxes over income taxes are definitely helpful. Really incisive reforms do not stop at the public budgets, though; instead, they set the scene for more growth in social policy, on the jobs market, in the corporate sector (privatisation) and in other political spheres.

**Institutional reforms needed to strengthen central management**

Successful reform countries additionally implement institutional reforms from among a whole spectrum of possible measures: crucial is an overhaul of budgetary procedures tailored to the country and its fiscal situation, more heavily centralised top-down management of the budget process, as a rule by the premier and the finance minister, more binding multi-year fiscal planning, and public administration reforms. Occasionally, constitutional amendments are also made, new budget regulations introduced or economic forecasting – which is important for medium-term budget planning – delegated to an independent research facility to limit the danger of the forecast becoming politically tinged.

### *Economic risks manageable*

**Economy generally suffers little**

Nowadays – in contrast to even ten years ago and having grown replete with experience – we also take a more relaxed view of the risks to economic activity from comprehensive consolidation packages. Experience in some countries has shown that, particularly when the bar is set very high and the measures taken very tough, there is likely to be an improvement in the production and labour market situation and subsequently also in the social security systems, and yet it still seems possible to achieve important socio-political goals. Such a change of direction is also acknowledged by the public and on the financial markets – in the ratings for public-sector debt, for example.

The studies by Schuknecht and his colleagues show that whole-scale reforms lowering the government spending ratio by 10 percent in seven years and correcting deficits have worked very well for the macroeconomy.[6] Aside from the purely fiscal dimensions, the gradual supply-side improvement in the wake of falling contributions and taxes on labour income and a moderate development in unit wage costs often helped with these reforms. Comparatively, it has also emerged that the countries which changed course in the first major period of budgetary reform at the beginning of the 1980s have

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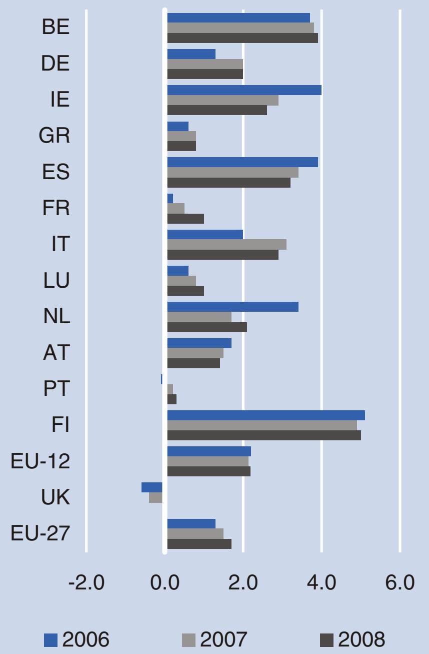
5 See Henriksson (2007) on Sweden's experience.
6 Particulars from Schuknecht, presentation at the workshop.

**Primary spending ratios**
% of GDP




Source: European Commission 1

greater economic progress to show for their pains than countries that embarked on reform a decade later. This is partly because it takes many years for positive supply effects to unfold.

In terms of social indicators, too, the effects triggered were not unequivocally deleterious; indeed, the improved economic situation shortly after the onset of consolidation policies often tended to be accompanied by a slight improvement in such readings. This may be partly because cuts in the social budget can typically be made in transfer payments without demonstrably impinging on the goals of avoiding poverty or preventing collectively hedged risks from being shifted back to the individual on an excessive scale. That said, there is no denying that, at least for a transitional period, people on transfer incomes and public-sector workers did as a rule see their incomes shrink and were obliged to bear the burden of adjustment. In contrast, wealthy individuals, who make an above-average contribution to the tax take, were seldom burdened with tax increases. And we still know too little about income distribution, although there is much to suggest that technological progress, the altered working environment and the international division of labour are driving the growing inequality in income distribution in the OECD countries more powerfully than the corrections that have been made in the system of taxation and transfer payments in the course of budget consolidation.[7]

***The faster the speed, the greater the success***

**Resolute, rapid reform pays off**

Meanwhile, countries that started off more slowly out of misplaced concern about political overdrive did not achieve their fiscal objectives any better, nor were they able rapidly to refloat their economies. Indeed, their debt-to-GDP ratios were lowered hardly at all, they relapsed more frequently into deficits that could not be explained cyclically, and the positive impacts on confidence that can result from an overhaul of public finances were either slow to materialise or proved fleeting.

**Signs of a common fiscal focus in the OECD**

On balance, the big OECD countries' fiscal policies are arguably now closer in line than before, as some of the countries with originally high debt-to-GDP ratios, spending levels and deficits have moved towards the centre, while some of the countries with very low government shares have seen slight increases, notably the United Kingdom under premiers Blair and Brown. This also makes it easier to gear fiscal policy more strongly to qualitative management concepts for public finances inasmuch as a political answer needs to be found to the question of which tasks in highly sophisticated services economies really do have to be dealt with by the state, through state expenditure and revenues, and how growth, employment and distribution goals can be promoted fiscally.

## Budget consolidation in Germany

**No major budget crisis in Germany, but no sustained consolidation successes either**

In most comparative analyses Germany is not one of the countries whose fiscal policy exhibits clearly definable periods of consolidation or successful budget overhauls. Its recent achievements have not yet been subjected to academic scrutiny. While Germany, too, has seen some notable budget deficits since 1967, peaking in 1975 at around eight percent of GDP, it has not experienced any fiscal disasters with double-digit deficits. But nor have there been any economic and fiscal periods hallmarked by rigorous consolidation. Although the latter part of the social-liberal coalition government was

[7] Bräuninger (2007).

arguably dominated in the years 1980-1982 by budget issues, the government was only ostensibly brought down by disagreement over consolidation policies. What ultimately led to its demise were fundamental differences of opinion over the direction that social, economic and fiscal policies should take and the conflict between fiscal and monetary policy as a whole.[8]

***Consolidation only one of various goals***

**Some successes in the late 1980s**

**German unification and growth bite**

The four administrations under Chancellor Helmut Kohl pursued consolidation rather sporadically, and although the government spending ratio was brought down in the second half of the 1980s, the level of debt continued to rise. Then, with German unification, the debt-to-GDP ratio also started to climb again. The change of course targeted under finance minister Hans Eichel was brought to nothing by the macroeconomic shocks post-2000, markedly anaemic growth and the attendant cyclical slumps in revenue for Germany. Only now that economic activity has picked up again Germany was able to balance its budget for 2007.[9]

**SPD-Green government's structural reforms of long-term budgetary significance**

Nonetheless, it can at least be said that the economically weak years (2001-2005) disciplined spending behaviour by the federal states and municipalities in particular.[10] The SPD-Green government also cut spending on education, internal security, administration and defence and reduced subsidies. Added to this were very substantial privatisation proceeds. However, Germany has a particularly high social budget by international standards, and it is there that the greatest consolidation risks have traditionally lain. Consequently, the 2001 overhaul of the pension system and the 2003 labour market reforms were of considerable implicit significance for budgetary policy, with both reducing people's short- and long-term entitlement to benefits and hence slowing spending momentum. The medium-term fiscal upside of both reform projects is currently becoming apparent – but an array of expenditure-boosting measures and the failure to implement adequate reform of the healthcare and long-term care system are already putting them at risk again in 2008.[11]

**Poor institutional framework**

**Germany's institutions should be strengthened by:**

**– output-based policy making**

**– greater budget control by parliament**

Germany's consolidation policy evidently lacks important pre-requisites that other successful countries exhibit. These include the institutional foundation for greater central management of fiscal policy by the Ministry of Finance and the Budget Committee with permanent support from government and parliament leaders, output-based management of specific policy measures rather than many ministries' input focus (with annual budget appropriation + inflation adjustment as the rule of thumb), medium-term fiscal planning with binding effect on the federal and Länder governments, stronger budget control mechanisms for parliament, and public-sector accounting that says more about the economics. Only now that a "grand coalition" government is in power does there seem to be a real possibility of cross-party agreement on the need for this kind of budgetary policy. Interestingly, in Germany even the government's "self commitment" to the requirements of EU legislation in the shape of the Stability and Growth Pact has hardly worked as a political strategy. Otherwise, why would Germany repeatedly have failed to comply with the Pact? Article 115 of the German Basic Law and similar regulations in the constitutions of the Länder have proved equally useless: Ketterer and Groneck

8 Scharpf (1987), pp. 185-198.
9 See Wagschal (2006), Chap. 6; Zohlnhöfer (2001), Egle (2003).
10 Deutsche Bundesbank (2006).
11 Böttcher and Deutsch (2007).

**Federal budget planning 2008 to 2011**

| | Actual 2006 | Target 2007 | Proposed 2008 | Fiscal projections | | |
|---|---|---|---|---|---|---|
| | | | | 2009 | 2010 | 2011 |
| | | | in EUR bn | | | |
| **Expenditure** | 261.0 | 272.3 | 283.2 | 285.5 | 288.5 | 289.7 |
| Change, % yoy | | 4.3 | 4.0 | 0.8 | 1.1 | 0.4 |
| **Revenues** | 261.0 | 272.3 | 283.2 | 285.5 | 288.5 | 289.7 |
| Tax receipts | 203.9 | 231.7 | 238.0 | 247.9 | 252.6 | 260.3 |
| Other revenue | 29.2 | 26.2 | 33.3 | 27.1 | 30.0 | 29.4 |
| Net borrowing | 27.9 | 14.4 | 11.9 | 10.5 | 6.0 | - |
| Memo item | | | | | | |
| **Capital expenditure** | 22.7 | 26.1 | 24.7 | 24.1 | 24.1 | 23.7 |

Source: Federal Ministry of Finance 2

calculate that between 2000 and 2005 alone they were overstepped 27 times.[12] Given these patent structural shortcomings, securing the present consolidation of the budget – the first since 1967 – by underpinning it institutionally and politically and adding qualitative control elements in various areas is a pressing political task.

## More public expenditure to be directed to enhance growth and sustainability

The remarkable progress Germany has made since 2006 in sorting out its public finances stems in the main from cyclically-induced additional tax receipts and swingeing tax increases at the beginning of 2007. So far, consolidation policy has concentrated on the revenue side and on quantitative aspects. Going forward, greater attention should be paid to the quality of revenues and expenditure. Better-quality fiscal policy is geared to ensuring that government revenues are not achieved at the expense of growth and, at the same time, that public spending promotes growth.

### *Classification of capital expenditure a major problem on the expenditure side*

**Quality of expenditure is an ongoing task**

On the expenditure side higher-quality fiscal policy must address the important challenges of globalisation and demographic development. It should also prevent quantitative consolidation measures from severely hitting areas of spending designed to promote growth, which can happen either because too little resistance is mounted against budget cuts in these areas or because, for reasons of fairness, the intention is to make reductions equally across all categories of expenditure. In fact, the aim must be to create additional scope for public spending that will drive growth and sustainability.

A key problem consists of identifying the categories of spending that are particularly relevant to growth. There are two main thrusts here:

**Growth impact and productivity of expenditure are core issues**

— First, the structure and level of public spending must be examined for their growth impact. Quality-based public spending policies need suitable indicators and tools to measure this. In other words, they are dealing with a problem of diagnosis.

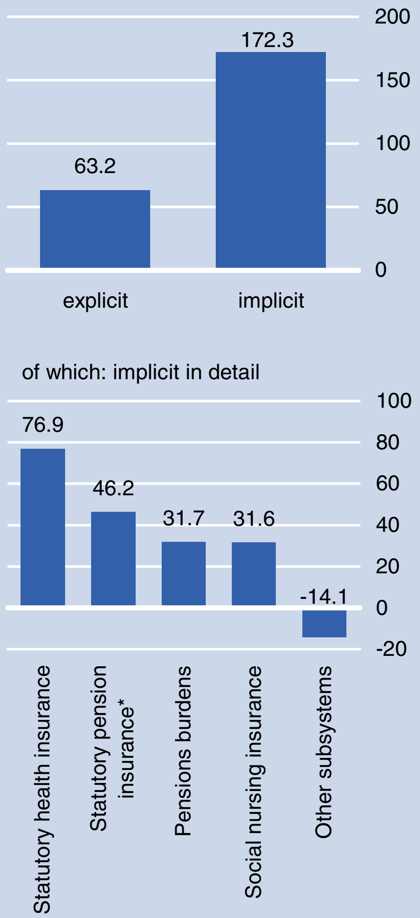
— Second, efficiency reserves need to be leveraged in the government sector by restructuring or redirecting public expenditure. In economic terms, this implies raising productivity levels in the

[12] Ketterer and Groneck (2006) and the German Council of Economic Experts (2006).

delivery of public services and hence boosting potential growth. Politically speaking, priority must then be given to the approval of public expenditure geared to growth.

With regard to the effects of public spending on growth, a distinction is traditionally made between current government consumption expenditure (on, say, the compensation of government employees) and capital expenditure geared to the future (on infrastructural projects such as transport, utility supply and communications systems). Government consumption spending is frequently generalised as unproductive, whereas public capital expenditure is regularly labelled as growth-enhancing investment in the future. When assessing the growth effects of public spending, however, this simplistic approach needs reexamining. There are some kinds of public spending that, while reported as capital expenditure, do not count as productive investment in the economic sense. Empirical surveys show that substantial growth effects can normally be expected only from infrastructure investment. But over the past 25 years this has accounted for a mere quarter to a third of total government investment.[13]

**Explicit and implicit debt ratios in Germany**
2004, in %




* including raising the statutory retirement age to 67

Source: Stiftung Marktwirtschaft 3

Ultimately, the simple equation "more public investment equals more growth" has been undermined in Germany by the very broad interpretation of the debt rule in Article 115 of the Basic Law.[14] Although the rule stipulates that net new borrowing by the Federal government must not exceed public investment expenditure, in many years the government has departed from this principle – most recently in each of the years from 2002 to 2006 –, taking as its justification the disturbance in macroeconomic equilibrium. Public spending and public debt rose, but in most cases growth remained anaemic. A problem here is the relatively broad definition of public investment.

But even with narrower definitions of investment, an economically productive effect cannot automatically be taken as a given. We see this with public fixed investment, for example. Even capital expenditure on the infrastructure calls for a more nuanced view. Empirical research shows that as a rule it does indeed trigger growth impetus; but especially in infrastructurally well-endowed economies, the law of diminishing marginal utility frequently holds: Whereas maintenance of the infrastructure yields good economic returns, the situation is far more critical with regard to new investment.[15] So simply focusing on public investment falls short of the mark.

### *Some government consumption enhances growth*

**Spending on education and research tends to foster growth**

On the other hand, there is a whole raft of expenditure related to government consumption which, according to modern growth theory, does far more for growth than previously assumed. In the theory and practice of fiscal policy attention is pointed to expenditure for education and research and development (R&D). In an era of globalisation public human capital investment in manpower development and training is becoming increasingly important for productivity and growth. Particularly in countries such as Germany with foreseeable demographic problems and an increasing scarcity of skilled labour, it is more necessary than ever to make use of all talents and to calibrate public education expenditure and systems accordingly. Government spending on education can also help make

13 Thöne (2004).
14 Deutsche Bundesbank (2007).
15 Thöne (2005).

**Reform of German budget legislation**

**Gearing to economic strength (GDP)**

| Regulatory situation (Maastricht) | Under debate |
|---|---|
| Max. debt level: 60% of GDP Max. deficit: 3% of GDP Aim of a balanced budget across the economic cycle (reduction of new borrowing in boom periods by 0.5% of GDP) | Max. general government borrowing: 0.5% of GDP; extensions of this borrowing limit to the budgets of the states. Obligation to repay the debt through a cyclical equalisation account. |
| Sanctions of up to 0.5% of GDP in the event of failure to comply over a period of several years | No sanctions envisaged |

**Gearing to definition of investment**

| Regulatory situation (Art. 109 and 115 of the Basic Law) | Under debate |
|---|---|
| Borrowing cap equivalent to the level of public investment | Definition of net investment ("Increase in value for the future") |
| Derogation to avert macroeconomic imbalance | Excluding privatisation proceeds, industrial assets, warranties and subsidies |

people more capable of lifelong learning and secure their long-term employability.

As far as implementing innovations in products and production processes is concerned, it is chiefly up to the business community to keep investing in R&D and to develop new technologies and transform them swiftly into marketable products. Nonetheless, public R&D spending can also play a very important part in making Germany more competitive when companies baulk at investments in R&D in view of the high volumes and risks involved. Of course, this comes with the proviso that public R&D spending acts as a complement to rather than a substitute for private-sector investment in R&D.

### *How does the EU treat the quality of government spending?*

In the EU the idea of the quality and sustainability of the Member States' public finances has been enshrined since 2000 in the Broad Economic Policy Guidelines. These require that emphasis be placed on the quality of public spending. A review of its sustainability by the Commission and Council forms an integral part of multilateral monitoring of fiscal policy within the EU. The debt level is taken as the main benchmark of sustainability. A Member State's budgetary position is deemed permanently sustainable if the level of public debt (see Chart no. 3) remains below the Maastricht mark of 60% of GDP in the long run. At present 10 of the 27 EU states fail to comply with this criterion on the basis of their officially reported public debt. But a snapshot of debt levels for 2007 says little about the long-term sustainability of the budgetary situation. Most importantly, there is no information on governments' implicit liabilities. The European Commission delivers an opening platform as far as demographic burdens are concerned by estimating the increase in public spending as a result of population ageing (general government, given no change in policy) at 3-9% of GDP up to 2050. Germany makes a comparatively good showing here at not quite 4%, in comparison, say, to Spain's "extreme reading" of 9.5%.[16] Although the EU has given high priority to the sustainability of fiscal policy for some time now and calculates sustainability indicators, there are still many unresolved issues in terms of the impact of public expenditure on growth.

### *What tasks does the government have in Germany?*

The fundamental problem of which tasks the state should take on and which public services it should provide appears in a new light in the context of the quality of public spending both in the EU and at the national level. There are more questions than answers here. How do government and parliament handle qualitative aspects of public spending? How can higher-quality public expenditure be enshrined in the political process? How can the quality of government expenditure be institutionally controlled and safeguarded?

**New borrowing rule needed**

The gross investment structure in the Basic Law having proved inadequate, the question of a new borrowing rule arises. A national solution needs to be found in the current debate on the second instalment of federalism reform. This should be clear, transparent and "Europe-proof", with the reformed European Stability and Growth Pact (SGP) serving as a perfectly good model (see box on the reform of German budget legislation). The SGP calls for national rules on borrowing limits to underpin consolidation successes

[16] European Commission (2005).

politically on a permanent basis. Germany should, for example, take seriously the objective of the reformed SGP to run budget surpluses in good periods of the economic cycle. These are necessary so that in a downswing the automatic fiscal stabilisers can work via budget deficits without causing public debt to swell further over the cycle.

***What contribution does and should the scientific community make?***

**Measuring growth and sustainability effects is problematic**

Politicians need the help of economic scientists to measure the effects of public spending on growth and sustainability. Given the considerable shortcomings attaching to the traditional yardstick of public-sector investment, further research must seek to devise other, more efficient diagnostic tools for public spending with a positive impact on growth.

**PEGS as one budgetary approach**

Moves are already being made in this direction, as indicated by the analysis of Public Expenditure for Growth and Sustainable Development ("PEGS analysis"). For this, a PEGS budget is drawn up using total growth- and sustainability-enhancing public expenditure, which is generally empirically confirmed, instead of public investment. Besides spending on the infrastructure (transport and telecommunications), the PEGS budget also captures a raft of functional categories of expenditure such as investment in education (nursery schools, schools and universities including support for scholars), extra-university R&D, family policy (including child allowance and maternity protection), the healthcare system etc. Model calculations of a PEGS budget for the Federal budget and the consolidated general government budget from 1975 to 1995 reveal that the shares of PEGS in GDP show a similar trend development to public investment.

**PEGS budget as analytical component**

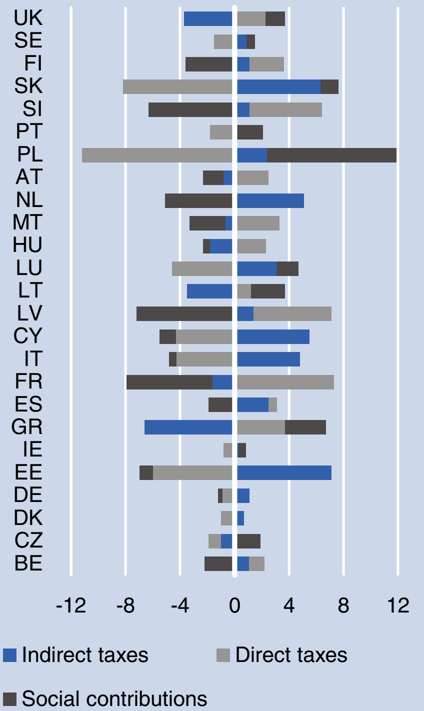
However, from 1996 the PEGS analysis suffers from conversion of the child allowance system from an item of government expenditure for sustainable development to a waiver of tax receipts. This structural break makes long-term intertemporal comparison practically impossible. As a result the PEGS approach has two (methodological) disadvantages in common with the public investment concept: the fixation on direct expenditure and the focus on input, which disregards efficiency aspects. This means that the PEGS budget is not the ultimate DNA for government spending stimulating growth and sustainable development, but at best an analytical component.

**No clear and objective criteria developed so far**

Research so far shows that no unambiguous and objective criteria have yet been developed in the relevant literature to determine better-quality categories of expenditure or to capture their impact on growth and the sustainability of government finances. Metaphorically speaking, we do not yet have a cookbook that will show us how to produce more growth from the ingredients in the various "high-quality" spending categories. To date, economic research has done no more than deliver some major ingredients, but we are still waiting for a recipe.[17] It is here that future research must begin its search for higher-quality fiscal spending policies. It is difficult to identify a clear direction. However, two aspects must move centre stage in future analysis. More attention should be paid to output/performance orientation in public spending and to improving productivity in the public sector. In this context greater use of cost-benefit analyses and comparisons of fiscal instruments should also be considered.

[17] Afonso et al. 2005.

**Change in the structure of spending in the EU 25**
Change in shares of total revenues in percentage points




Sources: Eurostat, European Commission 4

## Structure and quality of public revenues: concepts and possible indicators

In principle, public finances can be consolidated on both the expenditure and revenue side. However, the consensus is that the focus should be placed on spending. Even so, it is also a good idea to scrutinise receipts to see what specific amount of expenditure is best funded by what revenue type or structure. In terms of successful consolidation, this is equivalent to asking whether an ideal government revenue structure exists for this purpose or whether a certain structure increases the likelihood of consolidation being successful.

Making any hard and fast statement on this is problematic because the tax and contribution regimes in the various countries differ considerably and are also undergoing substantial change. In Denmark, for instance, the share of social contributions is extremely low since most welfare expenditure is financed by taxes. Poland, on the other hand, has ratcheted up its social spending over the past ten years and lowered the proportion of direct taxation in return. This makes it difficult to pinpoint a common thread towards a specific revenue structure.

### *A degree of convergence in tax structures in the EU*

But with regard to the EU it can be said that on average across the EU 25 there has been a slight increase in the share of indirect taxation in total revenues since 1995 and a decline in that of direct taxes and social security contributions. In 2005 the share of indirect taxation averaged 38%, against 32% for direct taxes and 30% for social contributions. The standard deviation in the different proportions is distinctly smaller with indirect taxes, suggesting that the member states have converged most in this respect. This is hardly surprising given that indirect taxation is subject to a wide range of European harmonisation regulations.

**Purely revenue increases not successful**

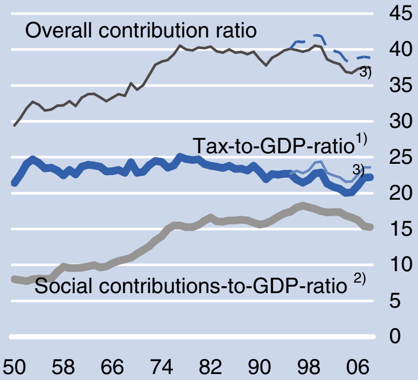
**No uniform pattern for revenue structures**

Analysis of successful consolidations has shown that there is indeed more than one way to produce the desired outcome. In many countries moderate upticks in contribution ratios, and hence higher government revenues, have helped revitalise public finances over the longer term. But in some cases countries have achieved the same effect by reducing their contribution ratios and stimulating growth that way.[18] However, pure-play revenue hikes did not work, as illustrated by Ireland in the 1980s. The picture is very mixed on the individual types of tax, though. There is hardly any similarity in revenue structure patterns in countries that have successfully put their finances in order, making it impossible to say whether a specific structure increases the likelihood of successful consolidation. But as far as the political implementation of reform is concerned, we can at least identify some instruments used more often by countries that have set their finances to rights.[19] In some cases the proceeds from the sell-off of government assets were used and, to encourage acceptance for austerity measures, taxes on top earners put up even though this did not generate any substantial revenues. A number of countries also introduced or raised ecotaxes.

What lessons can we learn from this for the situation in Germany? As already explained, there is no such thing as the ideal revenue structure. The ratio of direct to indirect taxes has changed

[18] See, for example, Wagschal (2006), pp. 31ff.
[19] See Wagschal (2006), pp. 147ff.

**Overall tax- and social contributions ratio**
1950 to 2008* in % of GDP




* 2006 und 2007 estimated. 1) Tax revenues in % of GDP. 2) Social security contributions in % of GDP. 3) Including child allowance (as from 1996 child allowance is offset against wage tax).

Source: DIW 5

repeatedly over time in Germany. In 1950 it was 50:50, in 1977 it was tilted towards direct taxes (63 to 37), and in 2006 the two were almost in balance again. Up to 2011 the Federal economics ministry predicts a growing emphasis on indirect taxes (52.5%). International tax competition is likely to drive taxes on consumption up further around the globe as the assessment basis is far less mobile than for factor incomes.

The most problematic aspect is the high burden of social contributions, with Germany top of the EU 25. Analysing the development in tax revenues and social security contributions as a percentage of GDP in Germany, we find that the former rose until World War II but has remained almost constant since 1945, while the latter climbed steadily up to the end of the 1990s.

### *Social security systems complicate consolidation*

Consolidation does only refer to the federal budget and the budgets of the states and municipalities; it must also include the financial situation of the social security systems. The question here is how these are funded because, unlike tax-financed systems, social contributions confer vested rights, or entitlements, on the contributors. What is more, in the state pension scheme these depend on the contributions paid in. As a result cutbacks that may be necessary as part of swingeing reforms to place public finances on a sustainable basis are incomparably more difficult to push through. The same holds true for measures designed to tie spending more closely to budget funds and economic efficiency, e.g. by indexation.

**Social security systems vulnerable to demographics**

Another problem emerges in this context, especially in Germany. Being heavily contribution-focused, the social security systems are particularly susceptible to demographically-driven increases in expenditure. This is true of all five collective security systems – pensions, nursing, healthcare, unemployment and accident insurance. With an already severe burden of direct taxation, pay-as-you-go social security contributions place further pressure on labour as a factor of production. Ultimately this can have a detrimental effect on economic growth by creating negative incentives to work. Moreover, high social contributions cause people to flee the social security systems, i.e. they trigger inefficient evasive reactions.

**Further convergence in EU states' revenue structures**

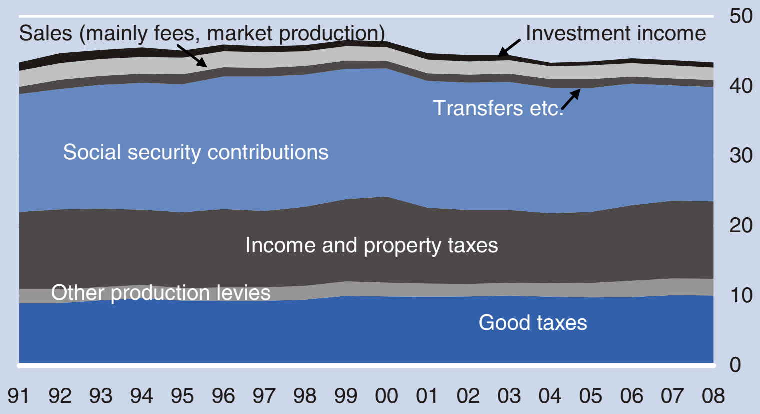
In future, too, Germany will have a mixture of direct and indirect taxes and social security contributions. However, the EU states' revenue structures will continue to converge because the tax and contributions systems, which were devised for closed economies, do not yet take adequate account of increasing international connectivity. Pervasive individualisation allows people and companies much more scope than they previously enjoyed. Altering the way in which the social security systems are financed, for instance with a larger proportion coming from taxation for basic security benefits and/or more full funding, would therefore seem to make sense for Germany, not only for the reasons already discussed.[20]

[20] See also the German Council of Economic Experts on new ways of financing the social security systems (2005), Chap. 5.

**Greater focus on indirect taxes may make sense**

Besides the mobility of the assessment basis discussed, which raises the issue of competitiveness, it may also be beneficial from employment and growth perspectives to increase the proportion of indirect taxes. They do, after all, have a different impact on savings and supply decisions than direct taxation.[21] Certainly, arguments are also advanced against this, with a stronger focus on indirect taxation being called into question mainly from a distributional aspect (e.g. owing to the regressive effect).[22] However, given the graduation in the rate structure (with lower rates for food etc.) the reasoning is hardly watertight. Ultimately this also touches on the pivotal issue of an optimal tax system, a subject of debate for some time among financial academics.[23] These qualitative aspects should be included in debate on the consolidation of public finances.

**Government revenues**
in % of GDP




Source: DIW 6

## Institutional and political framework conditions[24]

**Successful consolidation depends partly on the electoral system and number of political parties**

For almost twenty years now we have known from research that electoral and political party systems influence government activity and fiscal policy. While the impact of partisan composition on fiscal policy is empirically ambivalent and both conservative and social democratic governments[25] can claim good results in reorganising national finances, the electoral system and number of parties in government evidently play a part. In comparative studies Sachs and Roubini were the first to establish the link that countries with proportional representation are often ruled by coalition governments less successful in bringing the national budget into balance than parties ruling alone in parliamentary systems hallmarked by first-past-the-post voting systems.[26] This is due partly to the need to compromise and the immanent weakening of centralised political control in coalitions. In Germany's case several studies have also established this at the Länder (state) level: The partisan composition

[21] See also OECD (2007).
[22] See, for example, Bach (2005) on the distributional impact of raising value added tax.
[23] Alm (1996), p. 117; Homburg (2007) on optimal tax theory; Smekal et al. (1999) on the issue of consumption vs. income.
[24] On this topic see Wagschal (2007), Chap. 6, and the presentation at the workshop.
[25] Of the many country studies, in addition to the overviews by Schuknecht and Wagschal experience in Sweden with the Persson administration as from 1994 is an instructive illustration of a broadly based social democratic adjustment programme. See Henriksson (2007).
[26] Roubini and Sachs (1989).

of the Federal government has no influence on the fiscal policy of the Länder, whereas Länder ruled by coalitions make heavier weather of fiscal policy than one-party governments.[27]

Coalition politics also influence the fiscal strategies that are up for choice. Whereas democracies with majority rule customarily have a powerful finance ministry to cope with most problems, in multi-party governments cross-party agreements are necessary, and these are frequently combined with budgetary rules, output-based budgeting and top-down budgeting.

**Successful budget consolidators stand a good chance of re-election**

In Germany's coalition governments at the Federal level, too, genuine allocation decisions are usually taken only at the beginning of a legislative period on the budget for the next four years. While substantial interim adjustments are made only if the economy performs unexpectedly badly (or well), fine-tuning is very much part of the game. That is why it is so important for both quantitative and qualitative fiscal targets to be clearly established and communicated to the public at the beginning of an administration. In so far, considerable significance attaches to initial compromises between the ruling parties on the medium-term fiscal framework (described in literature on the subject as "commitment" strategy).[28] Wagschal also points out that successful budget consolidators stand a good chance of re-election; but they must get down to determined action early on if they want to reap the first rewards in two to three years' time and maintain their chances of re-election. Such zeal was last observed in the late 1980s under Chancellor Kohl and his finance minister Stoltenberg (and it delivered results), while Chancellor Schröder and finance minister Eichel ultimately let the budget drift for several years amid the country's growth and economic plight, although they did adhere strictly to the spending plan.

**Germany's budget process ranking among 18 EU Member States[1)]**

| | |
|---|---|
| Budget transparency | 6 |
| Multi-annual planning horizon | 4 |
| Centralisation of the budget process* | 13 |
| Centralisation during execution | 8 |
| Top-down budgeting techniques | 4 |
| Prudent economic assumptions and reserves | 17 |
| Performance budgeting | 10 |
| Overall | 9 |

* Judging by the position of the finance minister (+) and the right of parliament to amend the draft budget (-)

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1) Data according to the European Commission (2007), Part II.5, on the basis of a World Bank survey for 2003, in which 18 EU Member States took part.

Also important are the institutional rules for budget preparation and execution, whereby countries with more hierarchical procedures exhibit better chances of balanced budgets than countries like Germany with a firmly established "collegial departmental principle".[29] An EU survey ranks Germany only ninth of 18 member states in respect of the quality of its budget procedure, pinpointing particular weaknesses in decentralised budgeting and the absence of prudent economic assumptions and contingency budget reserves. Nor is Germany ideally ranged in political respects. The finance minister's relative standing in the Cabinet rides heavily on political constellations, such as support from the chancellor, and on the actors themselves. Often the whole government is required to determine key spending areas and the fiscal architecture. Consequently the internal government structures are not conducive to fiscal consolidation and therefore require the support of the parliamentary party leaders and, most importantly, of the Budget Committee, which in turn is obliged to wage a similar war on several fronts with all spend-happy committees.

**Budget preparation procedures barriers to strong qualitative budgeting**

As Lüder demonstrates,[30] in particular budget preparation procedures adapted to the departmental principle, which ask the ministries to specify their spending wishes and political projects a year in advance, then make provision for these in in-depth nego-

27 See Seitz (2002), Jochimsen and Nuscheler (2005). See Kitterer (2006) and Deutsche Bundesbank (2006) for an empirical overview of state government finances in 2006.
28 See the comparative study by Hallerberg (2004).
29 Alesina and Perotti (1995c), von Hagen (1992), European Commission (2007), Part II.5.
30 Lüder (2004).

tiations between the finance ministry and the spending ministry and ultimately culminate, in autumn, in Cabinet approval of the draft budget and the medium-term fiscal planning and in a resolution by Parliament, throw up barriers to strong qualitative budgeting, which would ultimately need to be centralised and work with defined targets and reviews. The second-best route would therefore be for each department to have its own qualitative, performance-based budgeting; but this would probably not work owing to a lack of resources in small units and, generally speaking, could hardly be implemented uniformly in practice, or at least not until the ministry of finance or an independent agency, such as the Office of Management and Budget in the US, were to prescribe standardised methodological procedures.

**Elements of performance budgeting and top down approach still underdeveloped in Germany**

Elements of performance budgeting[31] and a top-down approach to budget preparation and fiscal policy, although now practised in many OECD countries, are still seriously underdeveloped in Germany. Neither the Cabinet or Chancellor set the ministries clear targets with budgets to match, nor do the ministries themselves see any need to gear their spending to explicit, quantitatively measurable targets. While international experience with performance budgeting is on the whole mixed – in particular, complex tasks involving work by more than one government office are difficult to manage through agreements with ministers or agency heads –, the pressure to justify and review spending that explicit targets imply could prove helpful with clearly definable tasks, precisely for those ministries that operate heavily with money rather than regulation as a political tool (notably the departments of labour and social affairs, transport and partly also economics). After all, on the basis of the Federal government resolutions currently in place, active labour market and family policies are up for review – although no uniform parameters have been set on how this is to be done.

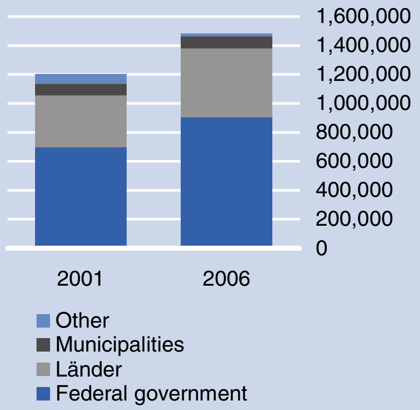
**Need for transparency and credibility of central assumptions and projections**

Budgeting transparency and comprehensiveness (in preference to a host of shadow budgets) are also helpful for consolidation. The transparency and credibility of central assumptions and projections play an important part here. To keep budgets under control, it is very useful, for example, to keep assumptions on medium-term economic growth, on the impact of political measures on the budget and on medium-term fiscal planning realistic. Whereas the ministries themselves deliver spending estimates for individual policy areas, the major player on the revenue side is the “Working Group Tax Revenue Estimates” (Arbeitskreis Steuerschätzung), a panel of experts and civil servants delivering half-yearly estimates, with growth forecasts currently coming from the Federal Ministry of Economics and Technology. Other countries have at least assigned economic forecasting to independent institutions. Autonomous assessment and involvement by parliament would also be conceivable. However, at our workshop various representatives pointed out that the precision of economic forecasting, regardless of who carries this out, leaves much to be desired even on an annual basis and all the more so for the multi-year projections necessary to fiscal planning. Unfortunately, there is practically no solution to this conundrum, unless the principle of prudence is applied and projections are, as a general rule, made at the potentially lower margin of the scenarios, with expenditure and revenues subsequently being adjusted in the event of better development along a path determined

[31] International comparative examination of this can be found in NESC (2002) and in OECD (2002, 2003).

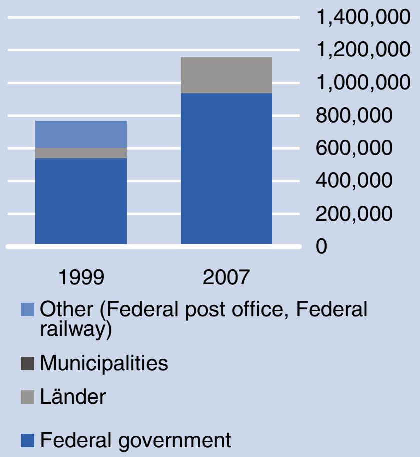
**Grand Coalition has applied prudential principle for first time**

**Central, state and local government debt**
in EUR m




Source: Deutsche Bundesbank, 2007 **7**

**Public sector bonds outstanding, by issuers**
Nominal value in EUR m




Source: Deutsche Bundesbank, 2007 **8**

ex ante. This is precisely what the European Commission recommends. There are various indications that the Grand Coalition, unlike previous governments, has for the first time applied the principle of prudence to both growth assumptions and budget appropriations, or that it has at the very least not been demonstrably over-optimistic, which is why the public have repeatedly been surprised with good news since 2006. Besides understating the cyclical forces driving the upswing and tax revenue (income tax, corporate income tax, trade tax) elasticity, finance minister Steinbrück's restraint in not speaking too early of success with consolidation helped ease the budgetary situation.

In terms of its parliamentary structures, too, Germany is better placed than some other countries. It is, for example, not customary for governments to be dominated by parliament in respect of the size of the budget or major spending guidelines and components, as can repeatedly happen in the US. Nor is "pork-barrel" spending for specific constituencies especially important, even though the departments of transport, defence and agriculture do lend themselves to this. But then neither has the German parliament equipped itself with any particular control mechanisms, dispensing for example with its own in-depth analysis of budget issues. In contrast, the US Congress has a dedicated analytical institution at its disposal in the shape of the Congressional Budget Office. Germany's parliament would be perfectly free to set up a similar institution for itself. Steffen Kampeter, the CDU/CSU parliamentary party spokesman on budgetary affairs, discussed this as an interesting option at our symposium.

Germany also possesses quantitative fiscal rules. One of these is Article 115 of the Basic Law – deemed ineffective – on limiting net borrowing. Reform of this is now pending. The other is the body of law in the EU Treaty together with the relevant regulations (p. 9).

In conclusion it can be said that Germany's political and institutional framework conditions for better qualitative management of the budgetary process are still very poorly developed at present, making some institutional reforms necessary.

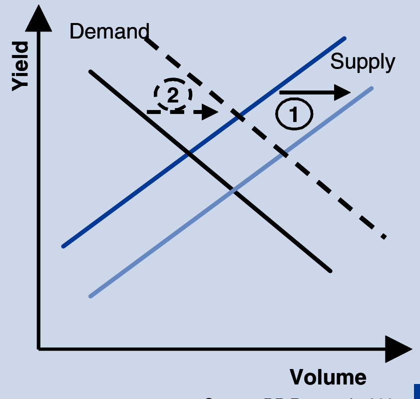
## The importance of the capital markets and media in reorganising public finances

### *Capital market: best-practice through rating*

Germany's central, state and local government finances are enshrined in Article 109 of the Basic Law (Grundgesetz). In principle this confers a comparatively large measure of budgetary autonomy on the Länder, which therefore account for a considerable part of public debt. However, the big state enterprises (such as the post office or railway) in particular no longer count towards public debt, as shown by the amount of bonds outstanding. The Federal government itself makes use of practically all financial instruments and also sets the benchmark to which the bond markets refer when determining yields. In the past, borrowers' notes represented the most important type of financing for the Länder. But EMU and globalisation have altered the economic and legal situation for the market in loans against borrowers' notes,[32] as a result of which borrowers'

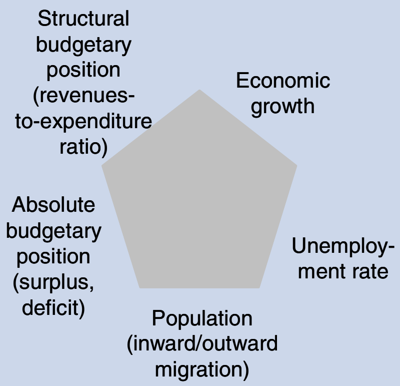
[32] Borrowers' notes provided the Länder governments with comparatively easy and low-priced financing in view of their relatively modest formal and legal requirements. However, loans against borrowers' notes have lost their privilege as cover funds for public Pfandbriefe (mortgage bonds). For legal reasons mortgage banks have had to alter their risk control. Implementation of the Basel II criteria for

**Economic advantage of rating**



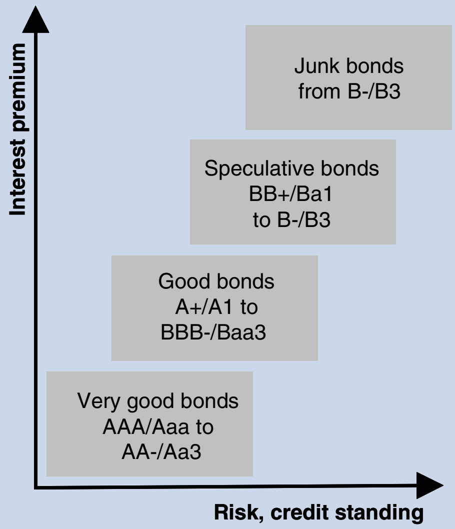

Source: DB Research, 2007 **9**

**Determinants of the rating of public sector bonds**




Source: DB Research, 2007 **10**

**Risk, rating, coupon**




Source: DB Research, 2007 **11**

notes, while still an important means of financing state government budgets, are steadily giving ground to the bond markets.

This automatically lends added significance to the capital markets' requirements of public-sector borrowers. For Länder government finances it poses a relatively new situation, whose opportunities should be exploited. The yield premiums the states are obliged to pay on interest rates charged to the Federal government result mainly from the liquidity of the bond markets and the rating agencies' assessments. Estimates of the potential savings that could be achieved by narrowing interest rate spreads of 30 to 40 basis points versus the central government, range from EUR 300 m to EUR 1 bn. Given that only a certain amount can be done to alter market liquidity for Länder bonds (e.g. concentration on so-called jumbo bonds) and that negatives as well as positives attach to a joint appearance on the capital market by the federal and Länder governments, quite apart from the legal issues this raises, it becomes necessary to use capital market know-how through rating agencies.[33]

***Rating: using financial market know-how for public authorities***

Chart 9 depicts the economic relationships on the credit market in simplified form. The starting point describes a market without ratings. Suppliers of credit are prepared to make liquidity available only on a limited scale. Movement 1 begins when borrowers submit to a rating review. Lenders step up their commitments – and lending rates fall. This makes movement 2 possible, which depicts the expansion in demand for credit. Although this pushes interest rates up again, the increase is disproportionately lower as a result of the greater market liquidity.

Quite different factors impact rating quality. The main determinants for public-sector bonds are listed in the adjacent Chart 10. Following the corporate analysis pattern, the various layers of government are considered as a "corporation". As a rule, however, ratings are scored across calendar quarters so that even if the market prices of the bonds alter, the ratings can remain constant. This means that a borrower's future solvency is rated and not its market performance. The federal structure in Germany has yet another special feature. The principle of communality in the fiscal federation regulated by the Basic Law guarantees the solvency of individual authorities. Bonds of the Länder of the Federal Republic, for example, can generally be classified as "very good bonds" or "good bonds" (see Chart 11).[34]

The way ratings work and their deeper importance can be illustrated rather well with reference to the special nature of the communality principle. On the face of it, there seems little justification for interest rate spreads given the theoretical obligation of the central, regional and local authorities to assume one another's liabilities. But in fact the rating agencies score on the basis of experience over the past 10-15 years in the relevant risk classes. A default probability of, say, 0.3% does not imply that there is only a 99.7% likelihood of the borrowers servicing their debt, but that the entire portfolio in this class is exposed to the respective risk. Since any one risk class is viewed relative to other risk classes, the award of a top rating does not necessarily mean that a default has been observed elsewhere,

international capital regulations makes new requirements, see Association of German Banks (2001), Standard & Poor´s (2001), Deutsche Bundesbank (2006).

33 See also in this context Bundesregierung (2004).

34 See also Standard & Poor's (2007).

but simply that the relative differences between the risk classes have to be calibrated.

**The viewer's focus decides on rating differences**

Key to explicit rating differences is the auditor's focus.[35] Considering a state independently of the fiscal federation seems appropriate as the Länder compete globally for funds, and it also has other advantages that are not to be underestimated. The fact that all German Länder are given top ratings means that while there may be differences in the long-range appraisal, these have very little effect on prices. The top ratings differ hardly at all in terms of default probability, so that lenders also have to make only marginal distinctions in yield.

**Risk weighting under the standard approach*, in %**

| Rating** | Sovereign | Bank*** | Non-banks |
|---|---|---|---|
| AAA to AA - | 0 | 20 | 20 |
| A+ to A- | 20 | 50 | 50 |
| BBB+ to BBB- | 50 | 100 | 100 |
| BB+ to BB - | 100 | 100 | 100 |
| B+ to B- | 100 | 100 | 150 |
| below B- | 150 | 150 | 150 |
| non-rated | 100 | 100 | 100 |

* The risk weighting set in Basel will probably also apply in the forthcoming Solvency Regulation.
** Long-term, e.g. Standard & Poor's (S&P)
*** Option 1 is applied in Germany, the risk weighting for banks being derived from rating of the respective bank's country of domicile.

Source: Deutsche Bundesbank, 2006 12

Nonetheless, in practice differences in bond ratings are very important. The key lever in this context is the lenders' financial reporting. Implementation of the Basel II rules (see Chart 12) makes considerable demands of valuation and pricing by the banks. For the most part banks respond to changes in the real economy more quickly than rating agencies, and consequently their portfolio structures are relatively flexible. The fact that even top-rated bonds occasionally fail to find a taker is partly a result of these statutory regulations. So the supply side of the credit market tends to exert a certain pressure on borrowers, even if they have been given top marks by raters.

But for the Länder themselves this pressure can have certain positives. A rating can deliver helpful pointers on how to set about restructuring public budgets and, beyond that, it may even have important economic policy implications. From a politico-economic aspect this is by no means insignificant, as it makes it easier for government to justify certain courses of action. And comparison with other borrowers can bring positive pressure to bear on political decisions by individual government units ("best practice").

## Monitoring by the media

**Consolidation is not a "vote winner" of relevance to political players**

Democratic monitoring of public fiscal policy by the media is another important aspect in periods of consolidation. Without a critical public behind them, politicians looking to put public finances in order often find it virtually impossible to carry the political argument. However, the subject matter is complicated; the broad masses fail to understand the intricate cause-effect relationships between government revenues and expenditures. Nor is consolidation a crucially relevant "vote winner" for political players either in a current context (cyclical revenue surpluses vs. structural adjustment of public budgets) or in long-range analysis (sustainability of government activity). In other words, the subject does not sway election results. The players' time horizon is limited. Most importantly, issues relating to the future are heavily discounted, meaning they attract very little attention.

[35] See iwd (2006); Deutschland-Radio (2006); Börsenzeitung (2007).

**Key issues in the 2005 Bundestag elections**

(in percent)

| | Alle | CDU/CSU | SPD | FDP | LEFT | Alliance 90/ Greens |
|---|---|---|---|---|---|---|
| Economic policy | 38 | 53 | 27 | 56 | 23 | 20 |
| Labour market policy | 34 | 42 | 26 | 42 | 42 | 16 |
| Social justice | 33 | 17 | 45 | 16 | 59 | 40 |
| Tax policy | 19 | 24 | 15 | 31 | 17 | 8 |
| Foreign and security policy | 13 | 6 | 23 | 5 | 8 | 28 |
| Schooling and education policy | 12 | 10 | 13 | 14 | 16 | 15 |
| Environmental policy | 11 | 3 | 13 | 3 | 6 | 52 |
| Policy on foreigners | 11 | 11 | 10 | 7 | 8 | 11 |
| Internal security, crime | 9 | 11 | 9 | 7 | 7 | 5 |

Source: Infratest dimap (2005): Election report, p. 62

13

**Lack of attainable consolidation targets**

Political decision-makers do not therefore perceive any urgent need to address this issue. Consequently, practically no targets are set, resulting in an absence of attainable consolidation goals and little or no presentation of successes or failures. But it is only in the context of target setting and (public) scrutiny that the media can meaningfully present cause-effect relationships and by so doing heighten people's awareness of the need to set government finances to rights.

**Media need simple metrics**

The media need simple metrics to quantify the success or failure of fiscal policy – and of budget consolidation in particular. That is why readily understandable indicators and threshold levels (such as the 3% limit for the general government deficit in the Maastricht Treaty) play an important part in political disciplining by the public and media. Similarly simple benchmarks would also be needed in the future to measure the qualitative improvement in general government budgets. Other suitable concepts are a "consolidation dividend" expressing the difference between the actual and theoretical interest burden that would have arisen without belt-tightening, such as that calculated by the state of Saxony.

**Fiscal policy can be advanced by a critical public**

Economic agents' tendency to be unable or unwilling to absorb (political) messages or information in their argumentation context makes different demands of political visions and mission statements and the way these are communicated by the media: messages devoid of emotion will fall on deaf ears. Moreover, wrapping up information in a story allows for the inclusion of potential opposing arguments.[36] By emotionalising issues in this way a kind of collective awareness can be formed on complex subjects. The media thus act as a sort of "bad conscience" for politicians, and fiscal policy can even be advanced by a critical public. The problem of government debt, for instance, can be divided into "digestible" bites. Of course, since payments are involved the measures actually taken will remain the same, but the positive need for action implied in the mission statements will facilitate their political passage and public scrutiny through the media.

[36] Viewed in this light, the current debate on the sustainability of the social security systems can be considered highly constructive, with "pension cuts" or "higher contributions for younger generations" being replaced by a message with the credo "For my grandchild's training place".

**Media coverage of the political process**

| Problem | Measures (problem-oriented) | Communication (emotionalised) | Target |
|---|---|---|---|
| Government debt | Economic growth<br>Tax increases<br>Contribution cuts | No problem<br>Difficult, possible with specific target groups<br>Generally easy, difficult with specific target groups | Consolidation |
| Sustainability<br>Interest burden | Budget structuring<br>Priority for debt reduction | Mission statements/ examples<br>Consolidation dividend<br>Intergenerational justice<br>Debt clock<br>Debt mountain | Sustainability |

Source: DB Research, 2007

14

## Conclusions on political governance to improve the quality of public finances

Restoring the quality of public finances remains a huge task Europe-wide. By restructuring public revenues and expenditure it is hoped to tap into growth and employment opportunities, to achieve distributional objectives more effectively and at lower cost and to boost government efficiency as a whole. The political framework for this will differ from country to country, depending on the political and institutional situation.

In Germany the following elements need to come together:

— consensus among the ruling parties on fiscal policy for the upcoming legislative period with agreements containing qualitative budget targets across individual departments and providing for evaluation on the way to this (performance management),

— an understanding in the government on the use of higher-than-projected budget funds for quality-designated policy areas[37] and, conversely, a ‘softly-softly’ regulation in the event of necessary budget overhauls,

— more centralised management of fiscal policy by the Chancellery and Ministry of Finance during the legislative period,

— greater clarity of diagnosis and therapy with regard to growth-enhancing government spending, and political consensus on promoting this and sparing growth in periods of austerity; a focus on the education and research system is certainly indicated here, but not on gross fixed investment by the public authorities,

— a permanent focus on altering the way the welfare state is financed, with fewer direct taxes and contributions, more indirect taxation and private funding where appropriate, for instance in the pension system or for long-term care,

[37] The decision matrix is of course more complex than this because in a positive scenario government must decide whether to reduce new borrowing or offload debt, step up spending or lower taxes, and vice versa.

— more use of qualitative indicators, for both inputs and outputs, in such central policy areas as employment, health and pensions, with the government setting targets where appropriate on changing these over the four-year legislative period; this would also be applied to annual budgeting and in relation to the annual appropriations; evaluations, cost-benefit analyses and similar tools would naturally be needed more frequently, and for this purpose a separate institution could either be set up or the task assigned to the Federal Audit Office,

— for medium-term fiscal planning an explicit quality review and quality management should also be conducted, based on indicators for both the revenue and expenditure side,

— explicit involvement by parliament, under the aegis of the Budget and Finance Committee, in quality aspects, indicators, metrics and control procedures. Particularly with regard to medium-term management, there would be a greater onus on parliamentary floor leaders to work with the Budget Committee to provide political support for major reorganisation on both sides of the budget in pursuit of better quality,

— gradual extension of qualitative management in the relationship between the federal and Länder governments, at least on the basis of indicators in the Fiscal Planning Council. But unlike Länder participation in complying with EU regulations and with the borrowing rule we are set to see shortly, more Federal Government influence would presumably not be helpful here. Indeed, there are powerful arguments in favour of the German states conducting their fiscal policy more independently than they have done so far,

— finally, the European Union also has a part to play. So far there is no concrete interpretation of how qualitative aspects should be defined and applied to the evaluation of national stability programmes. It is first up to the Commission to submit suitable proposals to the Council of Economics and Finance Ministers.

Some observers may consider it idle to start thinking about such things at a time when general government finances have just returned to equilibrium. It must, however, be pointed out that the 2007 balanced budget solves neither the problem of sustainable development in debt levels, nor the implicit demographic debt burden, nor the issue of growth-friendlier general government budgeting in the next two to three decades. The danger is consequently that public debate – and hence the political community – will settle for achievement of the objective of balancing the budget in quantitative respects. But that would fall short of the mark.

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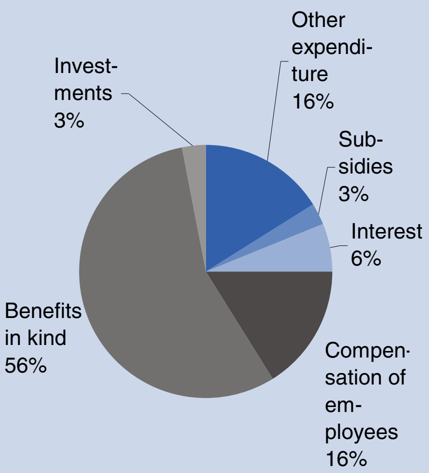
**Broad Economic Policy Guidelines 2005-2008, Integrated Guideline No. 3:**

To promote efficient allocation of resources, Member States should, without prejudice to guidelines on economic stability and sustainability, redirect the composition of public expenditure towards growth-enhancing categories, adapt tax structures to strengthen growth potential, ensure that mechanisms are in place to assess the relationship between public spending and the achievement of policy objectives, and ensure the overall coherence of reform packages.

Source: European Union

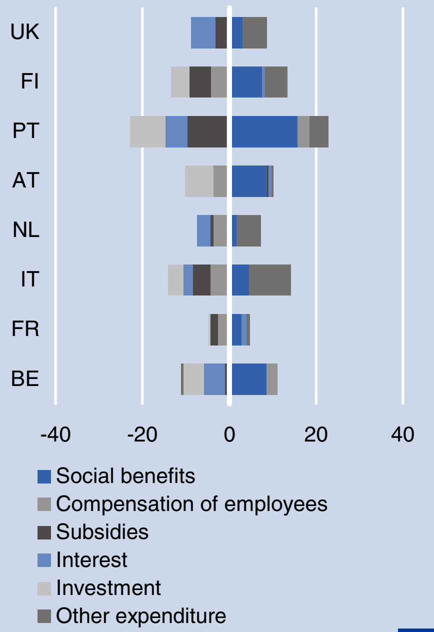
**Structure of expenditure in Germany - 2006**




Sources: Eurostat, Federal Ministry of Finance, 2007 **15**

**Changes in expenditure structures in selected EU countries**

in percentage points 1981/2006




Sources: Eurostat, Federal Ministry of Finance, 2007 **16**

# The quality of public finances – a comprehensive fiscal policy strategy for the future

International competition and mounting demographic pressure are lending growing urgency to questions on the future-proofness of public finances. A major fiscal challenge lies in ensuring that structural reforms are put in place that will strengthen the long-term sustainability of government finances while at the same time increasing the prospects of growth.

Fiscal policy is faced with twin tasks: besides complying with the budget rules laid down in the European Stability and Growth Pact or Germany's Basic Law, overall improvement needs to be made in the long-term growth orientation of public finances. It is becoming increasingly clear that the question of the "right" fiscal policy – i.e. one geared to the demands of stability and growth – should not concentrate exclusively on quantitative or level-based criteria. Above all, the possibilities of influencing the economy's growth potential are driven largely by the structure of public finances.

Elements of a fiscal policy directed to "better quality in public finances" are already institutionally embodied in various places. The reformed Stability and Growth Pact, for one, puts greater emphasis on enhancing growth potential and improving the long-term sustainability of public finances.[38] In the Lisbon Strategy's Integrated Guidelines 2005-2008 a rule on the reallocation of public funds also forms a pivotal part of the Broad Economic Policy Guidelines.

As a general rule, the principle of quality is intended to apply comprehensively and refers to three dimensions of public budgeting – expenditure, revenues and last but not least the institutional framework conditions under which fiscal decisions are taken.

In the light of this the issue was institutionalised at the European level in May 2004 by the EU's Economic Policy Committee (EPC)[39]. The objective of the EPC Working Group on the Quality of Public Finances set up for the purpose is to gain insights, based on a regular exchange of information and experience between the Member States, on the impact of fiscal policy decisions on growth and efficiency and to develop proposals on the implementation of quality-based fiscal policy.[40]

## Development in expenditure in Germany and selected EU countries

The critical development in expenditure in Germany and many other EU Member States forms the point of departure for debate on the quality of public finances. In many countries we see public finances becoming increasingly inflexible, chiefly as a result of rising social spending with a concomitant decline in investment.

In Germany, social benefits now make up almost 57% of total expenditure, having soared almost 10 percentage points over the past 25 years in the Federal Government or general government. At

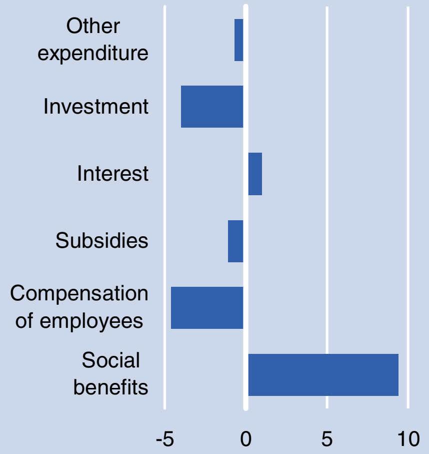
[38] See Council Regulation (EC) No. 1467/97, Council Regulation (EC) No. 1466/97.

[39] The EU's Economic Policy Committee (EPC), like the Economic and Financial Committee (EFC), is assigned to the Ecofin Council and prepares it on structural policy matters.

[40] An extensive reader summarising the findings so far by the Economic Policy Committee Working Group on the Quality of Public Finances will be published by the European Commission in collaboration with the EPC as a COM Economic Paper in April 2008.

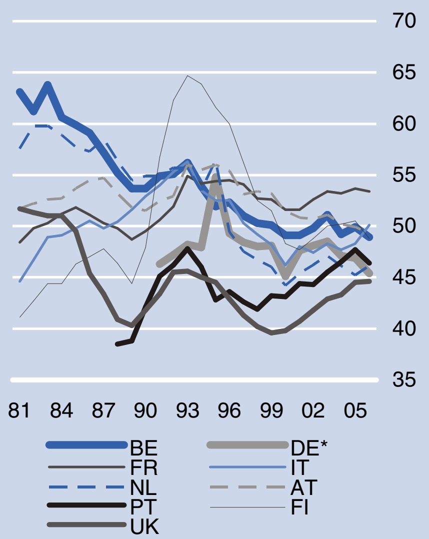
**Alteration in spending structure**

Change in expenditure shares in % points 1981/2006




Sources: Eurostat, BMF **17**

**Government spending ratios 1981-2006**




*including former GDR since 1991

Source: Eurostat **18**

the same time investment has trended steadily downward, falling by four percentage points from 7% of total expenditure in 1981 to around 3%.

Similar trends are evident, although with marked differences in the level of spending, in many other EU countries. In Belgium and Austria the share of welfare expenditure in total government spending has risen by around nine percentage points since 1981. Even in the United Kingdom, where the ratio of social to total government spending is the lowest in the EU at roughly 13%, an increase of more than three percentage points has taken place.

Meanwhile, the importance of spending on public investment has fallen dramatically. In Portugal its share of total expenditures has fallen by eight percentage points, in Finland by 4.2 percentage points and in Italy by 3.5 points, even though many of the countries considered saw their relative interest rate burdens shrink over the same period.

This trend appears not to be affected by the development in the government spending ratio. Indeed, the deterioration in the structure of spending was observed with both rising and falling government spending ratios.

## Measuring and defining quality

The quality concept used here takes its cue from the growth target of the Lisbon Strategy, which is geared to increasing an economy's long-term growth potential.[41] But even when confining the objective so narrowly to a growth target (abstracting, for example, from the budget's distribution and stabilisation objective), certain conceptual problems still arise. Notably, it is not easy to allocate public expenditure – or indeed revenues – precisely to growth-enhancing, growth-neutral and growth-detrimental categories.

Scientific research has very little to offer here in the way of clear answers.[42] Positive contributions to growth from public expenditure can be established for research and development, education and the infrastructure; and the structure of public revenues undoubtedly also has a significant influence on an economy's growth potential. However, very different figures are put on the exact size of the positive impact, and there are no clear-cut findings for many categories of expenditure.

## Detailed impact assessments as a result of better data availability

In addition to the methodological challenge, national differences in how government spending is recorded also make detailed impact assessment more difficult. The classifications available so far do not permit any in-depth economic analysis across individual countries.

**Informative data not yet available**

Uniform data classified economically by function are gathered Europe-wide only for the first, very general level of the United Nations' Classification of the Functions of the Government

[41] In principle quality definitions are also conceivable that broaden the analysis to include, for example, environmental aspects or employment outcomes as well as growth effects. In an international context some of the quality concepts applied are very open, calling merely for the efficient use of funds for politically predetermined but basically open targets. See, for example, the European Commission (2004).

[42] For comprehensive literature overviews see e.g. Afonso, Ebert, Schuknecht, Thöne (2005), European Commission (2004). The impact of institutional framework conditions on economic growth has recently been examined i.a. in European Commission (2006, 2007) and the trends and impact of taxation on economic growth in Heady (2007).

(COFOG). But with a total of just ten different categories (referred to as divisions)[43] this classification is not finely meshed enough for in-depth economic analysis and meaningful international comparison; for example, it cannot be used for analysis of spending on research and development or education across individual countries.

**New statistics in preparation**

To improve data quality and availability, a Task Force on COFOG was set up in 2004 on the initiative of the EPC under the aegis of Eurostat, the European statistics office. In addition to the EPC and the European Commission, national statistical offices and international institutions such as the OECD are involved in this. The aim of the task force is to collect statistics for the EU Member States on government expenditure in accordance with the COFOG two-digit divisions, in which public spending is broken down into altogether 68 economic functions, and to integrate these statistics into the current official statistical programme.

**Methodological issues still to be settled**

The data picture at the first COFOG level is still very mixed. Data in some countries are not yet classified in sufficient depth for the defined functions, resulting in significant discrepancies between other relevant national statistics. It has been found that some government functions can be allocated methodologically to more than one category, signifying the need for further harmonisation of concepts and definitions between the countries.

Nevertheless, progress so far on the project is very promising. Whereas only seven countries had delivered two-digit COFOG data to Eurostat by end-December 2005, statistics are currently available from 20 Member States[44], partly for different time horizons. Some of the existing datasets have been placed on the Eurostat website and are therefore available to the general public[45], and for 2008 further improvement in the database and its public accessibility are scheduled.

**Evaluation of labour market policy**

On the basis of instructions from the Bundestag, Germany's lower chamber of parliament, on November 14, 2002, the Federal Government had the outcomes of the First to Third Law on Modern Services on the Labour Market evaluated (Hartz Evaluation).[1)]

The intention was to ascertain the extent to which the objectives targeted with the labour market reforms had been achieved, and where room remains for improvement. Moreover, the approach chosen aimed not only to examine simultaneously the impact of individual instruments and regulations within a defined time frame, but also to identify the macroeffects of this new labour market policy. More than 20 research institutions with some 100 researchers in all took part in the evaluation.

The overall picture is mixed. The labour market integration grants (subsidies granted for a limited period towards employers' wage costs), government measures to promote further education (particularly those leading to qualifications), the promotion of self-employment and bonuses for agencies that successfully place job-seekers are producing comparatively positive results. Negative incentives to take up work result from job creation schemes and related instruments and also from personnel service agencies.

In comparison to earlier evaluations a marked improvement is evident in the effectiveness of labour market policies. Of the measures evaluated, the outcomes of 87% can be deemed positive, while the share of measures rated negative has fallen to 1.5 percent. For not quite 2% the findings are unequivocal or neutral. [2)]

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1) See the Federal Ministry of Labour and Social Affairs (2006)

2) See Eichhorst and Zimmermann (2005)

## Efficiency and effectiveness

Deeper analysis of government spending structures and, most importantly, examination of potentially growth-enhancing functions must not be restricted to collecting relevant data. Rather, it must reveal the causal relations between spending and growth trends and, in so doing, address the outcomes of the use of public funds.

From a political point of view, improving efficiency and effectiveness is important for two reasons. First, focusing on input in isolation – as, for example, with the Lisbon Strategy target "3% of GDP for research and development spending" – brings with it the danger of governments trying to cover up inefficiencies simply by throwing more funds at the problem. And second, by tapping into efficiency potential extra funds can be freed up to set new priorities or for further consolidation.

In many countries efforts to bring government finances into shape in recent years have left only limited scope for further short-term spending cuts. What is more, statutory commitments render many dominant categories of expenditure in the government budgets,

43 These functions include general public services, defence, public order and safety, economic affairs, environmental protection, housing etc.

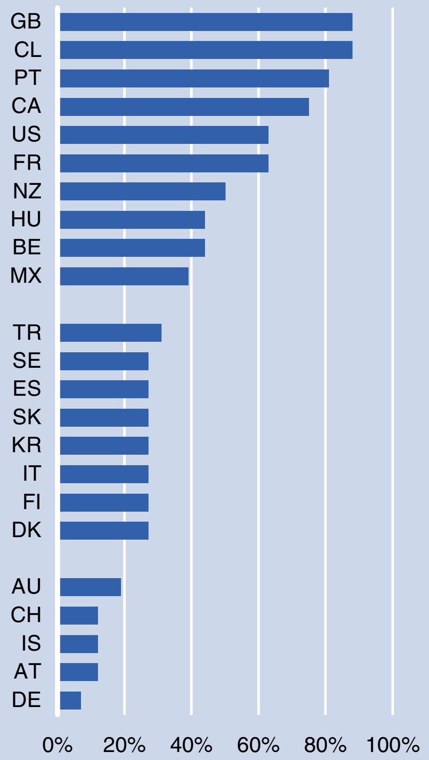
44 Bulgaria (2004), Belgium, Germany (only 2003), Denmark (1990-2005), Estonia (2001-2005), Greece (2001-2005), Spain (2000-2005), Ireland (1995-2005), Italy (2000-2005), Cyprus (1998-2005), Latvia (2003), Lithuania (2005), Hungary (2001-2005), Poland (2002-2005), Portugal (1995-2005), Romania (2003), Slovak Republic (2003-2005), Finland (2000-2005) and Sweden (2001-2005).

45 The data is available at: ec.europa.eu/eurostat.

such as social or interest expenditure[46], relatively inflexible in the short term, which again limits the possibilities for restructuring expenditures, at least on a short-range basis. The efficiency and effectiveness dimension of "higher quality" thus goes beyond monitoring the usefulness of potentially growth-enhancing expenditures to encompass a systematic review of all areas of government spending and requires the implementation of evaluation findings in institutional budgeting.

Yet there are still very few international efficiency analyses, not least because of the limited availability of suitable performance and impact indicators. But the studies available on the healthcare and education sectors do indicate a substantial efficiency potential. The results for education, for instance, show that performance can be increased by up to 12% without the injection of additional funds, and the potential efficiency gains from reducing inputs (same results using less funds) are as much as 25%.[47]

**Finance ministry involvement in performance measurement**




Source: Curristine (2006) 19

At the national level, though, efficiency and performance monitoring is far more pronounced and sophisticated. In Germany, for instance, the "Hartz" legislation on labour market policy has made comprehensive scientific performance reviews of the political measures mandatory, and Article 7 of the Federal Budget Code stipulates as a general rule that all measures impacting government finances be subjected to a performance review.

So far, however, the evaluations rarely enable comparisons of individual programmes. There is a lack of systematic information and analyses suitable for a macroeconomic review. Further shortcomings are the absence of uniform guidelines and an overarching reporting system providing horizontal information.

The inadequacies described can be explained partly by the highly decentralised organisation of performance monitoring in Germany. Conducting performance controls comes under the remit of the individual government departments. A comparison across the OECD shows that the level of involvement by the ministry of finance in government-wide performance measurement initiatives and their subsequent implementation is way below that in other countries.

While there is no such thing as the ideal level of involvement, different risks do attach to the various forms of control: With a highly centralistic approach there is a danger of the people responsible for achieving the set target being given too little freedom and flexibility to influence the outcome. This heightens incentives to misconduct and "window-dressing" information. Another not inconsiderable danger is that of inefficiencies in the process owing to the high cost of obtaining information. Extremely centralised approaches can cause unnecessary administrative expenditure if information is generated but the data not used, or not used appropriately, in decision-making.

In contrast, the dangers with a heavily decentralised approach are that there is not sufficient pressure for change (reforms are proclaimed but then not implemented) and no uniform, government-wide reporting framework. The absence of standardisation in the

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[46] Subsidies and personnel costs are frequently also cited as further relatively inflexible expenditure categories, although the latter, for example, also include spending on staff in the education system (see, for example, Mattina, Gunnarsson (2007). In Germany the share of expenditure in 2006 on the four categories mentioned totalled 81.5% (data sourced from Eurostat).

[47] Afonso, Aubyn (2005, 2006a, 2006b), IMF (2007), Gonand, Joumard, Price (2007), OECD (2005) and Sutherland et al. (2007).

development and presentation of outcomes also makes it more difficult to compare them and to set outcome-based spending priorities. Central coordination, on the other hand, can be conducive to the development of common objectives and initiatives.[48]

A need is therefore perceived to improve the evaluation methods currently employed in Germany in order to obtain more binding terms of reference and quality standards for conducting performance reviews. Of special importance here are the institutional framework conditions.

## Institutions: Securing growth-enhancing budgeting and sustainable public finances

**Outcome-based fiscal policy is on the advance**

In recent years many countries have put institutional reforms in place to improve their monitoring of the outcomes of government appropriations. A common feature of the reform initiatives is that they contain changes in national budgetary procedures. Many countries have moved to greater use of performance information in the budgeting process.[49] Outcome-based budgeting is most widely advanced and longest-established in the Netherlands, the Scandinavian countries and the United Kingdom. Other countries have introduced important reforms more recently. France, for one, converted its budgeting to a “mission”- and performance-based system in 2006 following gradual application of the relevant budget legislation (LOLF); reorganisation is being prepared in Italy and Spain. In Germany, the state governments have already implemented a number of budgetary reforms; the Federal government is currently drafting reform geared to a greater focus on performance in political (budgetary) debate and decisions.

**German Länder already apply this**

**Evaluation expected to improve programmes**

The main advantage of using performance and outcomes information in the budget process is that it directs the focus in the political and administrative bargaining process towards the outcome rather than the amount of public monies used. Whereas traditional methods gear political priority setting chiefly to inputs – how much money is spent on what functions? –, using performance information in the budget process trains the spotlight on the outcome achieved. Applied to individual programmes, performance-based budgeting can identify success or failure.

That the use of performance-based budgeting leads to ongoing engagement with, and systematic questioning of political priorities and measures is perceived as the greatest benefit. Programmatic improvements and changes can be expected from ongoing evaluation. Political activity is made more transparent and the judgements and decisions taken by the legislative and public are based on better information.

However, improving the quality of public expenditure requires more than simply introducing performance budgeting into accounting. Appropriate administrative capacities must be installed to process the information obtained, along with coherently structured incentives to motivate the officials responsible for taking the decisions. And problems with measurement, data quality and use of the information by the political executive still have to be resolved.

The institutional dimension of the “high-quality” debate must be interpreted in a broader sense and encompass all regulations,

[48] See Curristine, Lonti, Joumard (2007), Curristine (2005a, 2005b).
[49] For overviews and an analysis of national experiences see, for example, Curristine, Lonti, Joumard (2007), Curristine (2005a, 2005b).

processes and institutions to which budget planning and implementation are subject.[50]

**Budget institutions are very important**

Economic literature dealing with institutional determinants confirms that institutional arrangements correlate significantly to the specific outcomes of national budgets and that fiscal discipline can be tightened up through suitable structures in the budget process[51] Well-designed budget rules and institutions are conducive to achieving a sustainable budgetary position and can help avoid procyclical policies.[52] In this respect the importance of the projected improvement in constitutional borrowing rules as part of the second stage of federalism reform in Germany can hardly be overstated.

**Borrowing rule in Germany is a good illustration**

But further work is needed on the narrower issue of the relationship between institutional framework conditions and the structure of public budgets, and the specific contribution they make to economic growth. So far economic literature on the subject has concentrated on examining the impact of national fiscal rules and institutions on budget discipline, whereas budget structures and hence the quality of public finances in the narrower sense have not yet been analysed in any greater depth.

## Revenues

The third vital element of a comprehensive strategy to raise the quality of public finances is a growth-friendly system of revenues, and here in particular a growth-friendly tax system, given its outstanding importance in funding public works and tasks.

Structural issues are likewise gaining in importance on the revenue side. Here, too, looking at quantitative indicators alone – such as the tax-to-GDP ratio – holds out little prospect of obtaining satisfactory results, since the impact of taxation on economic growth rides in no small measure on the specific design of the tax system and the structure of the individual tax types.[53] Attention must also remain focused on how to square the objectives of promoting growth and generating revenues.

Distorting effects of taxes are discussed extensively in academic financial literature. By altering relative prices, taxes influence savings decisions, corporate location and investment behaviour, decisions on jobs and ultimately therefore economic growth. The negative effects grow disproportionately faster than the increase in taxation rates and rising levels of taxation.

Yet tax reform proposals that concentrate much more strongly on encouraging growth but then lead to significant revenue losses on the other side of the account, do not go far enough either: firstly, because different tax types involve different distortions and secondly, because tax regimes, besides aiming to foster growth, are – very importantly – also intended to generate revenues. For this reason, too, it is helpful to concentrate on the structure of the tax

**Excerpt from the conclusions of the June 2007 Ecofin Council**

The Council emphasizes the need to optimise public sector activities and to achieve better outcomes given limited public funds. Comparisons of efficiency in important spending areas reveal significant differences across Member States, and in many cases policy outcomes could be improved.

Member States already developed a number of strategies to improve spending efficiency, including more use of performance information with a view to enhancing the transparency of the budget process. The use of performance information in the budget process is an important tool for decision-making – moving the focus away from spending towards actual achievements. More systematic and independent evaluation of existing policies could help to strengthen the efficiency of public spending. There is a strong need for making better use of already available information.

/ …

[50] The broader institutional framework, for example the electoral system and political party structures, also exerts its sway over fiscal outcomes; see for example Alesina, Perotti (1995). But since these institutional framework conditions are as a rule beyond the influence of the finance minister and fiscal policy makers, they are not considered here.

[51] See for example European Commission (2006, 2007) on the influence of numerical budget rules and independent institutions as well as von Hagen (1992), von Hagen and Harden (1994), Alesina, Perotti (1995), De Haan, Moessen and Volkerink (1999) on the influence of the budgeting process (negotiating structure, role of the finance minister, structure of the parliamentary process, implementation, transparency, federal structures) on budget discipline).

[52] EPC (2005).

[53] See Heady (2007).

... /

The Council furthermore considers that the measurement of efficiency and effectiveness has to be developed further, based upon comprehensive and more comparable data on inputs, outputs and outcomes. Analysing efficiency and effectiveness for individual spending areas appears most promising to increase value for money. A more robust methodology and measurement framework should be established. Member States and the Commission could include analyses on effectiveness and efficiency in the Lisbon National Reform Programmes and the Community Lisbon Reform Programme.

The Council also welcomes changes and improvements related to national fiscal rules and institutions implemented by Member States, as well as the more extensive use at national level of medium term budgetary frameworks for budgetary planning. This may contribute to achieving better budgetary outcomes and increasing public spending efficiency.

Ministers also took note of some recent spending trends in Member States. They consider that a sound database is crucial in order to better analyse the structure of long-term spending trends and is an important prerequisite to ensure value for money within and across countries in line with the growth objectives of the Lisbon strategy. Member States, in particular those lagging behind in data transmission, should in close cooperation with Eurostat step up their efforts to compile and disseminate so-called COFOG economic functions data in compliance with earlier requests by the Council.

Although a certain stabilisation in the overall tax to GDP ratio can be observed, and many important tax structure reforms have been carried out in Member States, the challenges ahead linked to globalisation, mobility, ageing, and the consolidation of public finances raise difficult political and practical issues. The Council therefore stresses the need for revenue systems that can enhance growth and employment and deliver as stable as possible revenues. It encourages Member States in their national responsibilities to move further towards robust, fair, efficient and growth-enhancing revenue systems.

system and its implications for economic growth rather than simply considering the level of taxation. There is also the question of whether, in the light of current demographic trends, further substantial revenue cuts can be tolerated in the long term.

Faced with these challenges, many countries have mounted a sweeping reform of their tax regimes in recent years. Two clear trends in particular have emerged here: attempts to achieve employment-friendlier taxation of the factor labour, and reductions in tax rates accompanied by a broadening of the assessment basis.[54]

It is, however, questionable whether further scope still remains for widening the tax base and, amid intensifying tax competition, what assessment bases can be taxed in the future without denting the competitiveness of the business location and thus eroding growth. Many issues are still unresolved, and the components of a tax system that is growth-friendly yet at the same time continues to fulfil its fiscal function will need to be discussed in greater depth. Added to which, further questions on government revenues, such as the whole area of public-private partnerships, will have to be included in a wide-ranging quality-based analysis.

Another aspect of discussion on the structure of public revenues focuses on the impact that tax relief has on economic growth. With its “quasi-expenditure character”, this category on the revenue side of the budget brings us round full circle to an all-inclusive evaluation of public budgets. After all, the expenditure and revenue sides of the budget need to be designed as consistently as possible, aside from all partial considerations, comprehensively and with an eye to economic, fiscal and social objectives.

## Summary and outlook

In the past two decades, the scientific study of consolidation periods in OECD countries has taken huge strides forward. It is becoming increasingly clear that structural issues are of crucial importance. The economic growth effects of major structural reforms play a crucial part not only in the context of the Lisbon strategy; they are also an important control variable for the sustainability and stability of public finances. Yet many conceptual/theoretical and practical political questions surrounding the focus of fiscal policy on “high-quality” public finances still await a conclusive answer.

Politicians are aware of the importance and necessity of better-quality public finances, as adamantly underscored by the conclusions on the quality of public finances adopted under Germany’s EU Council Presidency.

But it is also evident that the different angles of public finances discussed here – efficient spending, budget institutions, revenue structures – need deeper economic and empirical analysis before the recommendations in the broad economic policy guidelines or Ecofin Council conclusions can be implemented into hard-and-fast benchmarks for national budget policy. We are, without question, only just embarking on this process.

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[54] See Heady (2007).

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Printed by: HST Offsetdruck Schadt & Tetzlaff GbR, Dieburg

ISSN Print: 1612-314X / ISSN Internet and e-mail: 1612-3158