

# East Germany's State and Local Government Budgets: Consolidation Efforts Fail to Prevent High Deficits

Fiscal policy has played a major part in the adjustment process taking place in east Germany. Not only have huge amounts of money been invested in the expansion and modernisation of the public infrastructure, but substantial funds have also been needed to alleviate the socio-political consequences of the decline in production and employment. All of this has constituted an enormous burden on the central, state and local government budgets, and on the social insurance institutions, for the volume of funds required has in no way corresponded to the tax revenue received in east Germany. A large portion of this burden has been financed via loans, leading to a sharp increase in the public debt. The massive borrowing was based on the hope that the east German economy would recover rapidly and that the region's states and municipalities would soon have receipts of the same dimension at their disposal as their west German counterparts. This hope has proved vain, however, and the east German state and local government budgets are now extremely short of funds – a situation that is being exacerbated by income losses caused by the weak business cycle and by reforms. One consequence is a massive decline in public investment spending.

## Consolidation on expenditure side since 1996

Up to the mid-1990s, the budgets of the east German *Länder* and local governments<sup>1</sup> were characterised by hefty growth in spending and indebtedness. It was not until 1996, when the process of economic recovery had come to a standstill in east Germany, that both the *Länder* and the local governments embarked on a policy of consolidation. The local governments, in particular, cut back sharply on spending – by no less than 14% between 1996 and 2001 (cf. table 1). The cutbacks affected investment spending in particular, which was

reduced by 30%. However, personnel expenditure also fell sharply (-16%), and staff levels were reduced by a quarter. To an extent, the personnel reductions were related to a process of large-scale modernisation in the town halls; in addition, municipal facilities were excised from the core budget.<sup>2</sup> The budget deficits of the local governments were reduced, and a small surplus was actually achieved in 2000; one of the factors that made this possible was the very favourable economic environment prevailing at the end of the 1990s. However, in 2001 municipal receipts were also much lower than those of 1996. While tax revenue increased – proceeding from a very low level – the rise was more than offset by the decrease in transfers from the *Länder*, which are quantitatively much more significant.

Expenditure by the eastern *Länder* was also cut back between 1996 and 2001, although the decline (2%) was much less severe than that seen at municipal level (cf. table 2). The *Länder* unloaded some of the burden of consolidation onto the local governments by reducing their transfers – those for investment grants more than those for operating expenses. Personnel spending (the largest expenditure item for the *Länder*) showed a moderate increase. The number of persons employed in federal state services was also reduced significantly during this period. Revenue increased by only 4% on balance; the tax revenue of the eastern *Länder* rose by 8%, and thus showed a weaker increase than the macroeconomic tax base.<sup>3</sup> This was partly because the German economy had stagnated in 2001, while a comprehensive tax reform also came into force. The economic downturn and the tax cuts resulted in substantial income losses for both the state and the local government budgets.

The *Länder* and the local governments of east Germany have made extensive use of the instrument of borrowing in the past. Despite the consolidation efforts, the debt per head of population has now exceeded that of the west German local authorities (cf. figure 1). One consequence of this development is that interest spending has expanded strongly and absorbed an increasingly large share of the receipts. This has significantly restricted the scope for fiscal policy, given that the income from the original source of revenue is low and there is a high degree of financial dependence on the central government and on the west German *Länder*. The financial burdens of reunification cannot be borne only by a single generation, for future generations will also benefit from the new infrastructure. Each generation receives an assortment of capital goods financed by

<sup>2</sup> This was one of the reasons for the sharp drop in investment spending, but the actual magnitude of the effect is not known.

<sup>3</sup> Nominal GDP had risen by 12% in east Germany (not including Berlin) during this period.

<sup>1</sup> Berlin is not included in this analysis.

Table 1

## Local Government Revenue and Expenditure in East and West Germany

Euro billion	1996	2001	2002	2003	1996	2001	2002	2003	Change (%)			
									2001/1996		2003/2001	
									West Germany			
Personnel costs	31.1	32.0	32.7	33.1	8.7	7.3	7.3	7.3	2.9	-15.5	3.6	0.0
Operating expenses	21.1	23.8	24.5	24.4	5.2	4.7	4.8	4.8	12.8	-9.0	2.4	0.4
Interest payments	4.8	4.3	4.2	4.2	0.9	0.9	0.8	0.8	-11.2	0.9	-3.3	-7.8
Current transfers to	12.7	14.9	15.5	15.6	1.8	2.3	2.4	2.3	17.3	26.0	5.1	1.5
public budgets	5.9	5.9	6.1	6.1	0.3	0.3	0.3	0.3	-0.8	20.5	3.8	-1.5
enterprises	2.2	3.0	3.7	3.5	0.9	1.1	1.1	1.2	35.5	19.8	16.6	10.0
social institutions	4.5	6.0	5.7	6.0	0.7	0.9	1.0	0.9	32.1	36.4	0.7	-7.2
Social benefits, etc.	24.8	23.7	24.3	26.2	4.0	3.7	3.8	4.2	-4.7	-8.9	10.7	15.1
Investment	19.1	19.0	18.7	16.6	7.4	5.2	4.9	4.8	-0.6	-29.4	-12.6	-7.5
Investment grants	2.1	2.0	2.0	2.1	0.7	0.7	0.7	0.7	-5.2	-10.2	3.6	11.3
Other expenditure	2.6	3.2	2.1	2.3	0.6	0.4	0.3	0.3	19.1	-43.4	-27.2	-5.3
Adjusted expenditure	118.4	122.7	124.0	124.4	29.4	25.2	25.2	25.4	3.7	-14.3	1.4	0.9
Taxes, etc.	40.8	45.1	43.4	42.7	3.3	4.0	4.0	4.1	10.4	21.2	-5.4	3.2
Income from economic activities	6.0	6.9	8.5	8.0	1.2	1.2	1.2	1.2	15.6	0.6	16.2	-0.1
Current transfers	28.3	30.0	29.7	28.3	12.1	11.2	11.3	11.2	6.2	-7.2	-5.8	-0.7
from the federal states	27.7	29.6	29.3	27.8	12.1	11.2	11.2	11.1	7.1	-6.9	-6.1	-0.9
from central government	0.6	0.4	0.4	0.5	0.1	0.0	0.1	0.0	-33.6	-57.3	17.6	.
Levies and charges	16.4	14.5	14.1	14.2	2.5	2.1	2.0	2.1	-11.5	-18.4	-2.2	-0.3
Investment grants	7.4	5.7	4.8	4.8	5.3	4.5	3.4	3.2	-22.8	-15.5	-16.7	-28.5
Sale of assets	5.5	6.0	5.9	6.0	1.5	0.9	0.9	0.7	10.5	-40.4	-0.8	-18.5
Other revenue	12.0	11.0	13.1	12.9	2.1	0.8	2.1	2.1	-8.2	-63.7	16.8	.
Adjusted revenue	116.3	119.3	119.6	116.8	28.1	24.7	25.0	24.6	2.5	-12.1	-2.1	-0.3
Financial balance	-2.1	-3.5	-4.5	-7.7	-1.3	-0.5	-0.2	-0.8	.	.	.	.
Euro per capita									East Germany as % of west Germany			
	1996	2001	2002	2003	1996	2001	2002	2003				
Personnel costs	502	510	520	525	613	531	536	540	122.2	104.3	103.1	103.0
Operating expenses	340	379	389	386	369	344	352	352	108.4	90.8	90.6	91.2
Interest payments	78	69	66	66	62	64	62	60	78.6	92.9	92.9	90.6
Current transfers to	204	237	246	247	129	167	178	173	63.4	70.7	72.6	69.9
public budgets	96	94	97	97	19	24	23	24	19.9	25.1	23.3	24.3
enterprises	36	48	58	55	63	77	82	86	176.1	161.8	140.5	156.2
social institutions	73	95	90	95	48	66	74	63	65.3	70.0	82.0	66.0
Social benefits, etc.	400	377	386	415	286	267	281	313	71.4	70.9	72.8	75.4
Investment	308	303	297	263	520	376	360	354	168.5	124.3	121.3	134.6
Investment grants	34	32	32	33	52	48	51	55	154.2	151.7	160.2	166.7
Other expenditure	43	50	33	36	44	26	23	25	103.4	51.0	69.6	67.9
Adjusted expenditure	1 911	1 955	1 968	1 970	2 076	1 824	1 842	1 870	108.6	93.3	93.6	94.9
Taxes, etc.	659	718	689	675	232	288	296	302	35.2	40.1	42.9	44.8
Income from economic activities	97	110	135	127	87	90	90	91	89.9	81.2	66.3	71.5
Current transfers	456	478	471	448	857	815	826	823	187.9	170.5	175.2	183.9
from the federal states	447	472	465	441	853	814	821	820	190.9	172.4	176.6	186.1
from central government	9	6	6	7	4	2	4	4	46.2	30.8	70.9	49.8
Levies and charges	264	231	224	224	179	149	146	151	67.6	64.7	65.5	67.5
Investment grants	120	91	77	76	377	327	250	237	314.9	358.2	324.7	314.4
Sale of assets	88	96	93	95	106	65	67	54	120.9	67.7	71.2	56.9
Other revenue	194	175	208	203	147	55	152	153	75.9	31.2	73.2	75.3
Adjusted revenue	1 877	1 900	1 897	1 848	1 984	1 789	1 826	1 813	105.7	94.1	96.2	98.1
Financial balance	-34	-55	-71	-122	-91	-35	-16	-58	.	.	.	.

Sources: Federal Statistical Office; DIW Berlin calculations.

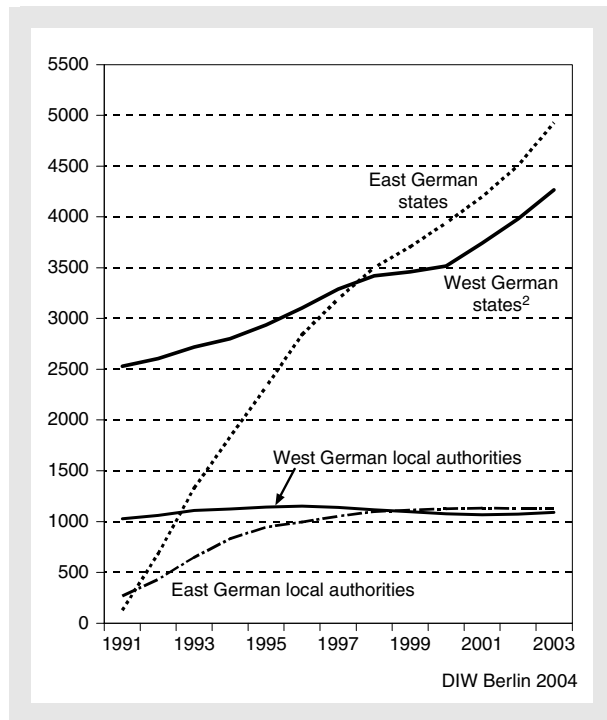
Table 2

## Federal State Revenue and Expenditure in East and West Germany

Euro billion	1996	2001	2002	2003	1996	2001	2002	2003	Change (%)			
									2001/1996		2003/2001	
									West Germany			
Personnel costs	64.8	68.9	71.1	71.6	13.2	13.8	13.8	13.8	6.4	4.1	3.9	0.1
Operating expenses	11.4	13.2	13.2	12.8	4.0	3.7	3.3	3.1	15.9	-7.1	-2.9	-14.8
Interest payments	11.8	12.8	13.1	13.5	2.1	3.1	3.3	3.4	8.6	46.1	5.0	8.5
Current transfers to enterprises	43.6	49.9	53.9	52.5	17.8	18.0	18.8	18.9	14.4	1.1	5.1	5.0
financial equalisation scheme	7.0	10.5	11.4	12.0	2.9	3.1	3.5	3.9	48.5	6.8	14.9	25.3
local governments	3.1	3.7	2.9	2.7	-	-	-	-	18.4	-	-26.2	-
other public budgets	27.7	29.6	29.5	27.7	12.1	11.2	11.2	11.2	7.1	-6.9	-6.6	0.0
social institutions	1.0	1.0	1.0	1.2	1.6	2.4	2.9	2.7	-2.0	49.3	29.3	9.3
social institutions	4.7	5.1	5.1	5.3	1.1	1.2	1.1	1.1	7.1	4.4	4.1	-9.7
Social benefits, etc.	4.1	4.7	5.4	6.0	1.3	1.6	1.8	1.8	14.7	23.8	25.7	11.2
Investment	4.2	4.5	4.1	3.9	2.3	2.3	2.0	2.2	7.7	1.3	-13.1	-5.4
Investment grants	13.8	12.3	12.1	11.6	11.4	9.2	8.8	8.8	-10.9	-19.6	-5.4	-4.2
to local governments	7.0	5.5	5.9	5.7	5.1	4.4	4.2	4.1	-21.5	-14.4	3.7	-7.3
to other categories	6.7	6.7	6.3	5.9	6.3	4.8	4.5	4.7	0.2	-23.9	-12.8	-1.3
Other expenditure	6.3	7.5	2.0	4.0	1.4	0.8	1.0	1.2	19.3	-44.9	-47.0	63.1
Adjusted expenditure	160.0	173.9	174.9	175.8	53.4	52.4	52.9	53.1	8.7	-2.0	1.1	1.5
Taxes, etc.	117.0	124.4	123.4	122.2	23.1	25.0	22.7	22.9	6.4	8.0	-1.8	-8.5
Income from economic activities	2.6	2.2	3.2	3.2	0.4	0.5	0.4	0.4	-16.4	24.3	46.9	-8.8
Current transfers from central government	13.7	16.2	15.6	15.8	13.3	14.3	16.1	16.0	17.6	7.5	-1.9	11.8
the financial equalisation scheme	9.8	11.5	11.1	11.3	10.0	10.5	13.2	13.2	16.9	5.3	-1.4	25.3
local governments	0.5	1.2	0.8	0.9	3.1	3.7	2.9	2.7	.	18.4	-28.9	-26.2
local governments	3.2	3.3	3.6	3.5	0.1	0.1	0.1	0.1	2.8	-39.2	6.6	-26.7
Levies and charges	3.2	3.1	3.5	3.6	0.6	0.5	0.6	0.6	-2.3	-5.9	15.3	10.5
Transfer of assets from central government	4.6	3.1	3.1	3.1	6.9	5.5	3.1	2.7	-33.0	-19.8	0.0	-51.8
Sale of assets	0.4	1.1	0.7	0.9	0.1	0.0	0.1	0.3	.	-13.3	-19.0	.
Other revenue	7.1	6.9	7.2	7.5	3.0	3.5	3.5	5.1	-2.4	16.7	8.5	47.4
Adjusted revenue	148.6	157.0	156.6	156.3	47.3	49.4	46.5	48.0	5.7	4.3	-0.5	-2.8
Balance	-11.4	-16.8	-18.4	-19.5	-6.1	-3.0	-6.4	-5.1	.	.	.	.
Euro per capita									East Germany as % of west Germany			
	1996	2001	2002	2003	1996	2001	2002	2003	1996	2001	2002	2003
Personnel costs	1 045	1 098	1 129	1 133	936	999	1 011	1 017	89.5	91.0	89.5	89.7
Operating expenses	183	210	209	203	279	266	243	230	152.4	126.8	116.4	113.8
Interest payments	191	204	208	213	150	225	238	249	78.9	110.2	114.7	116.6
Current transfers to enterprises	704	795	855	831	1 256	1 302	1 378	1 390	178.3	163.8	161.2	167.3
financial equalisation scheme	114	167	181	190	204	223	254	284	179.4	134.1	140.1	149.5
local governments	50	58	45	43	-	-	-	-	-	-	-	-
other public budgets	447	472	468	438	853	814	822	827	190.9	172.4	175.7	188.8
social institutions	16	15	16	20	116	177	215	197	.	.	.	.
social institutions	76	81	81	84	79	85	84	78	103.8	105.1	103.0	93.2
Social benefits, etc.	67	76	86	94	92	117	132	133	138.4	155.3	152.8	140.6
Investment	67	71	65	62	159	165	149	159	237.1	231.8	228.7	258.4
Investment grants	222	195	192	184	808	665	642	649	363.6	340.7	333.6	353.0
to local governments	114	88	93	91	363	319	310	300	319.7	362.1	333.1	331.3
to other categories	109	107	99	93	444	347	332	348	409.5	323.2	334.1	374.2
Other expenditure	102	120	31	63	97	55	75	91	95.0	45.6	238.2	143.5
Adjusted expenditure	2 581	2 769	2 776	2 783	3 777	3 795	3 868	3 916	146.3	137.0	139.3	140.7
Taxes, etc.	1 888	1 982	1 957	1 934	1 636	1 812	1 658	1 685	86.7	91.4	84.7	87.2
Income from economic activities	42	35	51	51	26	34	30	31	62.3	96.2	59.8	61.2
Current transfers from central government	222	257	247	251	944	1 040	1 179	1 182	425.9	404.2	477.7	471.1
the financial equalisation scheme	159	183	176	180	708	765	962	975	445.9	417.2	546.5	542.8
local governments	9	20	13	14	219	266	210	199	.	.	.	.
local governments	52	53	57	56	10	6	4	4	18.4	11.3	7.2	7.9
Levies and charges	52	50	56	57	39	38	41	42	75.2	75.3	72.6	73.8
Transfer of assets from central government	74	49	49	49	485	399	229	196	651.9	.	470.7	399.6
Sale of assets	6	18	10	15	4	4	7	22	67.8	19.5	71.3	148.0
Other revenue	114	110	114	118	212	253	258	379	185.9	230.9	226.2	320.8
Adjusted revenue	2 397	2 501	2 484	2 474	3 346	3 578	3 403	3 537	139.6	143.1	137.0	142.9
Balance	-184	-268	-292	-308	-431	-217	-465	-379	.	.	.	.

Sources: Federal Statistical Office; DIW Berlin calculations.

Figure 1  
**Indebtedness<sup>1</sup> of East and West German States and Local Authorities, 1991 to 2003**  
 Euro per capita



<sup>1</sup> Borrowing in financial markets in the wider sense. — <sup>2</sup> Not including city-states.  
 Sources: Federal Statistical Office; DIW Berlin calculations.

taxes and loans from the previous generation and passes on capital goods financed in the same way to the next generation. A permanent shift towards goods financed only by loans would modify this 'contract' to the detriment of future generations.

### Rapid deterioration in public finances in 2002 and 2003

The budget deficits of the east German *Länder* rose sharply again in 2002, although there was only a minimal increase in spending. In fact the *Länder* suffered significant losses both in tax revenue and in funds from the system of financial equalisation between the federal states. These losses were much higher than the slight increase in transfers received from the central government.<sup>4</sup> In addition to the weak business cycle, the

<sup>4</sup> Under the terms of the 'Investment Promotion Act for Rebuilding East Germany', the financial aid received from the central government was redeployed as 'supplementary transfers for special needs' so that the *Länder* now have free disposition over these funds, i.e. they are no longer earmarked for specific investment purposes.

impact of the tax reform was decisive. The *Länder* passed some of the burden on to the local governments under the regulations on municipal financial equalisation, whose volume is largely determined by the growth in revenue received by the *Länder*. The *Länder* also made considerable savings in operating expenses, while personnel spending did not rise further, despite the increases in negotiated wages. Payments to enterprises and interest expenditure expanded sharply, however. Major subsidies to enterprises included emergency aid for flood-damage repairs, while the higher interest payments were a consequence of the high deficits and also of the fact that there were fewer possibilities for redeeming high-interest old debts via low-interest new loans.

The rise in spending was even more minimal in the *Länder* last year (0.4%). The spending pattern was similar to the previous year's: personnel spending stagnated, while operating expenses were reduced. Transfers to the local governments also decreased, albeit only minimally. Grants to enterprises, by contrast, were again significantly increased. The *Länder* saw a perceptible increase in revenue (3.2%), which reduced their budget deficit from 6.4 billion euro to 5.1 billion euro. However, this was mainly due to special factors: Saxony and Saxony-Anhalt, especially, received substantial aid to repair flood damages. Tax revenue showed only a moderate increase, and both central government transfers and funds received under the system of interstate financial equalisation declined.

Unlike the east German *Länder*, last year the local governments saw a deterioration in their financial situation. While spending also rose here – though the increase (0.8%) remained below the rate prescribed by the financial planning council – revenue decreased. The local governments saw a slight increase in tax revenue, but they sold fewer assets and also received a lower volume of investment grants than the previous year. On the expenditure side, the sharp increase in social security benefits (10%) is particularly striking. This development is a consequence, on the one hand, of the continued rise in long-term unemployment and the abolition of labour market policy measures in east Germany; on the other, spending on 'basic insurance'<sup>5</sup> was introduced as a new budget item in 2003. By contrast, personnel, operating and interest expenditure stagnated, while invest-

<sup>5</sup> Under the terms of the law on Basic Insurance, the over-65s and persons judged to be fully unfit for work can claim basic insurance benefits, which correspond to social assistance. The local governments are usually the responsible authority. The federal government makes around 400 million euro a year available for this purpose via the *Länder*, while in Thuringia, the responsibility for 'supra-local social assistance' has been transferred from the federal state to the local government level. Cf. M. Wohltmann: 'Kreisfinanzen 2003: Sinkende Einnahmen und steigende Ausgaben führen zu Milliardendefizit in den Kreishaushalten'. In: *Der Landkreis*, February/March 2004, p. 102.

ment spending decreased again, albeit not as sharply as before.

### East vs west: still substantial structural differences in revenue ...

A comparison of per-capita income in east and west Germany<sup>6</sup> shows that there has been no significant narrowing of the substantial disparities. It must be remembered when looking at the figures that the populations of the two regions have developed differently, however. In the west German territorial *Länder*, the population has grown since 1996 by 1.3 million to 63.2 million, while it has shrunk in east Germany from 14.2 million to 13.6 million. The funds per capita available to the east German *Länder* in 2003 exceeded those of west Germany by 43%. However, their tax revenue amounted to only 84% of that of the western *Länder*. The differences in original fiscal capacity were even more marked; the redistribution of turnover tax is serving to substantially align tax revenue.<sup>7</sup>

The funds from the interstate financial equalisation system, which ensure that the less affluent territorial *Länder* achieve 95% of the average financial strength of all the *Länder*, are also extremely significant. In 2003, the east German *Länder* received around 2.7 billion euro from this fund, which corresponded to a hefty 5.6% of their income. The transfers from the central government were even more substantial. For example, the central government grants the financially weak *Länder* 'supplementary transfers'.<sup>8</sup> In addition, the east German *Länder* receive 'transfers for special needs' to compensate for 'burdens related to the division of Germany'. These compensate in particular for the funds needed to extend and modernise the infrastructure, as well as the extremely low tax capacity of the east German local governments.<sup>9</sup> These transfers amounted to a total of 9.9 billion euro in 2003, which corresponded to more than a fifth of all revenues.

The extent to which the east German *Länder* are dependent on aid from the central government becomes

clear when these payments are set against the transfers from the central budget to the west German *Länder*. In addition to the supplementary transfers, these are mainly funds for joint tasks carried out by the central government and the *Länder*, financial assistance from the central government under Article 104a §4(1) of the Basic Law for particularly important investments by the *Länder* or by municipalities, financial assistance to improve the traffic situation and for urban renewal and development, assistance towards housing construction, and central government funds provided under the laws on the disbursement of funds (*Geldleistungsgesetze*). In 2003, the west German territorial *Länder* received 229 euro per capita for these purposes, compared with 1171 euro per capita in east Germany, i.e. the difference amounted to 942 euro, which corresponded to 27% of all income in the east German *Länder*. The share has declined somewhat in recent years.

The disparities between the local governments are even more stark than those between the *Länder*. The taxable capacity of the east German local governments is still extremely low compared with conditions in west Germany, though the gap has narrowed since 1996. That year east German taxable capacity only amounted to 35% of that of west Germany, while on recent figures it reached almost 45%. The east German local governments took in 302 euro of tax revenue per head of population, compared with 675 euro in west Germany. The disparities in income and economic power become fully evident at municipal level because they have not been distorted by financial equalisation. There is a large gap in revenue from trade tax in particular, in part because the rates of assessment, which largely depend on economic power, are much lower than in west Germany.<sup>10</sup> Because of their low fiscal capacity and their considerable need for funds for infrastructure measures, the local governments in east Germany are extremely – and much more than their western counterparts – dependent on transfers under the municipal financial equalisation system. Almost 60% of municipal income are transfers from the *Länder*, compared with less than 30% in west Germany. Today the local governments in east Germany no longer have more funds at their disposal than their western counterparts. While in 1996 income in the east amounted to 1984 euro per capita, compared with 1877 euro in the west, the relationship now is the other way around, although the difference is smaller. In 2003, the east German local governments had 1813 euro per head of population at their disposal, compared with 1848 euro in west Germany.

<sup>6</sup> Because of their structural peculiarities, Germany's three city-states are not taken into consideration in this analysis.

<sup>7</sup> Three quarters of the federal states' share of turnover tax is distributed on a per capita basis; a quarter is subtracted ex ante to augment the fiscal capacity of those *Länder* with extremely weak finances (i.e. the *Länder* of east Germany).

<sup>8</sup> The result is that all those *Länder* that originally had weak tax capacity attain 99.5% of the average financial power of all the *Länder*.

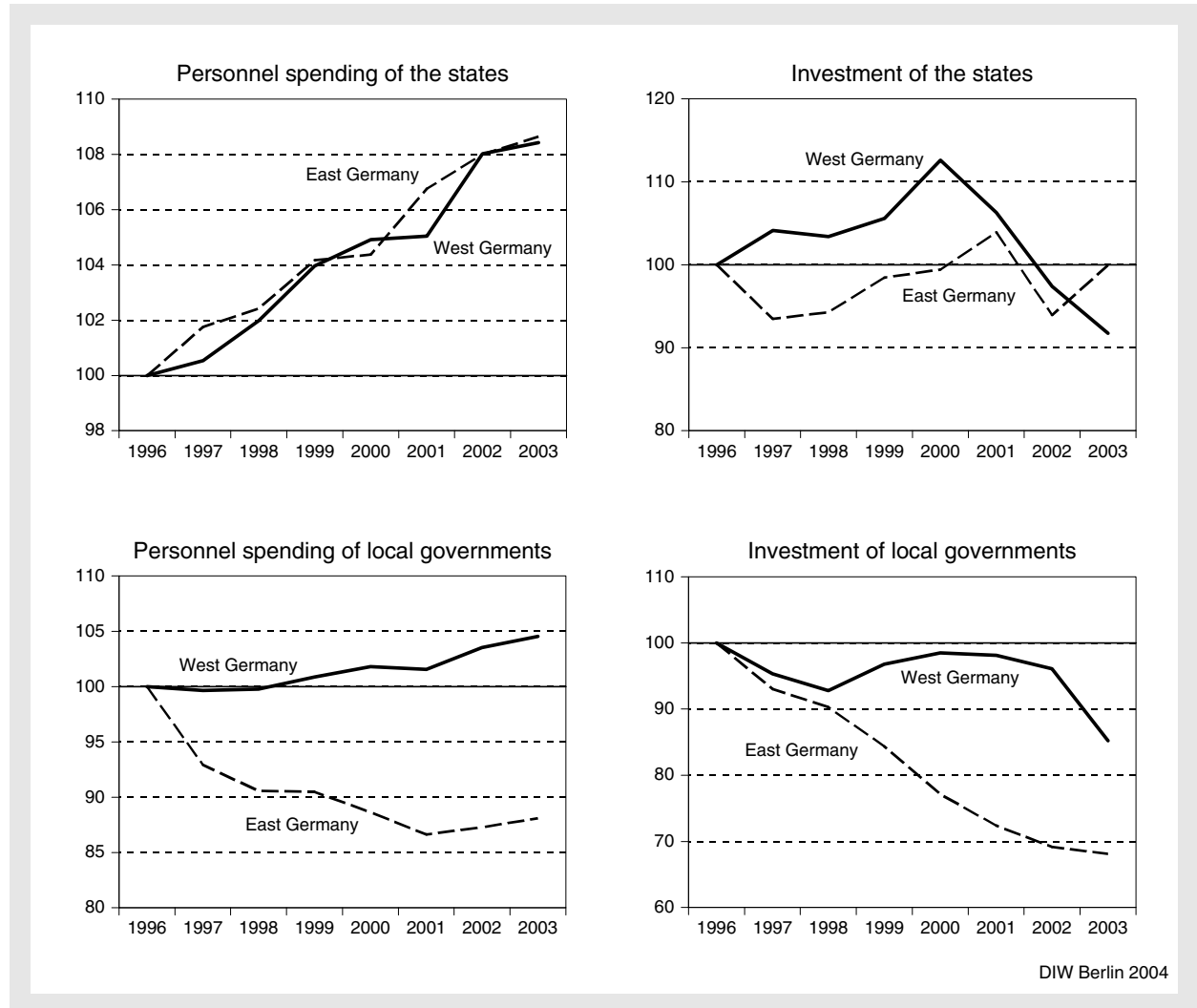
<sup>9</sup> There are also funds to compensate for the above-average 'costs of political leadership' in the smaller *Länder*. These transfers amounted to 330 million euro in 2003 and were received by all of the east German *Länder* except for Saxony.

<sup>10</sup> The average rate of assessment amounted to 389% in west Germany in 2002, compared with 358% in east Germany.

Figure 2

Personnel Spending and Investment by East and West German States<sup>1</sup> and Local Governments, 1996 to 2003

Per head of population, 1996 = 100



<sup>1</sup> Not including city-states.

Sources: Federal Statistical Office; DIW Berlin calculations.

... and on the spending side

The east German *Länder* are still spending much more per capita than their west German counterparts. The figure in 2003 was 2783 euro in the west, compared with 3916 euro in the east, i.e. 41% more. Compared with 1996, when the difference amounted to 46%, the spending gap has narrowed only slightly. There has been little change in personnel spending. The per-capita figures have been around 10% lower in east than in west Germany for a number of years; in other words, the trend has been more or less parallel in east and west (cf. figure 2). By contrast, operating expenditure and trans-

fers have become more closely aligned, although the transfers, and especially those to local governments, are still extremely high. The grants to enterprises reflect the intensive efforts to promote economic growth. The discrepancies between interest payments are becoming increasingly large.

The differences in personnel spending correspond to the degree of wage and salary alignment achieved in the public services. However, it must be remembered that the east German state budgets have so far had to assume the burden for only very few pensions for civil servants, while these constitute significant outlay in west Germany, i.e. 228 euro per capita.<sup>11</sup> If the pensions

Table 3

Employees<sup>1</sup> of East and West German State Services by Area of Responsibility

Per 000s of population

	West Germany		East Germany	
	1996	2002	1996	2002
General services	8.1	7.4	9.5	9.3
General administration	3.0	2.5	3.8	3.4
of which:				
senior political posts	0.4	0.4	1.0	1.1
taxation and financial administration	1.8	1.6	1.8	1.7
Public security and order	3.0	2.8	3.7	3.8
Police	2.9	2.8	3.7	3.7
Legal protection	2.2	2.0	2.0	2.2
Schools and pre-school education <sup>2</sup>	8.1	7.9	10.3	9.2
Universities	2.5	2.0	2.4	2.3
Non-university science and research <sup>2</sup>	0.4	0.5	0.7	0.4
Social security	0.3	0.3	0.4	0.3
Health, sports and leisure	0.2	0.1	0.4	0.5
Housing	0.3	0.2	0.4	0.3
Other	0.5	0.4	0.5	0.5
Transport and communications	0.5	0.3	0.8	0.7
Total	20.9	19.0	25.5	23.5

1 Full-time and part-time employees; part-time employees converted into full-time equivalents. — 2 Including administration.  
Sources: Federal Statistical Office; DIW Berlin calculations.

and allowances for civil servants are left out of the equation, then at 959 euro, the figure for the east German *Länder* is much higher than for west Germany (781 euro). This difference corresponds more or less to the differences in the employment figures: the number of public servants – measured in full-time equivalents – is still almost 25% higher in the east German *Länder* (23.5 employees per 1000 residents) than in west Germany (cf. table 3).

Disparities in the area of personnel are particularly evident in schools, in the central administration and in public security. Not only is the density of school pupils now much lower in east Germany, but the quantitative coverage in the general education schools – expressed as the teacher-pupil ratio – is much more favourable; in the vocational schools, on the other hand, the ratio is practically identical (cf. table 4). The student density at west German universities is substantially higher, and more

students are being taught there than in east Germany. This is also reflected in the personnel spending of the universities and in the basic funds allocated from the state budgets. Seen in relation to the number of students, these figures are much higher in east Germany (cf. table 5).

At municipal level, the per-capita spending of the eastern local governments fell below the western level for the first time at the end of the 1990s; it is currently 5% lower in the east. Significant progress in alignment can be seen in personnel spending. While this was still over a fifth higher than the western level in 1996, the difference shrank to 3% by 2003 as a result of staff reductions. In 1996, the east German local governments had 21 employees for every 1000 residents, but this figure had fallen to 14 by 2002. At 11.6, the ratio in west Germany was much lower, however (cf. table 6).

The differences regarding social security benefits (social assistance and youth welfare) are very marked. These were almost 25% lower in east Germany in 2003. This can be explained in particular by the fact that the number of participants in job-creation schemes and in vocational further training is (relatively) much higher, even if these schemes have become less significant in

<sup>11</sup> It is true, however, that the eastern *Länder* are also burdened with pension payments, for example, benefits paid under the GDR's special and supplementary pension systems. These are of a similar magnitude per capita as the pensions paid out of the west German state budgets, but are itemised as transfers, not as personnel expenditure.

Table 4

### Supply Indicators for East and West German Schools

	East	West	East	West
	1996		2002	
Pupils per 100 residents				
Vocational schools	15.0	11.7	10.4	12.2
General education schools	3.5	2.9	3.6	3.2
Teacher-pupil ratio				
Vocational schools	15.8	16.4	13.5	16.5
General education schools	26.6	22.8	23.9	24.0

1 Not including city-states.

Sources: Federal Statistical Office; DIW Berlin calculations.

recent years. Since participants in these schemes are not counted as long-term unemployed, they do not draw social assistance. Other factors are the lower income level and the lower cost of living in east Germany, which reduce claims on social welfare. The fact that the share of older women with their own old-age pension is higher in east Germany must also be taken into account, because it means there are fewer claims on nursing-care insurance and social welfare.

Some of the differences in spending are institutional in nature and depend, for example, on how child-care facilities are allocated, i.e. whether they are operated privately or under the local government. In general, the institutional care of children is given much more importance in east than in west Germany, and the funds spent by east German local governments on child care are accordingly higher than those spent by their western counterparts. In east Germany, two thirds of kindergarten places are supplied by municipal and a third by private providers. The relationship is the opposite in west Germany. The personnel costs itemised in the municipal budgets in east Germany are proportionately higher, and the subsidies paid to private bodies are proportionately lower. All in all, east Germany's local governments spent 2140 euro per child aged up to 10 years in 2001 (more recent data are not available), while the figure calculated for west German was only 1080 euro, in other words half the eastern figure.

In 1996, the difference with respect to municipal investment spending still amounted to two thirds, but it has now shrunk to a third. The decline in investment spending accounted for by far the largest share of the

decrease in total local government spending. The pace of the alignment process in availability of infrastructure capital decelerated noticeably as a result, however. The 'municipal share' in financing investment spending – real investment minus investment grants from the *Länder* – diminished from 143 euro per capita to 117 euro per capita. In west Germany, the corresponding figure recently was 187 euro, i.e. it was substantially higher. This illustrates once again how much the local governments in east Germany depend on transfers for their 'voluntary' spending.

### Outlook

Despite a restrained spending policy in recent years – more in east than in west Germany – neither the east nor the west German *Länder* and local governments have managed to reduce their budget deficits. On the contrary, these have risen on balance since 2000. At the same time, the gap between the per-capita indebtedness of east and west Germany has widened. However, it would be short sighted to interpret the high deficits in the east and west as an expression of unsound fiscal policy. The fundamental fiscal weakness of east Germany has been exacerbated by the burdens related to the tax reform and by the loss in revenue caused by the sustained economic lull. A further reduction in the deficit during this weak phase could only have been made possible by accepting high opportunity costs.

The fact that the cutbacks have primarily affected investment spending is particularly worrying, even if such expenditure is still higher per capita in east than in west Germany. If, like this year, next year brings more tax concessions, then further cuts will follow in municipal investment spending and in federal state spending

Table 5

### Indicators for Universities

	East Germany	West Germany
Personnel expenditure 2001 in euro per student	10 748	9 180
Basic operating funds 2001 in euro per student	8 197	6 993
Students 2002 per residents	18.5	22.9
Students 2002 per teaching employees	7.5	8.5

1 Not including city-states.

Sources: Federal Statistical Office; DIW Berlin calculations.



Table 6

Employees<sup>1</sup> of East and West German Local Government Services by Area of Responsibility

Per 000s of population

	West Germany		East Germany	
	1996	2002	1996	2002
General administration	2.7	2.6	4.1	3.3
Public security and order	1.3	1.3	1.7	1.7
Schools	1.3	1.1	2.1	1.2
Science, research and culture	0.7	0.6	1.4	0.9
Social security	2.6	2.6	5.5	3.1
of which: youth welfare facilities	1.3	1.4	4.0	2.0
Health, sports and leisure	1.0	0.8	2.0	0.9
Construction and housing, transport	1.8	1.4	2.1	1.6
Others	1.5	1.2	2.0	1.1
Total	13.0	11.6	21.0	14.0

1 Full-time and part-time employees, part-time employees converted into full-time equivalents.  
Sources: Federal Statistical Office; DIW Berlin calculations.

on human capital (schools, universities and research). A strategy of this kind stands in contrast to growth-oriented considerations, for excessively low spending on infrastructure curbs growth, especially given that there are still bottlenecks and quality deficits in important areas such as the municipal transport networks. Resorting to further borrowing is hardly an option any more for the east German *Länder* and local governments, for the burden of interest payments is already very high.

Since the planned strengthening of the financial capacity of the local governments via a reform of municipal finances has failed, it is now all the more important for the east German *Länder* and local governments to try to reallocate budget funds so as to use them more productively. There are still many 'consumption' areas in which the east German *Länder* and local governments are more generously provided for, and this occasionally appears unjustified. This applies to staff numbers both in the police force and in the state and local government administrations. It also applies to transfer spending, including spending on investment grants and subsidies, which could certainly be reduced and therefore redeployed for more specific purposes.<sup>12</sup> And it also applies to the funds for urban construction, for in this area, in

particular, the difference from west Germany has narrowed significantly or even disappeared, especially when the structurally weaker regions and cities are taken as the yardstick.

Ultimately, it will only be possible to resolve the financial problems of the eastern state and municipal budgets when the economy finally gets a foothold again and a longer term upswing sets in both in east and in west Germany. Only a favourable macroeconomic environment will allow the east German economy to catch up on west Germany, the original tax capacity in east Germany to increase and the dependence on west German transfers to diminish. One prerequisite for such a development would, however, be that the public budgets make their contribution by operating less restrictively, in other words they should temporarily accept higher deficits. The problem, however, is that the room for manoeuvre is largely exhausted in this respect in east Germany. The failure to strengthen the financial power of the local governments (including those in west Germany) in the long term via a reform of municipal finances is thus all the more lamentable. The planned additional funds for the local governments now cannot be expected to improve the situation, for these will only serve to absorb the new burdens resulting from the merging of unemployment and social welfare benefits.

In any case, the adjustment process in east Germany is by no means nearing its conclusion. Only when the

<sup>12</sup> Cf. Zweiter Fortschrittsbericht wirtschaftswissenschaftlicher Institute über die wirtschaftliche Entwicklung in Ostdeutschland'. In: *Sonderheft des IWH*, No. 7/2003, pp. 241f.

disparities in the original tax capacity – measured against the tax capacity of the poorer west German *Länder* – have disappeared will it be possible to consider the process complete. The second Solidarity Pact has provided the conditions such that the process can continue. Basically, the measures defined under the Pact can be regarded positively, given that the *Länder* have received a basis for planning early on. However, one doubt is whether the period of time planned for distributing the funds should not be shortened, i.e. whether the financial transfers should not be accelerated. Another question is if it was a wise decision – taken under pressure from the east German *Länder* – not to earmark the funds in any way. This decision means there is no way to guarantee that they will be used mainly for investment spending. After the experience of the implementation of the first Solidarity Pact, it will be necessary to keep a very close eye on events to ensure that the local governments are given a fair share of the funds from the second Solidarity Pact.

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