3

FISCAL POLICY

INTRODUCTION

Fiscal policy can be divided into two parts corresponding to the revenue side and the expenditure side. Revenue is mainly derived by the various levels of government from taxation. Public-sector enterprises may also be expected to make positive contributions, although in some cases this has proved to be an over-optimistic expectation. As will be shown in Chapter 5, the largest item on the expenditure side is social-policy spending. Other large expenditure items include education and defence. Policy interest, however, has been increasingly focused on the general level of government expenditure, along with the size of the budget deficit. Subsidies have been the object of particular attention. In both Chapter 8 and in the section on budgetary policy below, it will be emphasised that subsidies in the west were particularly at odds with the supply-side (free market) economics pursued after 1982 and with the problems associated with unification.

As already demonstrated in Chapter 1, such an extent of government intervention is inconsistent with the received theory of the SME. A recurrent theme of this chapter will be the extent to which fiscal policy failed in practice to conform with this theoretical framework. It will be found that not only government spending, but also high marginal tax rates have been perceived as problematical by taxpayers. After all, there is a need within the SME model for low marginal rates to stimulate effort and risk taking, although some progression in the tax system is necessary in order to achieve the social equity goal of this model. Not that these two elements—neutrality and equity—are unique characteristics of the SME, albeit that this is the model which must be tested here: a common problem of all tax systems is modifying income inequalities by means of a progressive tax system but avoiding very high marginal rates which may undermine risk taking. (Only the effect of tax rates on risk taking is relevant here. In the next chapter, the equally important role played by interest rates will be considered.)

Above all, it is in this sense that unification, and meeting its attendant costs by increasing government spending and taxation, hardly represented a new phenomenon. In principle, it was just another redistribution problem. Moreover, Germany has historically been a good example of how a sizeable part of the national income is re-distributed by government in accordance with equity rather than market considerations (Mendershausen 1974:78). If unification further constrained the reform of fiscal policy, however, membership of the EC in some ways proved to be a stimulus.

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In order to show that unification simply exacerbated existing fiscal problems, the following hypotheses on the pre-unification position need to be validated:

- tax rates were considered to be unacceptably high and the structure was in need of reform
- reducing expenditure had proved to be an intractable problem
- by German post-war standards, there was already a serious public-sector debt problem

REFORMING THE STRUCTURE OF TAXATION

Taxes are levied on incomes, capital and expenditure. The two general categories of income taxes are employment and corporate taxation. In addition, as will be seen in Chapter 5, both employers and employees contribute to various social insurance funds. Not surprisingly, value added tax is the major expenditure tax. Two factors make the structure of taxation in Germany complex. First, as already seen in Chapter 2, there are elaborate revenue-sharing arrangements between the various levels of government. (This factor also complicates the expenditure side.) Second, there is a large number of taxes, as will be shown in the next section. Even at this stage, however, it is instructive to note that *Wirtschaftswoche* (10/91:20) listed 30 taxes. By far the largest revenue earner was the tax on employees' income (DM 181.3 billion in 1990). Total tax revenue in 1990 was DM 549.5 billion (MRDB 2/93: table VIII[1]). Hence one third of total tax revenue was derived from taxes on employees' income. Rank 30 in the *Wirtschaftswoche* list was occupied by the tax on licensed premises in certain Länder (DM 11 million in 1990). Several minor taxes on sugar, salt, tea and lightbulbs/fluorescent tubes were abolished on 1 January 1993, although the coffee tax remained in force. Individual churchgoers may also elect to have a 'church tax' *(die Kirchensteuer)* deducted from their income. This voluntary 'tax' is authorised by Article 140 of the basic law (GG), which in turn refers to Article 137(6) of the Weimar constitution. On unification, it was introduced into east Germany. Its average rate was 3 per cent in 1991, when it raised DM 15.6 billion for the Catholic and Evangelical churches (iwd2 40/92). More detail on tax revenue and its distribution will be given in Figures 3.4–3.7 below. Initially, however, an overview of the tax structure will be given.

Income tax (ESt) is levied on the total income of an individual, subject, of course, to allowances being deducted in order to arrive at taxable income. For collection purposes, income tax is divided into:

- assessed tax on total income
- taxes on employees' income (LSt) deducted at source from salaries, wages, pensions, etc.
- capital yields tax of 25 per cent, deducted at source from dividends, interest, etc. received from limited companies
- directors' fees tax deducted at source from fees received by non-executive directors from overseas

Corporate tax takes two main forms. First, there is a national corporation tax (KSt) which is not levied on partnerships or small businesses. These latter type of enterprises are assessed for ESt. The tax yield of the KSt on retained and distributed profits differs. Second, there is a local trade tax (GewSt) which is generally payable by business enterprises, irrespective of their legal status. The liberal professions are presently the main exceptions. Hence, for

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collection purposes, corporate tax was divided into:

- a KSt of 50 per cent on retained profits
- a KSt of 36 per cent on distributed profits
- a local GewSt of up to 20 per cent of profits and capital values, deductible from KSt liabilities

Shareholders are entitled to include the corporation and capital-yield taxes for crediting against their total income tax liability. Such a provision—introduced in 1977—prevents double taxation. Consequently, Germany's system of corporate taxation favours the distribution of profits. When German companies complain about high taxation, therefore, they are referring to retained profits (Härtel in Cowling and Tomann 1990:350–1). Although the amendment of corporate taxation was, prior to being subordinated to the fiscal imperatives of unification, the subject of lively debate, no significant consideration was given to changing the distributional bias of profits taxation. It is noteworthy that this system is diametrically opposed to the principles underlying the systems in the UK and the USA. Yet paradoxically Britain's biggest 115 companies distribute at least twice and sometimes three times as much in dividends as the Germans (*Guardian* 20 June 1990). This higher dividend/earnings ratio may have more to do with firms in the UK (and USA) being driven by short-term profit considerations in order to avoid hostile takeover bids, an essential question for the sections on corporate finance, ownership and control, and mergers and acquisitions in Chapters 7 and 8. An even more surprising paradox will also be demonstrated in Chapter 8 (Figure 8.2). West German firms relied heavily on internal financing from retained profits. The expected effect of the system's bias in favour of distribution, namely a greater reliance on loans or equity finance, does not therefore seem to have materialised (Härtel *ibid.:* 352).

A major reform of taxation on personal incomes was introduced on 1 January 1990. Its implementation in West Germany at the beginning of unification year was coincidental: increasingly high marginal income tax rates had been a problem throughout the post-war period. This factor was the cause of a number of reforms, culminating in the 1990 amendments to the tax structure. There was a second important reason for the tax reforms during the 1970s and 1980s. As one of the world's most powerful economies, West Germany was expected to provide a stimulus to international economic growth. The Bonn and Louvre accords are two cases in point: they will be dealt with in a little more depth below. Since the gross annual cost of the 1990 tax-reform package in terms of the reduction in revenue was DM 40 billion, its implementation in unification year, given the enormous consequential increase in expenditure demands, posed a serious policy dilemma: either there would be an enormous increase in government borrowing, or the tax reform plans would have to be modified. There has tended to be a basic conflict of this description throughout the post-war era.

The dramatic economic changes in the period 1946–58 were analysed in general terms in Chapter 1. More specifically, Figure 3.1 plots the income tax schedules during this period—a period which was sequentially characterised by inflation, currency reform, liberalisation of markets and, ultimately, the introduction of full foreign-exchange convertibility. Notice first of all the swingeing increases in taxes introduced by the Allies in 1946. Even though this diagram shows average tax rates (taxation/taxable income at current

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prices), the relatively high position of the 1946 schedule can be easily seen. Reuss (1963:83) reports that marginal income tax rates (the change in taxation relative to the change in taxable income) were raised to a maximum of 95 per cent. Although these rates were the highest in German history, they were designed to reduce the huge monetary overhang which had been one of the legacies of the Nazi regime (Denton *et al.* 1968:187–8). In 1948, the Allies feared that if they allowed the drastic tax cuts sought by the Economic Council chaired by Erhard, budget deficits and consequential inflationary pressure might vitiate their currency reform. (As will be seen below, the Council therefore introduced tax privileges which are still problematical.) The first amendment under the new German jurisdiction (still subject to reluctant Allied approval) resulted in a decrease of 15 percentage points in the top rate (Reuss *ibid.*). By 1953, 80 per cent was the maximum marginal rate on taxable incomes between DM 250,000 and DM 350,000, with an overall maximum of 70 per cent on incomes over DM 500,000—a product of the staggered marginal system in operation at that time (*ibid.*: 83–5). In 1955, the maximum rate was 63.45 per cent with an overall maximum of 55 per cent.

Wallich (1955:104–5) termed the 1953 changes as 'the little tax reform' and reports that the debate about the 1955 measures was 'distinctly muted'. By way of contrast, the 1958 reform was 'major' (Denton *et al.* 1968:194). A new proportional 'entry stage' was also introduced, whereby a flat rate of 20 per cent was payable up to DM 8,000 (single person) or DM 16,000 (married person). Thereafter the rates were calculated so as to rise continuously with even the smallest rise in income, with two separate formulae being used in a progressive zone. The reduction in the upper proportional rate to 53 per cent, also introduced in 1958, cannot be gauged from Figure 3.1. This is because in average terms the new rate was payable on incomes over DM 1 million! Although some of the essential features of the 1958 reform are not completely clear in Figure 3.1, the 'low' position of the 1958 curve relative to preceding tax regimes can be seen at a glance. In other words, the virtue of Figure 3.1 is that it demonstrates the continual process of adjustment during the period 1946–58; the actual amount of tax payable on a given income is indicated for each of the amendments to the tax structure which took place during the period. For example, the 1958 schedule in the figure shows the entry rate of DM 4,261 which was applicable to a married person (allowance of DM 3,360) with one child (additional allowance of DM 900). It then shows how the average rate rose, given this unlikely case of a taxpayer entitled only to these basic allowances. Nonetheless, marginal rates of tax and the effects of inflation are not apparent in the figure. These difficulties can be resolved by plotting income margins along the horizontal axis and by using a constant price level—as can be seen by comparing Figures 3.1 and 3.2.

Summarising, it can be said that the 1958 reform introduced an initial formula which resulted in a constant marginal rate of 20 per cent but a gradually rising average rate. This rising average rate is due to the fact that tax-free allowances decline as a percentage of total income as income rises. In this sense, all tax regimes are progressive. Moreover, higher-income groups tend to avail themselves more of tax-free allowances which makes the income tax system bear more heavily on lower-income groups—a paradoxical result when the social objectives of taxation are borne in mind (Denton *et al.* 1968: 191). Conversely, if

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the tax-free allowances available to lower-income groups are raised, a certain proportion will be removed from the tax system altogether, whereas the absolute value of the tax relief is greater for higher-income earners because they are taxed at higher marginal tax rates. Emphasis in the present analysis, however, is on marginal rates.

In the 1958 model, following the application of a constant marginal rate of 20 per cent up to a total taxable income of DM 8,009 for a single person, the marginal rate increases. The degree of progression was governed by two formulae, the first being applied to total taxable incomes between DM 8,010 and DM 23,999. Thereafter, the second formula was applied until total income reached a level of over DM 110,000. At this latter point, the upper constant marginal rate was applied. Let T be the tax payable and Y the taxable income, then:

$$T=0.2\,(Y\text{—tax-free allowances})$$

In the progressive zone the two equations were:

$$T=0.2\,(\text{tax threshold—tax-free allowances})+aY+bY^2$$

$$T=A+cY+dY^2-eY^3$$

(Where A, a, b, c, d and e are all constants)

Finally, the upper proportional zone also displayed a constant marginal rate (53 per cent) but an average rate that rose to a given finite income:

$$T=0.53Y\text{—a constant}$$

(The equations are based on the German original source of Figure 3.1, page 163. The log function introduced in 1954 can be found in the same series of reports, 1955:164. The 1981 formula-based schedule is analysed in OECD 1981b:40–1.)

The next major reform, enacted in 1964, can be seen in Figure 3.2. The first function for 1965 shows how the proportional entry stage was lowered from 20 to 19 per cent and the curve of progression was smoothed out. The top rate of 53 per cent can be clearly seen, as can the effect of the 3 per cent surcharge of 1965. In 1975, the bottom rate of tax was raised from 19 to 22 per cent, payable on taxable income to DM 16,000 for a single person—double the 1958 point. (The 22 per cent level in the lower proportional zone can be clearly seen in Figure 3.2 but see Owen Smith 1983:87, for a graph of the DM 16,000 entry into the progressive zone. Figure 3.2 is based on a constant-price assumption, although note the 1981 entry into the progressive zone—DM 18,000.) In 1975 the progressive range began at this point (DM 16,000) with a rate of 30.8 per cent, rising to the previous top rate of 56 per cent. However, the step increase which featured this jump from 22 to 30.8 per cent was removed in 1979, thus resuming its pre-1975 exponential rise but from DM 18,000 (Figure 3.2). In real terms, and this is the main point about Figure 3.2, the shape and position of the marginal rate curve changed very little between 1965 and 1981. Changes in the tax structure in 1975, 1979 and 1981 compensated for inflation but left unchanged in real terms the starting point of the progressive region (OECD *Economic Survey* 1982:42). A similar change in the tax structure—not shown in the figure—took place in 1978 *(ibid.)*.

In turning to Figure 3.3, the reader will be able to combine the approaches of the two previous figures. First, it can be seen that there were further reforms of marginal tax rates in 1986, 1988 and 1990, with

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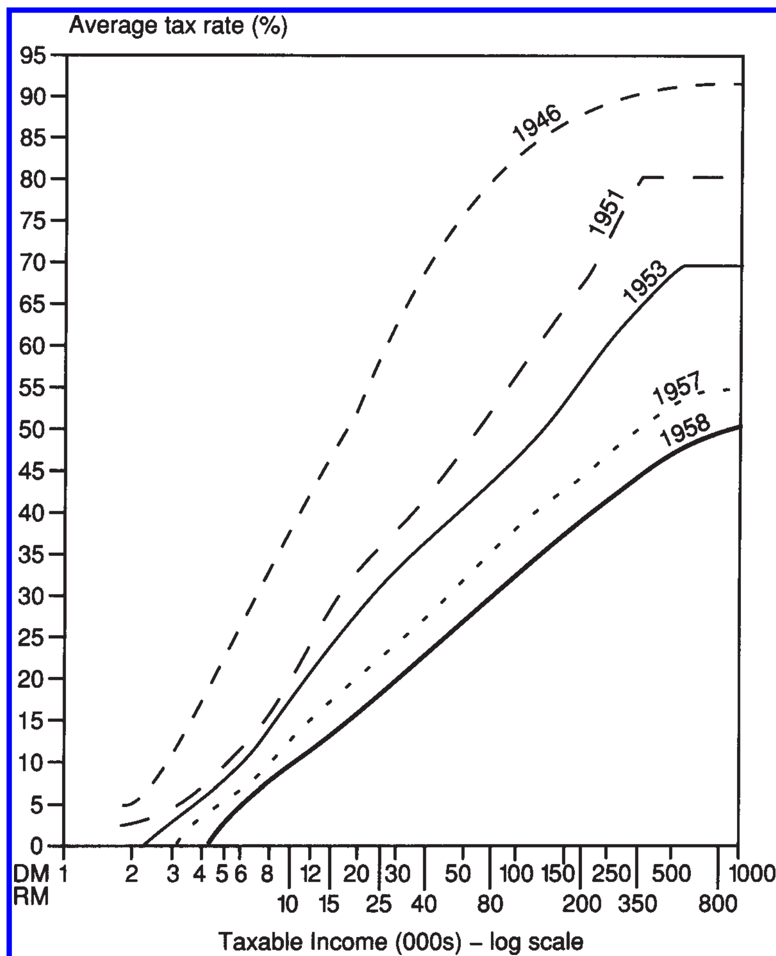

Figure 3.1 Income Tax on taxable income: 1946–58 (at current prices)

Source: BMF, *Vorbemerkungen zum Haushaltsplan* 1959:169 (reproduced in Reuss 1963:87)

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the 1990 function becoming a straight line. It can also be seen that the amount of tax actually paid by the tax payers indicated on the horizontal axis (the average rate of tax) fell in 1990 when compared to 1986. Clearly, then, the 1990 reforms are significant for several reasons which can be summarised as follows:

- the annual minimum rate on taxable income was reduced three percentage points to 19 per cent
- the annual maximum tax rate was reduced by the same amount to 53 per cent
- the tax threshold for single persons was increased by DM 1,080 to DM 5,616; children's allowances were increased by DM 540 to DM 3,024 per

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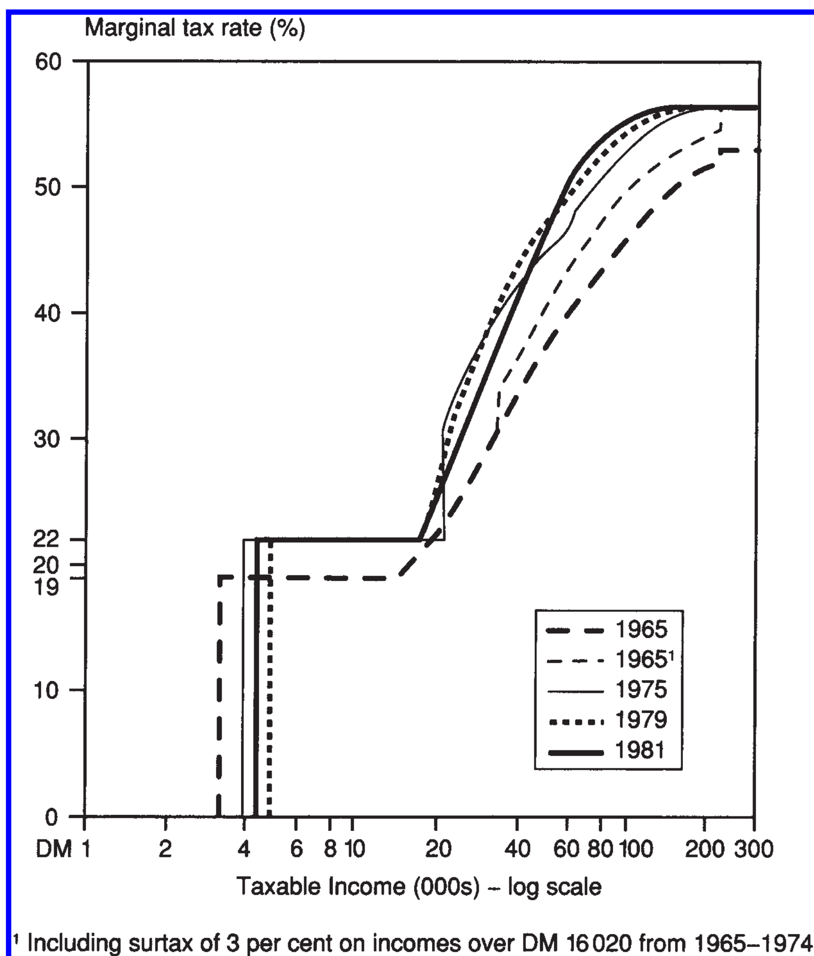

Figure 3.2 Marginal tax rates at constant prices: 1965–81

Source: SVR, *Jahresgutachten* 1981/82 (reproduced in OECD Economic Survey (Germany) 1982:43)

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year; in addition, children's educational allowances were increased

- most important of all, the gradient of the marginal rate function between the lowest and highest threshold was converted from an exponential to a linear function (also see Figure 3.3)

By way of contrast, the reform of both the level and structure of corporate taxation was being actively considered at the time of unification, although the 50 per cent level of corporation tax was introduced concomitant to the reforms analysed in the previous paragraph. Prior to 1 January 1990, the level had been 56 per cent. Yet the Deutsche Bank *Bulletin* (December 1989:4) estimated that corporation and trade taxes combined meant a marginal rate of almost 60 per cent even after the tax cuts of 1990:

Even those who claim that West German corporate taxation is on the whole average in international terms admit that the 'psychology of high tax rates' counts

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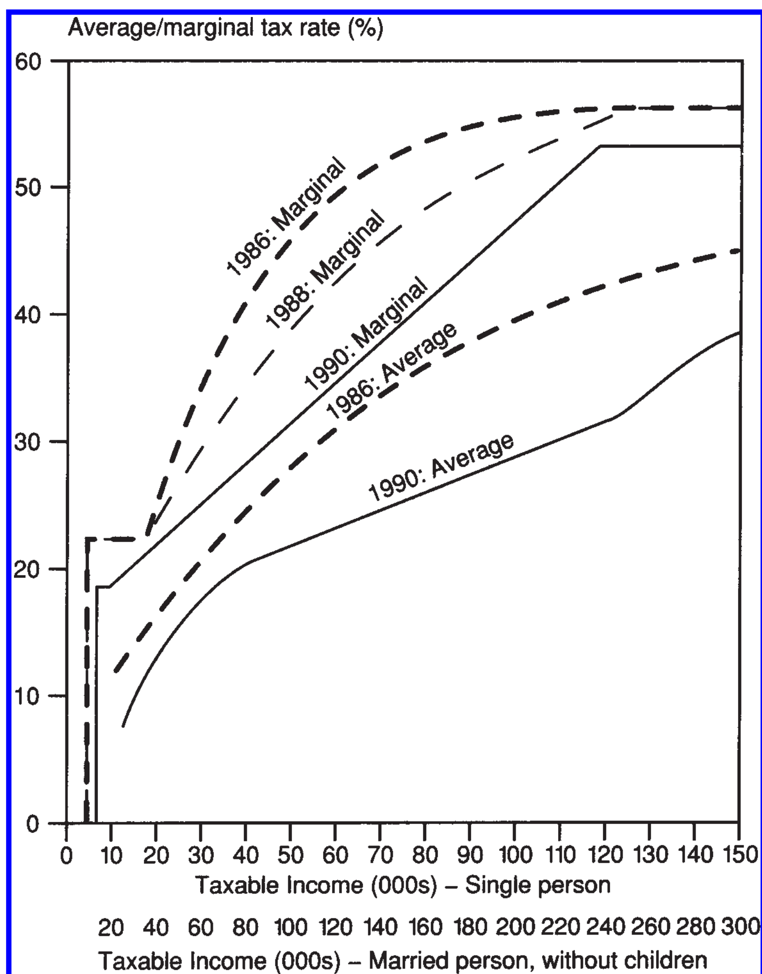

Figure 3.3 Tax reforms: 1986–90 (at current prices)

Sources: Der Spiegel 42/87; 18; Dresdner Bank, *Wirtschaftsberichte* April 1987:12

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against West Germany as a corporate location.

(ibid.)

Certainly the West German business community became acutely concerned about EC 1993 and the real or imagined threat posed by high tax rates in Germany. For example, the chief executive of IBM Deutschland estimated that his company paid 54 per cent tax on distributed profits compared to the 26 per cent paid by IBM England (*Der Spiegel* 6/88). His interviewers asked how the figure of 54 per cent was arrived at, given the 36 per cent corporation tax rate on distributed profits. The reason was that trade and capital-yield taxes had been included. Had profits not been remitted to the parent company, the rate would have been 70 per cent. His interviewers countered that this assumed the most pessimistic scenario imaginable,

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and quoted an estimate (made by Professor Littmann) of an average corporate tax rate of 34 per cent; the interviewee pointed out that this average value was deflated by the inclusion of companies which recorded losses. Ironically enough, IBM was to record large international losses in the early 1990s. Such was the substance of this aspect of the cost debate surrounding West Germany's future viability as a competitive industrial location *(Standort Deutschland)*.

Differing estimates of the corporate tax burden are not unusual. Indeed, different methods of calculation yield a variation from 20 to 70 per cent of net income; even using the same methodology produces the estimates of 20, 34 and 54 per cent made respectively by the SVR, Professor Littmann and IW (Deutsche Bank *ibid.*). Consider also the IfW comparative research on undistributed profits reported in the OECD's *Economic Survey* (Germany—1989:90). The data are net of tax allowances and since these differ significantly as between countries, the results are misleading. Such a data base is selective because 'profits' would be more meaningful if defined as total revenue minus total costs. However, no business enterprise, least of all a German company, would release such data to the general researcher. Nearly 25 per cent of the tax in the IfW model comprises local taxation; since the study also assumes the pre-1990 rate of corporation tax of 56 per cent on the remaining 75 per cent of profits, the tax burden is about 70 per cent. The MRDB (8/89:44–5), on the other hand, reported an average rate of corporation tax for 1983 of 43 per cent. This ratio was, however, 'higher than the actual burden since the profit on which it is based has already been reduced as a result of several tax concessions, such as special depreciation allowances'.

Along with the contention that wage costs were also adversely affecting international competitiveness (see Chapter 6), there is at least something in the view that the corporate community was crying wolf. Quite apart from the positive locational factors emanating from the high efficiency of German labour brought out by the IBM interviewee quoted above, there is the fairly spectacular array of standard or itemised deductions for business expenses implied by his interviewers. There are also other allowances. For example, all trade insurance premia are deductible, as are uninsured pension commitments and employee welfare funds. Accelerated depreciation allowances are widely available (see Chapter 2). In any case, the post-tax profits of large companies in particular had been booming prior to unification (*Der Spiegel* 13/89). Yet the vast majority of medium and small businesses, which comprise 90 per cent of the total number of companies, are subject to income tax rather than corporation tax. It is therefore the top rate of income tax which is the relevant policy consideration in this case. The minority FDP partners in the Federal coalition government advocated a radical reduction of marginal tax rates, not least to favour small businesses faced with EC 1993 (*Wirtschaftswoche* 26/ 89:41).

In fact EC 1993 concentrated the policy makers' minds wonderfully when it came to corporate tax reform (Härtel in Cowling and Tomann 1990). The trade tax is the general element of company taxation which received particular attention. The Federal government established a commission to examine the alternatives. Partially unrelated to company profitability, it can bear more heavily in a recession (Flockton 1990:59). But its complete abolition is constitutionally difficult: it is the main source of income for local authorities. Their autonomy would therefore be adversely affected. An

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alternative source of income for local authorities would be an even greater degree of revenue sharing—already a problem area as seen in Chapter 2. A removal of the capital-tax element, and a concomitant widening of the taxable income base, therefore seemed to be the most favoured line of reform (OECD *Economic Survey,* 1989:91). Reform of this tax would not be new: in some cases (until 1979) the trade tax had also contained a pay roll tax. When the pay roll element was abolished, the local authorities' income tax revenue share, details of which are given below, was raised by one percentage point to 15 per cent.

The tax on working capital *(die Gewerbekapitalsteuer)* was duly scrapped on 1 January 1993. Small businesses also received some relief from the GewSt and there was an increase in the threshold at which the wealth tax *(die Vermögensteuer)* on companies became payable. This latter tax is unrelated to sales. The conservative-liberal Federal coalition reduced its rate on coming into office and subsequently agonised over its reform (*Die Zeit* 37/91). More significantly, the *Standortsicherungsgesetz* received the approval of the Federal cabinet late in 1992. Scheduled to come into force on 1 January 1994, it reduced the rate of the KSt on retained profits to 44 per cent while the rate on distributed profits was reduced to 30 per cent. Similarly, businesses not eligible to pay KSt, received a reduction in their ESt to 44 per cent (SZ 10 December 1992). (The top rate for personal income remained 53 per cent.) In all these amendments, depreciation allowances were also reduced so that the fiscal effect was neutral. As a result of the amendments' fiscal neutrality, the likely effect on investment was uncertain (Dresdner Bank *Trends* June 1993).

West Germany's membership of the EC ultimately stimulated a reform of VAT. Proposals for such a reform can be traced back to 1953 when they formed part of a package recommended by a panel of advisers to the BMF (Denton *et al.* 1968:190). In the same report, the panel had dealt with the tax system as a whole. The 1958 reform of income tax discussed above was based on one of their recommendations. However, the government did not accept their recommendation for an overall reduction in corporate tax and introduced the two-tier system which favoured distributed profits. The financial requirements remaining after the re-shaping of income and corporate tax, the report stated, would have to be met by indirect taxation. No increase in these taxes was envisaged: quite the contrary because as a result of the drastic increase of the turnover tax in 1951, the Federal government's revenue from this source was already as great as income and corporate taxation combined. As will be seen below, achieving budget surpluses was the principal policy objective of the time.

In the report to the BMF (see the previous paragraph), the stated aim was rather the reform of the turnover tax to encourage competition and prevent concentration. No one in Germany doubted that the cumulative indirect tax system of the time encouraged vertical integration and price distortions; it was thus alien to the competitive order. Hence, the cumulative turnover tax, which was levied like a 'cascade' at each stage of the productive and marketing processes, should, the report contended, be replaced by a non-cumulative turnover tax, or 'value-added tax'. Ultimately, a bill containing proposals for a value-added tax appeared in 1963 and the final measure reached the statute book in 1967. Consequently, the normal rate of value-added tax was to be 10 per cent as from January 1968, but it was raised to 11

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per cent to help balance the budget. A special rate of 5 per cent was also introduced by the 1967 legislation.

It is appropriate to look at the EC side of things in a little more depth. Articles 95 and 96 of the EEC Treaty respectively outlaw taxing imported products more highly than their domestically produced competitors; similarly, repayments of tax on exports may not exceed the taxes actually paid on the product in question. Calculation of the taxes so included is extremely difficult under a cumulative tax system and this gave rise to claims and counter-claims among member states that exports were being given hidden subsidies by overestimating the refundable taxes. Concomitant to the German reforms of the 1960s, therefore, efforts were being made at the EC level to introduce a neutral and transparent turnover tax system. In 1967, two VAT directives introduced such a tax and this replaced all other turnover taxes in member states. France and Germany were the first members to comply—in 1968. Other members followed later, the last one being Italy in 1973. New members are required to introduce the tax within three years of their accession.

VAT rates differ widely within the EC. To achieve fiscal harmonisation with EC 1993, the Commission proposed that two VAT rates should be applied: a standard and a reduced rate. Since the recommendation for the former was between 14 and 20 per cent, and the latter between 4 and 9 per cent, Germany was particularly well placed to conform: her rates since 1983 had been 14 and 7 per cent respectively. Moreover, she remained in such a position when the proposed minimum standard rate was increased to 15 per cent because the Federal Minister of Finance (Theo Waigel) announced in June 1991 his intention to seek parliamentary approval for a new German rate of this amount as from the beginning of 1993. (It will be shown that this increase in VAT revenue will also assist in financing unification.) The minimum standard rate, finally agreed as late as October 1992 by the EC Council of Ministers, applied to both VAT and the special excise taxes on mineral oil, alcohol and tobacco (MRDB 10/92:19; BfG *Standpunkt* 7/92). The German reduced rate remained unchanged (OECD *Economic Survey* 1992:103n). Britain was the only member country to retain a zero band for goods such as food, books and newspapers; pressure to scrap the zero rating on transport was expected to begin as early as 1994 (*Guardian* 1 April 1992). British zero rating on domestic energy was to be abolished from 1994, although the British secured a reprieve for the sale of duty-free goods until 1999.

As would probably be expected, Germany's system of excise duties is as incongruous as that of any other Member State. It is for this reason that even less progress has been made in harmonising excise-duty structures than VAT structures. Germany, along with other wine producers, imposes no duty on still wine; this is in contrast to the UK, Denmark and Ireland where duty on this item is very high. These three states also charge a relatively high duty on spirits, whereas Germany is nearer the median in this frequency distribution and there is also only a small amount of duty payable on sparkling wines and beer. Petrol and tobacco, of course, bear fairly heavy duty. More surprisingly, especially as it ran contrary to the EC specific proposal to abandon such duties on the grounds of collection costs, duty in Germany was also payable on tea, coffee, sugar, salt and light bulbs. These duties were levied by the Federal government and were known as *Bagatellsteuern,* or taxes of little

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significance. In 1991, they raised only DM 517 million out of a total tax revenue of DM 662 billion (*Handelsblatt* 29 April 1992; MRDB 2/93: table VIII(1)). With the exception of the tax levied on coffee, they were ultimately abolished as from the end of 1992. Four *Bagatellsteuern* were retained by the Länder and local authorities, however *(Handelsblatt ibid.)*.

The effect of GEMSU in 1990 on the structure of German taxes was allied to the effect of EC 1993. An inevitable increase in taxation to meet the costs of unification was not proposed by the Federal government until February 1991. As well as the increases in unemployment and pension contributions to be examined in Chapter 5, a one-year surcharge of 7.5 per cent on income and corporation tax was proposed to run from 1 July 1991. The SPD majority in the Bundesrat sought to modify the bill so that only taxpayers with annual earnings of more than DM 60,000 would be affected until March 1994. Also affected were excise duties on petrol and tobacco, as well as motor vehicle and insurance taxes. The ultimate compromise was to agree the implementation of the foregoing measures but to postpone any immediate modification of the local trade tax. The tax was not to be levied in the east until at least 1993, but would remain in the west (FT 17 June 1991). As a result of these tax increases, the total tax burden on individuals was expected to rise to over 45 per cent of GNP by 1994—a historic peak (IDS *European Report* 355). From January 1995, as a result of the solidarity pact agreement, there was to be a further surcharge on income tax of 7.5 per cent. (The wealth tax was also to be increased.) These higher income taxes were to compensate for the higher share of VAT conceded to the western Länder. These changes will be considered in a wider budgetary policy context below.

THE INCIDENCE OF TAXATION

All tax reforms are, of course, undertaken with a view to introducing changes in this context. As shown in the last section, the reforms in post-war West Germany covered all forms of taxation with varying degrees of success. For example, the general structure of the personal income tax schedule remained unchanged during the period 1958–89. The basic policy problems were concerned, first, with where taxation at the lower proportional rate should commence and what that rate should be; second, the progressive zone rose with such an initial steepness from the lower rate that the marginal rates bore heavily on tax payers propelled into this zone by rising real incomes; third, the upper proportional zone was varied over the period. The 1990 reform marked a highly significant phase in the attempts by policy makers to address all three problems, especially the second one.

It was indeed this second problem which grew more serious as the period progressed. As the original German source of Figure 3.1 makes clear (p. 165), the 1958 reform of the tax schedule, plus the increase in allowances, meant that approximately 75 per cent of the reductions in tax liability benefited individuals in the lower proportional zone. Including persons no longer eligible for taxation, this zone now contained 95 per cent of all pre-reform tax payers, representing some 80 per cent of taxable income which provided 50 per cent of income tax revenue. Hence, the remaining 20 per cent of taxable income in the variable marginal rate and upper proportional zones provided the other 50 per cent of income tax revenue. (Only 0.1 per cent of taxpayers included in these latter data earned more than DM

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100,000, representing 4 per cent of taxable income.)

Only a decade later—in 1968—the proportion of taxpayers in the variable marginal rate zone had more than trebled to 15.5 per cent (OECD source of Figure 3.2). By 1974 this proportion had reached almost 42 per cent, although the reforms of 1975 and 1979 had the effect of reducing it to 35 per cent in 1980. Even so, in 1980 taxpayers in the variable marginal rate portion of the schedule paid 78 per cent of total personal income tax revenue, while the 15 per cent of tax payers with marginal rates of over 35 per cent provided half that total *(ibid.)*. The Dresdner Bank (*Wirtschaftsberichte,* April 1987:12) estimated that by 1985 two-thirds of all tax payers had moved into the variable marginal rate zone. This bank attributed the move into this zone by more and more nominal incomes to inflation, whereas the OECD source above preferred to associate the move with rising real incomes. There is probably a significant input from both sources, although real wages (net of taxes and social insurance contributions) fell for the six successive years to 1986 (OECD *ibid.* 1987:15).

The position in the mid-1980s can be seen as a major driving force behind the reforms depicted in Figure 3.3. The Dresdner Bank data outlined above, and reported in more depth by this writer elsewhere (1989:62), indicated an average tax rate on employees' income in 1985 of 18.8 per cent plus a further 14.9 per cent for social security contributions. Moreover, the marginal rate of these two items reached over 60 per cent. The Deutsche Bank (*Bulletin* April 1987:14) referred to the 1990 reform as meeting 'the decades-old demand to eliminate the disproportionately sharp rise in tax rates on middle-bracket incomes'. Two powerful examples (see also Figure 3.3) are, first, that the marginal rate for a married couple earning DM 60,000 fell from approximately 32 to 25 per cent; secondly, on DM 80,000 it fell from roughly 38 per cent to about 28 per cent. In absolute terms, of course, the fall in the upper proportional rate brought even bigger windfalls: DM 12,000 to single persons earning more than DM 120,000 (married couples DM 21,000 if earnings exceeded DM 260,000—*Der Spiegel* 3/90:88). In addition, there had already been adjustments towards levelling off the tax scale in the progression zone in both 1986 and 1988 (MRDB 8/90:43). The OECD (*ibid.* 1985:30) predicted in 1985, however, that these two latter adjustments to the schedules would merely compensate for inflation since 1982. The 1990 reform can thus be seen as going some considerable way towards meeting the SME model's requirements—only to be undermined by subsequent developments. There was thus a perceptible increase in the incidence of personal taxation, especially if social-insurance contributions are included. Between 1970 and 1985, for example, total deductions from each DM 1000 of pay rose on average from DM 220 to DM 310 (TVF 18 February 1993). The 1990 reform brought this amount down to DM 299, but inflation of pay rates, the 7.5 per cent 'solidarity' surcharge of 1991–2 (see below) and increased social-insurance contributions (see Chapter 5) caused the average deduction to rise to DM 323 and DM 335 in 1991 and 1992 respectively.

As already implied several times above, allowances give rise to difficulties in calculating the actual incidence of taxation. Reasonably straightforward from the operational point of view is the 1958 'splitting' of the income of married couples which is still in operation: unless they opt to be assessed separately, their combined

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income is halved, and the tax on this sum is doubled. On the other hand, this system possesses a number of discriminatory features, particularly in terms of the costs of child raising, single-parent families and married women whose husbands have a high tax liability (Spahn *et al.* 1992).

Tax allowances as such are classified as follows:

- a basic tax-free allowance *(der Grundfreibetrag)*
- an initial deduction *(der Vorwegeabzug)*
- a child allowance *(der Kinderfreibetrag)*
- allowances for prudential expenditure *(die Sonderausgaben)*
- a ceiling to allowances *(der Höchstbetrag)*

Hence, whether one considers a single or married person there is a basic allowance. As well as an additional basic allowance for children, all employees receive a lump sum allowance (DM 2,000 in 1990). Interestingly, the Federal Constitutional Court (BVG) ruled in 1990 that the government must ensure that the level of income deemed necessary for a decent existence for families with children is entirely free from tax (IDS *European Report* 355). As a result, family tax allowances and benefits were significantly improved in 1992 (OECD *Economic Survey* 1992:34). Claims for improved basic and child allowances could be backdated to 1986, together with a supplementary allowance for 1983–5 (also see Table 5.5 below). The BVG also required the tax exemption limit for low incomes to be lifted. In addition, employees may deduct social and many private insurance contributions and premia ('prudential expenditure'), thereby lowering taxable income. Regular payments on a savings contract with a building savings bank are also an appreciable deduction in the category—see the section on housing finance in Chapter 7. The effort-inducement aspect of the SME can be seen from other employee-related outgoings such as travel, trade union membership and running a second home, all of which are classified as 'normal' expenses. Then there are a number of exemptions such as unemployment and redundancy pay. Premia payments for overtime, as well as Christmas, marriage, long service and SAYE bonuses are also exempted to pre-set limits. Finally, there is a category of 'extraordinary' expenses. Social policy preconceptions in this area have led to educational and single-parent allowances, the latter being in addition to the basic single-person household allowance. As a result, a typical employee in 1980 earned DM 33,607 gross. However, income tax deductions amounted to DM 10,902, leaving a net taxable income of DM 22,705 (OECD *Economic Survey,* 1982:42).

Total taxation as a proportion of GNP lay well within the range 20 to 25 per cent during the post-war period, but this apparent stability is misleading. The relative contribution of indirect taxes to government revenues has diminished (OECD *ibid.* 1985:27). Social security contributions have risen fastest, and receipts from the direct tax on employees' incomes also increased rapidly relative to other direct taxes. Perhaps the relative tax rates reveal the basic problem: in 1989, the effective social security contribution rate was 32.5 per cent; the average effective personal income tax rate was 20.1 per cent; the standard rate of VAT was 14 per cent (OECD *ibid.* 1990:120). This latter source shows that, as a proportion of GNP, direct and indirect taxes contributed very similar amounts to general government receipts: 12.5 and 12.3 per cent respectively in 1989.

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Social security contributions on the other hand amounted to 16.9 per cent of GNP. It is this latter feature of Germany's tax system which pulls her to the middle of the EC's tax league—on other tax ratings she has a lower incidence (MRDB 8/89:41).

The increasing incidence of direct tax and social insurance contributions on the employed population has been a policy issue for many years (Owen Smith 1983:82–5). It is becoming increasingly difficult to estimate the direct tax element because the tax on employees' income is only a special type of income tax which overlaps increasingly with assessed income tax (MRDB *ibid.:* 44). A growing number of employed persons are assessed for income tax because their total income exceeds the limits of DM 24,000 for single and DM 48,000 for married persons. These limits date from 1948 and 1973 respectively.

Nevertheless, there has been a conspicuous growth in income tax on employees compared to assessed and corporate income taxes. As a percentage of GNP the former grew from 1.7 per cent in 1950 to 8 per cent in 1989; over the same period the average of the latter taxes amounted to 3.5 per cent (BMA *Statistisches Taschenbuch* 1990: table 1.23). The same source can be used to calculate even more telling statistics (tables 1.13 and 1.15). Expressed as a proportion of average gross income per employee in employment, the average deduction for income tax and social-insurance contributions rose from 12.5 per cent (1950) to 33.9 per cent (1989). Social-insurance contributions, which are examined in depth in Chapter 5, almost doubled during this period, rising on average from 7.9 per cent to 15 per cent as a proportion of average gross income per employee in employment. The fall in average real disposable ('net') wages in the 1980s was mainly the consequence of these trends *(ibid.)*. The amendment of the income-tax schedule in 1990 (Figure 3.3 above) caused total statutory deductions from pay to fall for the first time during the period 1950–90 (*ibid.* 1992). This average decrease of —1.4 per cent in 1990 was followed in 1991, however, by an increase of both tax rates and social-insurance contributions. As a result, total statutory deductions rose on average by 13.2 per cent and they again represented a third of average gross income per employee in employment *(ibid.)*. Meeting the costs of unification would probably increase this proportion still further.

During the 1970s and 1980s direct taxes on income as a whole rose from 14 to 17 per cent of total income from employment and public service pensions, plus corporate and property origins (MRDB 8/82 and 8/89). The effect of the various tax reforms can be clearly seen in these sources. The 1975 reductions induced a temporary one percentage point decrease but by 1977 the ratio reached a new peak of over 18 per cent. By 1981 it was back down to 17 per cent, while the 1986 and 1988 adjustments brought down another upward trend. Until unification, it was expected that the major reform of 1990 would bring about a resumption of the 16 per cent figure last achieved in the mid-1970s. Quite apart from this two decade exercise of running fast in order to stand still, there was a significant difference between both decades in terms of the relative behaviour of the tax and social insurance ratios. The average ratio of tax to GNP in the 1970s was half a percentage point higher than in the 1980s, when it was 24 per cent. (The average ratio for 1970–5 was much the same as 1965–9—MRDB 8/76:16.) However, when social insurance contributions are included, the average for the 1970s is 38 per cent, compared to 39.5 per cent for the 1980s.

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THE ALLOCATION OF TAX REVENUE

'Allocation' in this context is an important fiscal issue not just because there are competing demands on the expenditure side, but also from the three levels of government (Federal, Länder and local authorities) in terms of securing a guaranteed share of tax revenue. As seen in both Chapters 1 and 2, the attempts to resolve this latter problem go to the very heart of German fiscal policy. The 'provisional' regulations of 1949, based on the 1922 model, were eventually replaced by a constitutionally guaranteed revenue-sharing model. The Federal government's share in this arrangement has declined, although it remains in gross terms the largest single recipient of tax revenue.

Until 1980, the yield from employees' and assessed income taxes was allocated on the basis of a 43 per cent share each for the Federal and Länder governments, with the remaining 14 per cent going to the local authorities. Following the abolition of the pay-roll element of the trade tax in 1980, the ratios became 42.5:42.5:15, but the Federal and Länder governments each receive a 7 per cent share of the trade tax. Since 1970, the yield from corporation and investment income taxes has been divided equally between the Federal government and the Länder. Although both VAT and the turnover tax on imports are also shared between the Federal and Länder governments, the Federal share gradually declined from 70 per cent in 1970 to 65 per cent in 1986. To assist the Länder in meeting their share of the transfers to the east, the solidarity pact agreement in 1993 specified that their share of VAT receipts should rise (see the budgetary policy section below). Hence, the Federal government's share fell to 58 per cent of total receipts. In addition, the Federal government redistributes a given proportion of its share to the financially weaker Länder. Since 1987 this amounts to 2 per cent of its share in turnover tax revenue. The payment to the EC out of this latter tax yield is also deducted from the Federal government's share. The EC also receives a share of customs duties.

Even prior to unification, therefore, the Federal net share in total tax revenue had been falling. In 1970, this share amounted to 53 per cent; by 1989 it had declined to 45.9 per cent. On unification, the financially weaker Länder in the west were faced with the daunting prospect of becoming net contributors to the revenue sharing mechanism and also seeing the eastern Länder receive an equal share in turnover tax revenue. The unity treaty envisaged a phased introduction of turnover tax sharing by the new Länder, from 55 per cent on unification but culminating in an equal share by 1995. The dire financial situation in the east resulted in equal shares being introduced in 1991. Although the western Länder contributed to the German Unity Fund, the question of eastern participation in the revenue sharing arrangement remained unresolved. It was the Federal government which was obliged to take the initiative: in 1991 about 25 per cent of the federal budget of DM 410 billion represented unification costs. This represented expenditure over a broad front, including investment inducements, infrastructure improvements, financial assistance to the eastern Länder and local authorities and employment creation.

As well as the shared tax yields, there are a number of taxes exclusively levied by each level of government. For example, the Federal government (the largest recipient of such revenue) enjoys exclusive rights to the proceeds from the taxes on mineral oils, tobacco, insurance and spirits. Petrol tax was increased 14 times

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between 1950 and 1991; diesel tax was raised on ten occasions (*Die Zeit* 28/91). A 25 per cent average increase in mineral-oil tax in 1991 was introduced within the framework of the Solidarity Act *(das Solidaritätsgesetz)* to contribute towards the costs of unification (OECD *Economic Survey* 1992:102n). Note that reference was made to an *average* increase. There are fairly wide differentials between unleaded and leaded petrol, and between petrol and diesel. The Länder, on the other hand, do not have a perfectly uniform tax system, although they all levy taxes on motor vehicles, property and beer; there is also an inheritance tax at this level. It will have already been gathered that the trade tax is by far the most important source of revenue for local authorities: this tax accounts for 7 per cent of total tax revenue. There is also a tax on land and buildings at this level.

It is shared tax revenue, however, which still brings in the lion's share, amounting to 75 per cent of the total tax yield. This is demonstrated in Figure 3.4 where shared taxes on income and expenditure amounted to almost DM 400 billion in 1989—the last full fiscal year prior to unification. A generally accurate picture of the subsequent position can be gleaned from the figure, but the reader should bear the following factors in mind. In 1989, GNRP rose by 4 per cent, thus increasing tax revenue. In 1990, the major tax reform predictably affected revenue, while in 1991 the unification surcharges also created an abnormal revenue impulse. Finally, GEMSU generated a continuing debate about relative shares in tax revenue and the financing of transfer payments. Part of this debate was reported in Chapter 2. Its culmination was marked by the solidarity pact, to which the analysis returns below. Nonetheless, the relative magnitude of independently levied taxes can also be gauged from Figure 3.4: the rank order being Federal, local authorities and the Länder. (The 7 per cent share of the trade tax has been added to the shares of both the Federal and Länder governments, but 14 per cent deducted from the local authorities' tax revenue.)

The breakdown of the Federal government's tax revenue can be seen in Figure 3.5. As would be expected from the above emphasis on the increasing importance of personal income tax as a revenue raiser, just over a third of revenue emanates from this source. It is even more important to the Länder (50 per cent) and the local authorities (just over 40 per cent)—see Figures 3.6 and 3.7 respectively. Even though the Federal government received 65 per cent of the revenue on turnover taxes, they did not proportionately produce a very much higher share of total taxes when compared to the Länder. (Recall that both the EC and the Länder are entitled to part of the VAT revenue flow nominally accorded to the Federal level. Also recall that one of the effects of the solidarity pact agreement in 1993 was to reduce the Federal share of VAT receipts to 58 per cent.)

Hence, the taxes increased by the Federal government to assist in financing unification were either the large revenue earners or, with one exception, taxes levied exclusively at the Federal level. As well as the 7.5 per cent surcharges on income and corporation taxes, therefore, mineral oil, tobacco and insurance taxes were raised. These latter three taxes are included in Figure 3.5, although insurance taxation (DM 4.19 billion in 1989) is included in the 'Other' category in this figure, as is the DM 2.65 billion share of the trade tax. Only a relatively small change was made to the taxes exclusively levied by the Länder as a result of the unification

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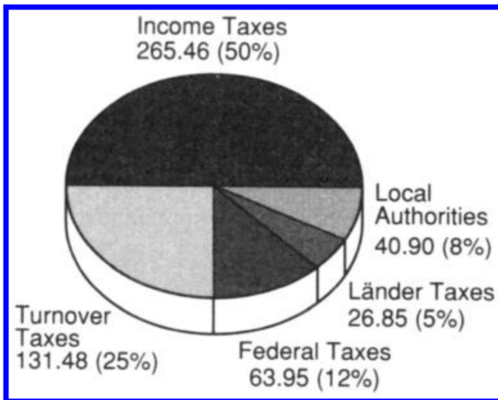

Figure 3.4 Total Tax Revenue 1989
(DM billion)

Source: MRDB Tables VII(5/6)

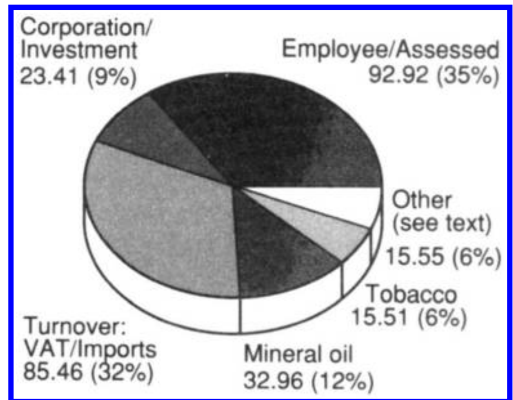

Figure 3.6 Länder Tax Revenue 1989
(DM billion)

Source: Figure 3.4

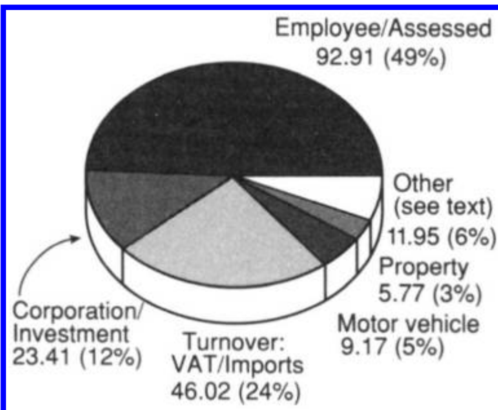

Figure 3.5 Federal Tax Revenue 1989
(DM billion)

Source: Figure 3.4

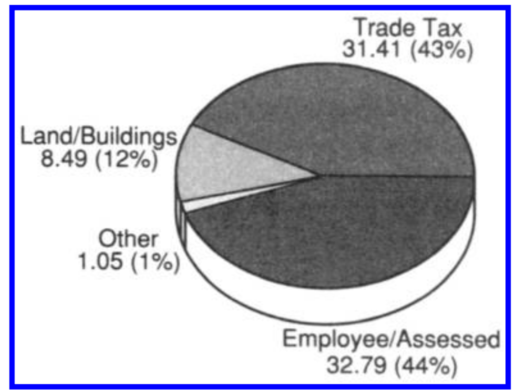

Figure 3.7 Local Authorities' Tax Revenue 1989
(DM billion)

Source: Figure 3.4

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tax increases, namely the tax on diesel-powered motor vehicles, but there has in any case been a move away from independent taxation in favour of a jointly-levied tax base. In 1970, the independently levied taxes still accounted for 35 per cent of total tax revenue.

Finally, Figure 3.7 shows the importance of the trade tax to the local authorities: it generates more revenue than the corporation tax and the same amount as assessed income tax. The latter two generated DM 30 billion and DM 36 billion in 1989, while the gross amount of the trade tax was also DM 36 billion. After allowing for the Federal and Länder share of DM 5.3 billion, it still left over DM 31 billion for the local authorities. It is by far the most important local tax, and as such it represents the backbone of the fiscal

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autonomy constitutionally guaranteed to the local authorities. On the other hand, it has already been seen that it also represents the largest tax problem for German businesses. Resolving this dilemma—it should be re-emphasised—is probably the biggest problem confronting the German policy makers.

BUDGETARY POLICY

The general government budgetary position reveals very little about the disaggregated levels of the four critical variables in public finance, namely revenue, expenditure, borrowing and debt. Indeed, it has already been seen in Chapter 2 that a principal budgetary problem is co-ordinating the fiscal policy of the three levels of government. Similarly, it will be seen in Chapter 5 that the social-insurance funds, including the finances of the Federal Labour Office (BA), are also part of the general budgetary arrangements. The importance of these latter items can be gauged from the inclusion of 'social' in both SME and GEMSU. National accounts include the revenue and expenditure of the three levels of government and the social-insurance funds. Even this general-government budget, which will shortly be analysed in depth, yielded an estimated average deficit balance between revenue and expenditure of DM 100 billion in the early 1990s (Heilemann 1991b:300). Yet in 1989 it had produced a surplus of DM 4 billion. This deterioration took place in spite of even higher tax revenue in 1991 and 1992 than anticipated (Dresdner Bank *Trends* December 1991). In addition, however, several shadow budgets are included in the public-sector accounts. Some of them were analysed in Chapter 2 where it was seen that two of these funds emanate from the post-war refugee Equalisation of Burdens programme (*Lastenausgleich*—LAG) and the ERP. They had become relatively insignificant prior to unification (MRDB 8/92:24–6). Two completely new special funds were respectively set up under the GEMSU and unification treaties. The first was the German Unity Fund (Table 2.2) and the second was the Debt Management Fund (*Kreditabwicklungsfonds*—see below). It was also seen in Chapter 2 that the Upswing East project was adopted in March 1991.

Hence, the general public-sector accounts are quite complex, even when one omits public enterprises. But such enterprises account for a significant amount of total public-sector debt. Using the term 'public enterprise' in its widest sense, therefore, one is bound first of all to refer to the Treuhandanstalt—an eastern privatisation agency established prior to GEMSU (see Chapter 8). Its deficits were expected to reach DM 55 billion before it had fully discharged its functions (BMF *Beteiligungen*…1990:8). By September 1992. in fact, the Treuhand's debt had reached DM 73 billion (MRDB 3/93: table VIII(10)). Its borrowing powers were extended as part of the solidarity pact in 1993. The financial needs of its enterprises, which will outlast the Treuhand's planned existence, could reach an estimated DM 400 billion by the year 2000, net of asset sales (Flockton and Esser 1992). Because the Federal government was its guarantor, however, the Treuhand possessed a triple-A credit rating. In 1991, its financial deficit, that is the difference between its revenue and expenditure, was DM 20 billion; between 1992 and 1994 this deficit was expected to rise to DM 30 billion annually, all of which would have to be borrowed (FT 12 November 1992). As a result, the three levels of government, the shadow budgets and the Treuhand had a collective borrowing requirement provisionally

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estimated at DM 150 billion in 1992–5 per cent of GDP; in 1989, the borrowing requirement was DM 27 billion (BfG *Standpunkt* 1/93).

Moreover, the railways in both the west and the east, along with the Federal post office, were also all in deficit. These financial problems, along with constitutional constraints, prevented the expeditious privatisation of the railways and post office (see Chapter 8). By adding the shadow-budget and public-enterprise deficits to the general-government deficit, Heilemann (1991b:300) estimated a total public-sector deficit for 1991 of DM 150 billion, or 6 per cent of GNP; he suggested that the magnitudes of the deficits were reaching the tolerable limits for a democratic society. (The post-GEMSU growth in the components of this total deficit are also illustrated in Figure 7.4c). This public-sector deficit corresponds to the amount which must be borrowed by government, its agencies and its enterprises. Since reference is here being made to the public sector as a whole, it is convenient to conceptualise this exigency as the German public sector borrowing requirement (PSBR). Such a flow of new debt, when added to the stock of accumulated debt, indicates the level of national debt, which must be serviced by reimbursing and paying interest to lenders. The PSBR is therefore a critical indicator of unification costs. Consider in particular the following comparison. German public-sector borrowing in 1992, expressed as a percentage of GDP, may well have exceeded the borrowing requirement in the USA and Japan (*Economist* 20 March 1993). Yet the USA was still inflicted with the legacy of Reaganomic profligate deficit spending.

Summarising the argument thus far, it can be said that the deficits of the Federal and Länder governments, along with the local authorities, represent the tip of the iceberg. The borrowing requirement of these three levels of government was provisionally estimated at DM 71 billion in 1992 (MRDB 5/93:44–5). By 1993, the recession in the west, and industrial collapse in the east, were reducing tax revenue but increasing unemployment benefits. The Federal government was forced continually to revise its budget deficit estimates. In addition, the other deficit items noted above—the shadow budgets, the Treuhand, the railways, the post office—meant an additional borrowing requirement of DM 118 billion, a sum which also included the borrowing by the Federal government's special-purpose banks (*ibid.;* and see Chapters 2 and 7 for a review of the special-purpose banks). In 1993, the annual German PSBR was expected to reach DM 231 billion, or over 8 per cent of GDP (FT 26 May 1993). It can also be shown that the West German PSBR historically caused policy strains. Budgetary policy therefore requires closer examination.

Initially, the trends in the general-government budgets will be traced. It has already been indicated that the general-government budget in this context consists of the accounts of the Federal and Länder governments, local authorities and social-insurance funds. Figures 3.8a, 3.8b and 3.8c contain detail on the trends in these budgets. It will be noted from the source that the data for the diagrams were obtained from national accounts. This basis was preferred because they are compared to GNP itself in Figure 3.8c. Financial statistics (or flow of funds analysis) show larger absolute magnitudes but the same trends (also see MRDB table VIII[1]). When the shadow budgets are added to the three levels of government, however, the emphasis is on financial statistics because the problem is one of

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financing the deficit. The same is true when public enterprises are included.

In Figure 3.8a, it can be seen that the federal budget balance—that is federal revenue minus federal expenditure—nearly always makes a significant contribution to the general budgetary balance. There have been three distinct phases in the post-war period. Surpluses in both balances in the 1950s gave way to more mixed experience in the 1960s and the very early 1970s; from 1972, with the exception of 1973, there was a continuous series of Federal deficits. The general budget balance also slipped seriously into the red after 1973, with the exception of 1989. Of particular note is the behaviour of deficits and surpluses between 1967 and 1970. It will shortly be shown that this was the heyday of Keynesian economics: reflation by deficit spending during a recession and deflation by running surpluses during the subsequent recovery.

Now compare Figures 3.8a and 3.8b, noting the shorter time period covered in 3.8b. Take first of all the Keynesian heyday of 1967–70. All three of the individual balances under consideration were in deficit in 1967 and 1968. In 1969 and 1970 it can be seen that the Federal-government and social-insurance balances were in surplus, whereas the Länder and local authorities were still running deficits. It can be concluded that it was the Federal government which made the most constructive contribution to the Keynesian reduction in government spending when the economy had recovered in 1969–70. Note also that the social-insurance balance was positive in 22 out of the 30 years included in Figure 3.8b. These surpluses made particularly substantial contributions to the general balance in 1989 and 1990. Yet the policy makers' consternation about the perceived future course of the social-insurance funds will be a recurring theme in Chapter 5. It will be seen that this trepidation preceded unification, although this event was clearly associated with still further significant social-policy problems. Prior to the recession which began in 1992, the strong expansion of employment was expected to go on contributing to a social-insurance surplus until 1994 (Fritzsche *et al.* 1991:22). Thereafter, demographic trends would undermine the historically sound financial basis of this budgetary item (Chapters 5 and 6 above).

Figure 3.8c, like Figure 3.8a, contains only the general and federal balances. It is therefore possible to cover the period 1950–90 again. Above all, Figure 3.8c gives a good relative picture in that the budget balances are expressed as a ratio to GNP. In this sense, the surpluses of the 1950s are somewhat larger than the deficits from the mid-1970s, with the oscillations of the 1960s and early 1970s still apparent. Note how the budgetary position was improving in 1989 just prior to unification—tax revenue rose markedly as a result of high economic growth and reference has also been made to the strong finances of the social insurance funds. Apart from 1989, however, there was not a substantial improvement in the Federal position after 1982. Yet this was another watershed year—as will shortly be shown. Supply-side economics was espoused by the incoming Christian-liberal coalition at Federal level. This economic philosophy requires a minimum amount of government intervention in economic affairs, with economic agents being left to order their affairs in free markets.

A number of further inferences can be drawn from Figure 3.9 which is again based on a ratio, this time public debt and its principal components as a percentage of GNP. The experience of the three levels of government analysed thus far are plotted in these new terms. But an

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important point has to be made about the data included in the general stock of debt. They include not only the three levels of government, but also the ERP and LAG Funds mentioned in the first paragraph of this section. The German Unity and Debt Management funds—also mentioned in the first paragraph of this section—are included in the general debt data for 1990 and 1991 (MRDB 3/93: table VIII(9)). In 1991, the debt of the eastern Länder and local authorities was added for the first time. Hence, the definition of general accumulated debt was extended so as to include the government and shadow budgetary debt incurred as a result of unification. At the end of the first six months of 1992—not plotted in Figure 3.9—total general debt in absolute terms was estimated at DM 1.2 trillion (=1.2×10^{12}) *(ibid.)*. But recall that the social-insurance funds, and more particularly government agencies and enterprises, all had separate accounts (*ibid.:* table VIII). Since unification, accumulated debt had already risen 30 per cent (iwd2 11/92). (The total social budget, also including the new Länder, reached DM 1 trillion in 1992—see Figure 5.2b.)

It is plain from Figure 3.9, however, that the ratio of the stock of general accumulated debt to GNP climbed steeply after 1975: from 25 per cent to 42 per cent at the end of 1990. The steepest rises were incurred during the recessions following the two crude oil price shocks (the mid-1970s and early 1980s). It is particularly important to note, however, that the absolute level of accumulated debt rose annually during the period 1950–91. Where the debt/GNP ratios display a fall in Figure 3.9, it is mainly due to a relatively strong growth in GNP, although debt has generally grown fastest during recessions. Note also that in 1991 the GNP of the new Länder has also been included. The debt/GNP ratio thus declined to 42 per cent. It will be shown in Table 3.1 below that the ratio for West Germany had already reached 41.1 per cent in 1989. By 1992, the debt/GNP ratio in the west reached 45.6 per cent because the numerator for the west included most of the debt, but the denominator did not include the east's GNP; if the east's GNP was added to the denominator, however, the debt/GNP ratio fell to 42 per cent (also see Table 3.1). Once again, it can be adduced from Figure 3.9 that the Federal government played a dominant role in a rising trend: in 1991 it was responsible for half the total debt. The Länder also became sizeable contributors. Indeed, the Länder's behaviour is particularly notable because of the decline and subsequent stability of their debt/GNP pattern during the 1950s, 1960s and early 1970s respectively. The local authorities show the opposite trend: a gradual rise and then a tapering off in their debt/GNP ratio. It was the threat of a 50 to 55 per cent ratio of general accumulated debt to GNP by the mid-1990s (as a result of unification) which forced the Federal government to increase several taxes during and after 1991. As already implied, the precise ratio would clearly depend on the factors which affect the denominator and the numerator. Among other things, these factors respectively consist of economic growth and the extent to which the increase in government expenditure could be contained (Fritzsche *et al.* 1991:22).

The critical budgetary problem is thus the extent of the gap between revenue and expenditure. It will be shown below that the surpluses of the 1950s contributed, along with an undervalued exchange rate, to the international speculation which plagued German monetary policy from 1960. On the other hand, deficit financing became a problem from 1975. The

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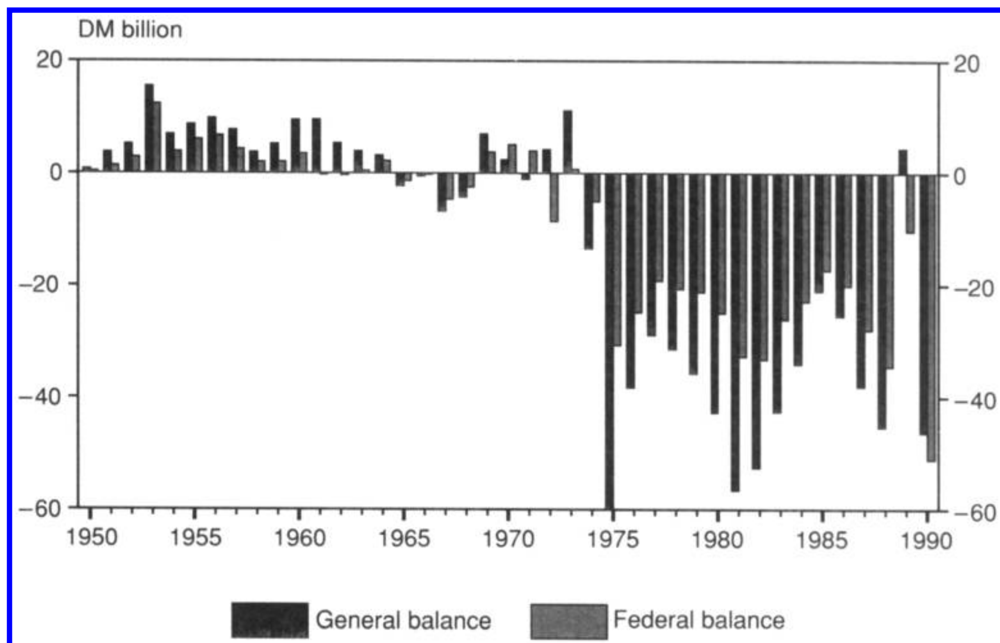

Figure 3.8a General and Federal Government Budgets

Source: OECD National Accounts (Vol. II)

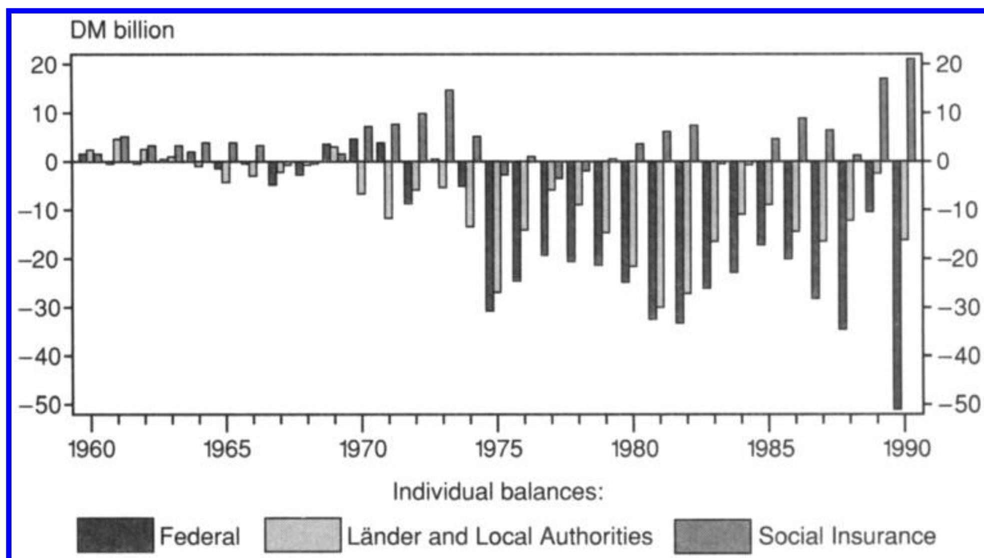

Figure 3.8b General Government Budgets' Components

Source: Plotted from OECD National Accounts (Vol. II)

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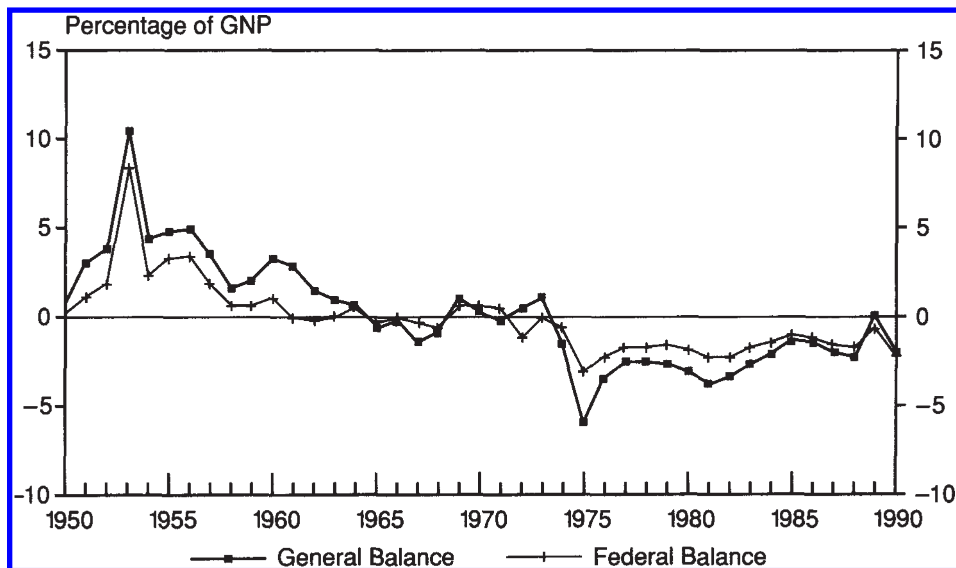

Figure 3.8c Budget Balances as a percentage of GNP

Source: Plotted from OECD National Accounts (Vol. II)

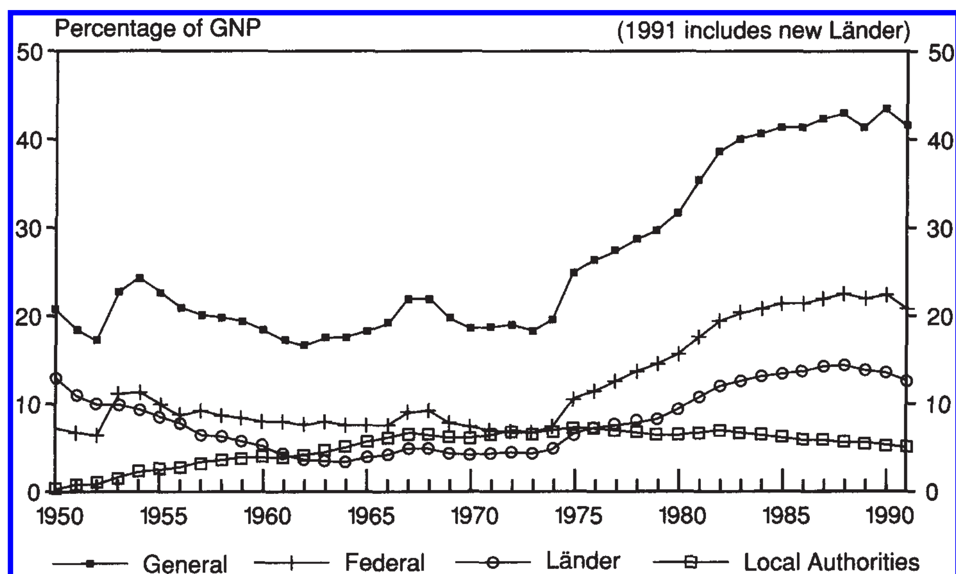

Figure 3.9 Public Debt as a percentage of GNP

Source: Plotted from Dresdner Bank, *Statistische Reihen*

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consequent borrowing requirement by the three levels of government was always a matter of keen policy interest, with particular emphasis on the contribution of the Federal government to any indebtedness. The minority FDP coalition partners in various post-war governments at Federal level have been particularly vigilant in this respect. For example, they brought down the Erhard government in 1966 when it was discovered that the federal borrowing requirement in 1967 was likely to exceed DM 4 billion—a post-war record at the time. Similarly, although the FDP saw the assumption of the Economics portfolio in 1974 as a means of controlling SPD 'excesses', they deserted the Schmidt regime in 1982 when a decade of deficits culminated in another post war record at the federal level of DM 33 billion (Hellwig and Neumann 1987:112–13; Riemer 1983:9). Even this sum paled into insignificance when predictions for the first united-German budget in 1991 anticipated a federal deficit of DM 66 billion, with a possible PSBR of DM 200 billion or 7 per cent of GNP. Again, the FDP objected strongly with threats of resignation.

There are a number of budgetary options if spending demands unexpectedly increase. (The rise in unemployment in the 1970s and 1980s, or unification are good examples of such unexpected increases.) These options are not mutually exclusive, so they may therefore be pursued concurrently.

First, the government can increase its long- and short-term borrowing, although the bitter experience of German governments' unsophisticated forays into this field in the past—see Chapter 1—have resulted in such policies incurring constitutional constraints and electoral unpopularity. The next option is to increase taxation. It has already been seen above that this was done as a means of partially financing unification. However, successive West German governments have tried to reduce the direct tax burden, again as seen above. Then there is reducing or switching expenditure. Subsidy reductions in the west, for example, were advocated, under the threat of resignation, by the FDP Federal Minister of Economics (Möllemann) at the time of unification. (His eventual resignation in early 1993 was precipitated by a matter unrelated to subsidies.) Very little inroad was made. Hence, the seemingly intractable problem of subsidies is analysed in Chapter 8 where the topic is related to privatisation and deregulation. This is because yet another policy option is selling off government assets by privatisation in order to raise revenue. Finally, where a particular policy cannot be achieved by purely budgetary means, a government may give tax incentives or introduce regulatory frameworks. These closely allied policy options are thus vitally significant areas when studying German economic affairs. As Stolper and Roskamp (1979:384 and 387) point out both Germans and their critics have, for reasons which are not entirely clear, played down the importance of fiscal measures and other direct intervention by the state; they add that the price mechanism was skilfully modified in this sense in order to influence market decisions. A good perspective of German budgetary policy can therefore be gained by examining post-war experience by using this rather wider definition.

There were three eras of budgetary policy, although each of them were linked by transitional phases. First, during the 1950s, the 'housekeeping' era under Fritz Schäffer (the Federal Finance Minister) was typified by a determination to balance revenue and expenditure. Fortuitously, budget surpluses were achieved but the Federal Minister of Economics (Ludwig

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Erhard) judiciously utilised subsidies and tax concessions to stimulate recovery and remove bottlenecks. Second, there was a gradual movement to Keynesian aggregate demand policy during the 1960s, culminating in Karl Schiller's 'magic square' approach in 1967. As the 1970s evolved, the failure to clamp down on public spending once growth had recommenced, along with a growing international perception that West Germany—and Japan—should act as locomotives to pull the world out of recession, caused increasing disillusionment with demand management. Third, improving the productivity of the supply side of the economy, accompanied by a withdrawal of government, became the policy ethos. This process was espoused by the Kohl government from 1982. Initially, the Federal finance ministry was headed by Gerhard Stoltenberg who was later replaced by Theo Waigel.

An essential starting point is the Erhard liberalisation of markets which accompanied the Allies currency reform in 1948. While radical, the Erhard package was far from a complete liberalisation (Hansson 1990:28; Wallich 1955:16). Wide sections of the economy such as housing, farming, transport and coal were not regulated by market forces alone; capital formation was not integrated into the market economy at all (Abelshauser 1982:49). Shonfield (1965:274–5) lucidly describes the schizophrenic approach to economic policy which characterised the early years of the Bonn Republic:

While the Ministry of Finance was busy keeping house, and conscientiously disregarding the effect this exercise might have on the rest of the economy, the Ministry of Economics was most actively intervening wherever opportunities for more production, aided by strategically placed subsidies or tax concessions, presented themselves.

More will be said about the Finance Ministry in a moment. Of immediate relevance here is the fact that the tax concessions directed at stimulating capital formation forced saving by encouraging the ploughing back of profits (Mendershausen 1974:75–6; Stolper and Roskamp 1979:388; Wallich 1955:161–2). In order to remove bottlenecks by financing investment in vital industries (mainly coal, steel and electricity), the Investment Aid Act, 1952 placed a levy on the rest of industry. As already seen in Chapter 1, Marshall Aid counterpart funds were also used to remove medium- and long-term economic bottlenecks. Moreover, government funds financed over half of Germany's current investment programme in 1949, even though deficit financing was prohibited both constitutionally and by the Allies (Heller 1950:538 and 542–3). In short, Erhard's role in economic recovery—not least his pragmatic approach to industrial and competition policy—was a far cry from the neo-liberal philosophy frequently attributed to his administration (Berghahn 1986:151 and 158).

To illuminate further the back drop to this period of budgetary policy, it is necessary to remove another common misunderstanding. Bomb damage to industry—as opposed to transport and housing—was relatively negligible. Germany's productive capacity was certainly in disarray, but her post-war industrial potential was roughly equivalent to that which had existed in 1938. Wartime destruction had simply cancelled out the additions to capacity (Dyas and Thanheiser 1976:43). Indeed, reconstruction with technically more advanced capital equipment meant that Germany had a more

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superior capital stock after the war than before hostilities had commenced (Abelshauser 1982:35; Vogl 1973:4). Generally speaking, bomber raids obliterated housing and commercial premises in city centres but left industrial capacity on the outskirts intact (Manchester 1969:522 and 525; Mellor 1978:142). Destruction of plant was only 10 per cent for metallurgy; 10–15 per cent chemicals; 15–20 per cent engineering and 20 per cent textiles (Grosser 1974:91). In this sense alone Germany did not start from zero in 1948; further, good luck and economic policy had prepared the German economy to take advantage of the impetus provided by the Korean boom. Between 1951 and 1958 economic expansion was sparked off by the demand for exports and domestic investment (Stolper and Roskamp 1979:380, 393 and 397). When Marshall Aid came to an end in 1952, West Germany had begun to produce export surpluses (Knapp 1981:424). These real-economy factors have to be added to what has been said about government intervention in the previous paragraph. Some of them meant that an industrial recovery began even before the currency reform. It was further stimulated by government intervention thereafter.

Consequently, the Finance Minister could indulge in what has already been described as 'housekeeping'. Schäffer ran the federal budget with a surplus until he left the ministry in 1957—a year prior to the major tax reform analysed around Figure 3.1 above. Although only part of the general-government budgetary picture, these surpluses were deposited at the Bundesbank and became known as the 'Julius Tower' —a historical reference to the fortress in Spandau where Prussian kings had stored their war treasures. The term had somewhat pejorative overtones, given the high tax rates at the time (see Figure 3.1 above). The surpluses themselves were partly the result of an underestimate of revenue, but mainly came about as a result of an overestimate of future defence commitments. They represented a source of forced savings—in addition to the ploughed back profits referred to immediately above. Hence, they unintentionally skimmed off internal demand, and probably served as an additional incentive to West German industrialists to seek further overseas markets after the Korean boom; they probably also helped to damp down the boom of 1955–6 illustrated in Figure 1.1 (Denton *et al.* 1968:226). In addition, the budget surpluses eliminated the inflationary potential caused by the trade surpluses arising from export earnings. Schäffer's financial orthodoxy must mean that these anti-cyclical features of his budgetary policy were accidental: he simply regarded his policies as consistent with Article 110(1) of the basic law (GG) which required him to balance the budget. He did not wish to be a party to any repetition of the disastrous polices which produced the economic collapses described in Chapter 1 (Hartrich 1980:165). However, as will be seen in Chapter 4, his very success in stabilising West German prices aggravated the balance of payments problem of subsequent years (Stolper and Roskamp 1979:399).

What Schäffer saw as the pillaging of his Tower began even before he left for the Justice Ministry in 1957. Significantly, agricultural subsidies were increased by the 'Green Plan' and there were marked improvements in pensions (Denton *et al.* 1968:226; Shonfield 1965:285). But it was in 1960 that the next phase in budgetary policy really began. There are two basic features which need to be stressed. First, there was a new determination to use fiscal policy alongside monetary policy for anti-cyclical purposes. Second, expenditure by

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all three levels of government increased more rapidly than revenue, thus creating budgetary deficits and endangering price stability after 1963. Erhard's seeming inability to prevent public expenditure and public income from moving apart brought down his government in 1966, although his government had initiated detailed financial planning in 1964 (Korff 1983:60). Moreover, it was at this juncture the phrase 'deficit spending' was used for the first time (Knott 1981:19).

The 'Grand Coalition' of Christian and social democrats which replaced the Erhard administration set about pruning public expenditure and raising revenue. These efforts to balance the budget ironically coincided with the first post-war recession of 1967. Such a situation demanded a U-turn. Public investment was therefore increased and special depreciation allowances were introduced. A reform of budgetary policy which would give policy makers more flexibility was required—a process which had begun under Erhard (Denton *et al.* 1968:228).

Hence, the final break with what might be termed fiscal orthodoxy came in 1967. It was replaced by Keynesian demand management in the sense that fiscal policy was formally assigned a role for the purposes of stabilisation and counter-cyclical intervention. An Act to Promote Economic Stability and Growth (StWG) reached the statute book in that year. The original Erhard plans were transformed into the more ambitious mode of the new Federal Economics Minister Schiller. A 'magic square' of macroeconomic policy goals replaced the former 'magic triangle'—economic growth being added to high employment, price stability and balance of payments equilibrium (Bendix 1978:58–9; Spahn 1978:61). This Act provided the government with a wide range of instruments with which to counter cyclical movements. More especially, it linked the budgetary arrangements of the three levels of government more closely together—thus potentially creating, it was thought, a greater degree of coherence in the formulation of the Federal budget (Denton *et al.* 1968:229).

The magnitude of the changes stimulated by the StWG can be gauged from the number of subsequent changes made to Section X (Articles 104a–115) of the GG which is the Section concerned with fiscal policy. For example, as it proposed to change the budgetary relationship between the Federal government and the Länder, the StWG required an amendment to Article 109. An authorisation was inserted into this Article for the Federal and Länder governments to maintain an anti-cyclical reserve fund at the Bundesbank, a fund which was to be changed in size in the opposite direction of changes in the level of economic activity. Finally, the Article was also amended in 1969 by the Budgetary Principles Act (HGrG) which required these two levels of government to cooperate in fiscal policy implementation and planning. The federal authorities can only proceed with any Article 109 measure after receiving the consent of both houses of the Federal parliament, thereby ensuring that the representatives of the Länder in the federal upper house are involved. Both houses must also approve another StWG measure, namely the variation in either direction of income and corporation taxes by up to 10 per cent, as well as the introduction of investment premia, all as counter-cyclical measures. In order to accommodate the changes in budgetary policy required by the HGrG, the Federal government changed its budgetary regulations in 1969 by the Federal Budget Act (BHO); the Länder followed suit over the following few years. Such a battery of measures meant (EC 1990a:44):

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- pursuing a budgetary policy consistent with macroeconomic equilibrium
- planning revenues and expenditures in the medium term, also bearing macroeconomic needs in mind
- implementing a comparable and homogeneous system of budgetary procedures
- guaranteeing the co-ordination and compatibility of measures implemented at the three levels of government (with the Länder maintaining the right to coordinate the role of local authorities in their respective areas)

Another constitutional amendment to Article 115 was introduced as a result of the StWG and HGrG. This provided all levels of government, subject to federal legislative authorisation, with a legal basis for deficit spending. The general rule is that borrowing to finance a deficit in any one year must not exceed investment expenditure provided for in the budget, unless it is necessary to avert a macroeconomic imbalance. Subsequently, 'investment expenditure' has been defined as the sum of government gross fixed capital formation (national accounts definition), investment-related subsidies to public enterprises and subsidies which aim at fostering investment in the private sector. In 1989, following a fairly heated political debate during the intervening two decades, the Federal Constitutional Court (BVG) published some general rules designed to clarify the federal borrowing requirement in the context of the term 'macroeconomic imbalance' (EC 1990a: 43):

- the PSBR is only allowed to exceed investment expenditure if there is (the risk of) a severe macroeconomic disequilibrium
- exceeding borrowing requirements must be justified by the need to reduce the (risk of severe) macroeconomic imbalances
- the limit of Article 115 is a maximum limit and a simultaneous application of Article 109 (public bodies have to make allowance for the needs of macroeconomic equilibrium) might require smaller budget deficits in periods of favourable economic performance or a risk of overheating

As well as these far reaching constitutional changes, the StWG established a Business Cycle Council while the HGrG established a Finance Planning Council. The latter is composed of the federal and Länder finance ministers, the federal Economics Minister, representatives of the local authorities and, frequently, representatives of the Bundesbank. It is chaired by the federal Finance Minister. Its terms of reference require it to meet at specified intervals throughout the year in order to make annual and five-yearly joint budgetary plans. The Business Cycle Council consists of the Economics ministers from the Federal government and Länder, plus again local authority and Bundesbank representatives. It is more concerned with the short-term economic impact of fiscal policy, but because the finance ministers dominate budgetary policy it has been somewhat over shadowed by the Finance Planning Council; the concern over federal finance subsequent to the Act has also meant that the Federal government preferred to take a longer view. There was also a Concerted Action Council set up under the StWG. It was composed of government, employers and trade unions but, for reasons to be explored in Chapter 6, it broke down in 1976.

There are some other institutions which

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issue pronouncements on economic trends and policies. The most important is arguably the Council of Economic Advisers (SVR), set up by statute a few weeks before Erhard became chancellor in 1963. Schiller had more in common with the SVR than Erhard and he joined them in quantifying the four policy goals of the StWG—goals which also appeared in the act which established the SVR (Wallich 1968). The SVR prepares an annual report and other analyses of economic activity, all of which contribute to the general debate about economic policy (Knott 1981:19). A similar function is carried out both collectively and individually by the five independent economic research institutes (DIW, HWWA, Ifo, IfW and RWI—plus their joint working party). In 1992, an east German institute was established in Halle, although it did not initially contribute to the joint reports of the other five institutes. Members of the SVR and the research institutes also serve on the councils of academic advisers (wissenschafliche Beiräte) in the various Federal ministries, the most important of which are the councils which advise the Ministers of Economics and Finance. The national employers' and trade union bodies also possess their own economic research institutes (IW and WSI respectively). An important non-market orientated group of academics *(Memorandumgruppe),* which attempts in particular to influence trade union policy, publishes a rival report to the SVRs. A valuable source of labour market analyses is the Federal Labour Office's research institute (IAB). Hence, official projections must compete with the wealth of information generated by these multifarious bodies. As can be imagined, a continual debate on economic policy is conducted by all these actors and agencies. The 1992/3 SVR report was, for example, thought in some quarters to constitute a good case for independent economic advice (FT 17 November 1992). On the other hand, the amount of economic advice, unaccompanied by action on the part of the policy makers, was subjected to some criticism (SZ 17/18 November 1992).

How did these manifest changes work out in practice? The first thing to note is that the share of general government current revenue in national income rose considerably in the 1960s and early 1970s (from 35.1 per cent in 1960 to 42.3 per cent in 1973—OECD *Economic Survey* 1985:27); the revenue share then rose more slowly to 1980 (44.5), stabilising thereafter (44.7 in 1989—*ibid.* 1990:120). Second, the deficit spending during the 1967 recession was handled in a text book manner, with surpluses re-emerging in 1969–70; thereafter, deficits and public debt rose during the 1970s and early 1980s to levels unprecedented in post-war West Germany as policy makers struggled to deal with an unfavourable external environment (Lipschitz and McDonald 1990:167). Excluding the Bundesbank transfers which—as will be shown later—is the relevant concept when trying to assess the stance and economic impact of budgetary policy, the budget balance remained practically unchanged until 1988 when the debt/GDP ratio reached record heights (EC 1990a:17). Expenditure was therefore outstripping revenue. In short, unification did not present an entirely new budgetary scenario, but before passing on to unification, the Schmidt and early Kohl eras must be examined. It was during these two regimes that the tax, expenditure and debt problems exacerbated by unification came to the fore.

To stimulate the lagging economy, the Federal government passed four special budget programmes during 1974 to 1975. At a micro level, for that matter, the government stimulus in 1967 applied to the

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coal industry was analogous to that given in 1974–6 to the construction industry and the inner-German border areas, particularly Volkswagen (Knott 1981:18). But by 1976, due to opposition from many sides, it had retreated from using the budget for stabilisation policy. It cut investment grants to the Länder, passed no additional stimulus programmes (despite continued high unemployment), and turned instead to tax and (the Bundesbank's) monetary instruments (*ibid.:* 15). The change in the SVRs fiscal impulse—as measured by their definition of the difference between the actual and a 'neutral' budget—was negative in both 1976 and 1977 (Franz 1990:19). This cautious policy generated a heated debate; Knott *(ibid.)* sees it as leading to the strict monetary policy to defend the DM despite a current account deficit in 1979. Franz (*ibid.:* 20) sees both oil price shocks as being accompanied by restrictive monetary policy as a response to a previous overly expansive policy. (See Figures 1.1, 1.2 and 1.3 for an indication of these trends.) Giersch *et al.* (1992:154) summarise the post-housekeeping era of budgetary policy in the following manner:

> If we look back over the whole drama of macroeconomic policy in the period 1960–73, an element of tragedy can hardly be dismissed: an impressive apparatus of policy counselling had been established and, at least in the eyes of the public, the door to a new era of demand management had been opened when the sharp and frightful recession of 1966/67 was overcome, seemingly through the magic tools of fiscal and monetary policy. Just as this optimistic belief in the power of government as a macroeconomic manager reached its peak, an irresistible wave of inflation flooded through the channels of the Bretton Woods system. Soon it became clear that under pegged exchange rates a relatively open economy like that of West Germany could not remain an island of stability, and the hopes pinned on the macroeconomic power of government were badly disappointed.

This excellent summary has much to commend it, even though a few factors which resulted in an overvalued DM exchange rate seem to have been overlooked. For example, the very success of the housekeeping era in building up budget surpluses ironically contributed, along with retained profits, to the forced savings which led to exporters seeking larger markets. The consequent export surpluses in turn contributed to international instability as speculators anticipated a revaluation of the DM's nominal exchange rate. Moreover, the real exchange rate of the DM was arguably undervalued as an immediate consequence of the 1949 devaluation (see the trade sections of Chapter 8). Equally, the West German policy of counteracting the appreciation of the DM, in the search for continuing export-led growth, meant that the DM was undervalued over the bulk of the post-war period (Peacock *et al.* 1980: para 3.8). In short, it will be seen in Chapter 4 that speculation in favour of the DM was inevitable. It built up a remarkable head of steam in the period cited in the above quotation (1960–73). Another issue would be to query whether 'Keynesianism' was confined to the shorter period 1967–73. The tax changes in 1975 were designed to be reflationary and those in 1979 were introduced as a result of the Bonn G5 summit in 1978. The latter were seen by the Federal government as 'measures to stimulate demand and improve economic growth'. Further, both of these Schmidt tax reforms are seen by Lipschitz and McDonald (1990:167) as 'prime examples of Keynesian policies'. The critical point here is that the 'locomotive theory' led West

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Germany into introducing expansionary fiscal policies in order to bring about an international economic recovery—just prior to the second oil price shock.

But this version of Keynesian economics was fundamentally flawed. Keynes put forward a short-run model which was designed to reflate aggregate demand in a depressed *national* economy. Locomotive theorists applied this notion to the industrial market economies as a whole. Differing budget deficits, saving propensities, rates of technological change and, affecting all these factors, defence-spending commitments rendered the Keynesian model inapplicable. These factors were responsible for the large West German and Japanese export surpluses. In any case, the now influential monetarist opponents of the locomotive strategy differed from this (misconceived version of) Keynesianism in both diagnosis and policy prescription (Giersch *et al.* 1992:241). Both oil shocks also caused domestic inflationary pressure to rise. West Germany herself entered an extremely difficult phase in her post-war economic development. At the end of the 1970s a whole series of policy issues thus came to the fore: foreign competition, inflation, unemployment and both budgetary and current account deficits.

As a result, the Schmidt government found itself confronted by a policy dilemma. Reflation increased inflationary pressure while deflation increased unemployment. Improving the supply side of the economy became the vogue policy approach. This brought Kohl to power in 1982. Kohl's U-turn *(die Wende)* was based on the notion that budgetary policy required consolidation. A priority would be the reduction of the deficit and expenditure; there would also be a privatisation programme. Tax changes would follow: the progressive nature of personal taxation, the tax burden and special exemptions would be targeted. As shown above (Figure 3.3 and the section on the incidence of taxation) there was nothing really new in these tax goals. Indeed, the out-going Schmidt government had introduced major reforms in 1974 and 1979; as a post-war government it also needed little convincing that budgetary deficits generated apprehension throughout the economy. Indeed, Schmidt's search for budgetary consolidation began in 1980; it was his FDP Economics minister (Lambsdorff) who caused the coalition to be dissolved in 1982 with his 'blueprint' (Hellwig and Neumann 1987:112–13):

> [This document] called for a clear turnround, asking in particular for a more determined policy in such matters as fiscal consolidation, industrial deregulation, and the degeneration of the 'social net' of the welfare state into a 'social hammock'.

Because of the gradual shift in emphasis, however, it is not possible to be absolutely precise about the paradigm shift by West German policy makers and advisers from a policy emphasising the role of aggregate demand to a supply-side orientated approach. Indeed, Helmstädter (1988:415) argues that 'the continuity of thought on German economic policy can be demonstrated…(by) the SVRs 1986–87 Report'. Hence, fiscal policy's role in the offensive strategy against unemployment consists essentially of the removal of distortions in economic incentives—in other words removing the heavy tax burden, high marginal rates of taxation and subsidies. Monetary policy's task, on the other hand, is to protect the value of money by expanding the money supply in line with the growth in productive capacity at approximately stable prices. As the above quotation from

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Giersch *et al.* (1992:154) made clear, however, aggregate demand and fiscal policy were perceived as having a far more important role during the period 1960–73. In fact, the SVR was unable to see the gradual shift in its own views on what governments could achieve in this respect; moreover, Giersch himself was convinced that arriving at some ground rules to make wage bargaining consistent with stabilisation was a protracted process (Riemer 1983:165 and 171). Significantly, Helmstädter (*ibid.:* 413) also quotes from the SVR's 1976–7 Report in which the Council insisted that demand management should be supplemented by a 'supply-oriented policy'. This was shortly after the failure of Concerted Action—an attempt at incomes policy more fully reviewed in Chapter 6. Suffice it to say here that its failure marked for many the end of Keynesian 'full employment' aspirations. However, this emphasis on incomes policy revealed an attempt by the SVR and Federal government to resolve the macroeconomic distributive problem by simultaneously achieving high levels of employment and low rates of inflation. It was therefore a fundamentally different approach from the sole emphasis on price stability by the Bundesbank.

Admittedly, it would be extremely easy to exaggerate the extent to which policy makers and their advisers espoused either Keynesianism or the Friedmanite monetarist counterrevolution (Riemer 1983:80). An effort was made to integrate the SME into the Keynesian framework, and this was coupled with a preference for private rather than public expenditure (*ibid.:* 269 and 280). There was a profound debate about whether the Freiburg SME model and Keynesianism could be reconciled. The chosen target monetary aggregate, an attention to the short-term countercyclical requirements of the economy and a continued emphasis on the behaviour of the wage bargainers all indicated no fundamental change in monetary policy (*ibid.:* 234–8). It will also be seen immediately below and in Chapter 8 that the degree of government involvement in economic affairs did not fundamentally change in the supply-side era. The truth is that the West German brand of Keynesianism was not suddenly superseded by Friedmanism in the early 1970s, nor was there whole-hearted support for the supply-side revolution in the 1980s. This lack of a clear-cut macroeconomic approach exacerbated the problems generated by unification. Moreover, new policy problems emerged in both the 1970s and 1980s because the system of managed exchange rates generated at least as many problems as the Bretton Woods system of the 1950s and 1960s. As in other market economies, the need to resolve the 'distributive struggle' between the wage bargainers remained a prime policy problem.

If there was a clear paradigm shift, it was in the advice given by the SVR. Much to the chagrin of the Erhard government, the Council initially supported Schiller's search for a synthesis between the SME and Keynesian aggregate demand management. In the 1960s, the Bundesbank was identified by the Council as an institution which demanded monetary and fiscal orthodoxy but disregarded the costs of forgone growth (*ibid.:* 148). There was to be a combination of fiscal, incomes and exchange-rate policies which would offer an innovative expansion of the state's economic steering capacity (*ibid.:* 99). It was the unexpected phenomenon of stagflation, preceded by a profits explosion and then a profits squeeze, which caused this new policy framework to be called into question. Hence, by the time the 1975 recession had

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made the 1966–7 affair appear comparatively trivial, the SVR had moved nearer to the Bundesbank's philosophy that employment creation required above all else expectations of low inflation (Paprotzki 1991:227). In its 1975 Report, the SVR thus stated (Riemer *ibid.:* 190):

The more profit margins shrank, and the more slender the prospects for businesses to pass on increasing costs in spite of accelerating inflation, the more the propensity to invest was undermined…

Moreover, the economic environment in which the implementation of the Kohl policies took place, however, was far more favourable than those experienced by the Schmidt government (Owen Smith 1989a). Price inflation and interest rates decreased markedly, culminating in a fall of the price level over the previous year in 1986. The rapid decline in crude oil prices was the principal cause. Even as prices and interest rates increased again, the trade balance, economic growth and investment reached high levels—in the case of the trade balance, record levels. An indication of the behaviour of these variables has already been gleaned from Figures 1.1 and 1.3, while the discussion around Figures 8.8 and 8.9 will explore the reasons for the record trade balance. In short, as early as 1986, the recovery under Kohl was longer lived than the protracted recession following the second oil shock (OECD *Economic Survey* 1986:61). Only unemployment remained obstinately high, although it had reached a plateau and therefore differed from the rapid rises under Schmidt (Figure 1.2). Moreover, while the transfer of profits from the Bundesbank were of minor importance in the 1970s, they increased appreciably after 1982; transfer payments and public investment both fell, thereby decreasing expenditure and the fiscal impulse (Franz 1990:27; Hellwig and Neumann 1987:134). However, several measures were taken to stimulate private investment: general investment premia, special depreciation allowances and subsidies for housing construction (Franz, *ibid.*).

Little wonder, then, that the Louvre G7 agreement resulted in some of the tax cuts planned for 1990 being brought forward to 1988 (OECD *ibid.* 1987:19). The German and Japanese governments were again urged to stimulate domestic demand in order to bring about an international recovery. Although fiscal policy had been tightened 1982–6, however, the total public-sector deficit had already begun to rise again in 1987, a rise steeper than the 1978–80 'locomotive' one induced by the Bonn summit. This rise coincided with a fall in the Bundesbank's profits, but the fiscal impulse of budgetary policy was again positive. Moreover, observers had become even more critical about government economic intervention. Hellwig and Neumann (1987:114 and 127–9) complained that 'the Kohl government had simply done nothing in such matters as deregulation or government subsidisation of lame-duck and eternal "infant" industries…[and] structural rigidities in the labour market'. Nearly every OECD *Economic Survey* after 1984 contained a critical account of such matters, and the EC (1990a) devoted a chapter to 'Regulations, subsidies and the need for a forward-looking supply-side policy'. The *Economist* (20 February 1988 and 8 June 1990) probably summarised the common view:

West Germany's economy is riddled with rigidities: tightly regulated labour markets, generous unemployment benefits, and regulations which cover everything from shop-opening hours to the composition of

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beer...cutting subsidies will not be easy...the coalition government has achieved [very little] in the last nine years.

Trapp (1987) effectively echoed these views when he considered the 'locomotive' theory which characterised the Bonn and Louvre accords, although the inflationary pressure and current account deficits which West Germany experienced at the end of the 1970s are attributed to the reflationary measures taken as a result of the former agreement. Evidence to be presented in Chapter 4 would favour an explanation of this deterioration in economic conditions based more on the effects of the second oil shock. Similarly, the disinflationary effect of the third oil shock on the West German economy was a major contribution to the fall in prices in 1986, while the record trade surpluses in the second half of the 1980s inevitably led to the Louvre requests from deficit economies for domestic reflation on the part of Germany and Japan. Trapp (*ibid.:* 242) explicitly concedes the salutary effects of the third oil shock, having correctly postulated an alternative strategy of protectionism on the part of 'weak' countries (*ibid.:* 237). Nonetheless, it is easy to see from Trapp's fairly representative and trenchant opposition to Keynesian domestic reflation why Louvre led to some coordinated intervention in the foreign exchange, but very little change in fiscal and interest-rate policy. Indeed, it is ironic that the economies (the USA and the UK) which introduced more labour market flexibility and deregulation—the policy prescriptions favoured by Trapp—continued to build up serious trade problems. The employment growth achieved by the USA in the 1970s and 1980s receives approbation but the UK is not considered (*ibid.:* 243).

After unification, budgetary policymakers and advisers became increasingly concerned with meeting the costs of transfers to the east. Both the increase in VAT from 1993 and the solidarity pact have been mentioned above, but a little more detail about the controversies surrounding their introduction will illustrate the main thrust of budgetary policy in the early 1990s. Leading members of the Federal coalition government had argued prior to the 1991 election that no tax increases would be necessary to finance unification. A package of such measures, including a temporary 7.5 per cent income tax surcharge, was however introduced in July 1992 (OECD *Economic Survey* 1992:102n). The SPD Länder in the west were particularly opposed to the increase in VAT proposed by the coalition. They would have preferred to see a further increase in the German Unity Fund. Most of the costs of this off-budget item were financed by the Federal government. Since the SPD held the majority in the Bundesrat, it was February 1992 before the VAT increase was approved, mainly because the SPD Brandenburg voted with Berlin. The eastern Länder were anxious to secure a settlement so that the consequent increase in tax revenue in 1993 could be anticipated. Increasing VAT rates to finance part of the public transfers necessary after unification was, however, inconsistent with the envisaged rules on EMU fiscal harmonisation (Chauffour *et al.* 1992:263). Moreover, the increases in indirect taxation probably had a far stronger inflationary impact than the increases in direct tax (*ibid.:* 264; Figure 3.11 below). Although the impact of tax rises was relatively less damaging to growth, their inflationary cost was 'enormous' compared to their benefits *(ibid.)*. Chauffour *et al.* (*ibid.:* 271) conclude that in this sense the fiscal policy

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adopted to finance unification had precisely the inflationary effects that monetary policy was seeking to avoid. (Inflationary pressure and short-term interest rates were already increasing prior to GEMSU—*ibid.* 257).

In many respects, however, the solidarity pact of 1993 better represented the complex process of compromise involved in reaching agreement on financing the costs of unification. By this stage, these costs were expected to reach DM 110 billion per year from 1995 (FAZ 2 March 1993). This sum included DM 60 billion for the revised revenue sharing arrangements and DM 40 billion to service the accumulated debt of the new Länder. Tolls for the use of motorways, higher mineral oil taxes, a 'solidarity surcharge' and cuts in social spending were all discussed. The road and oil taxes were intended to meet the burgeoning debts of the railways prior to privatisation. Ultimately, an income tax surcharge of 7.5 per cent from January 1995 was agreed. This avoided the need for a tax hike during the super election year of 1994 when a total of 16 elections were due at federal, Länder and local authority level. But the decision to use a tax surcharge followed months of disagreement. A proposal that the surcharge should be borne by the 70 per cent of the working population who contributed to unemployment insurance was considered inequitable by the 'social' wing of the CDU, the SPD and the SVR. This would have left *Beamte* and the self-employed contributing far less to the costs of unification. Moreover, the SPD successfully opposed cuts in social spending. Something was nevertheless being done about the public sector borrowing. Combined with the unions forgoing real pay increases in the west it left the Bundesbank with few excuses for maintaining its relatively high interest rates.

CONCLUSION: UNIFICATION AND FISCAL POLICY

Prior to unification, or more accurately GEMSU, the principal areas of subsidisation which received increasingly strident criticism in the west were: agriculture, coal mining, housing, the railways, steel, shipbuilding and power generation. Many of these sectors, together with some aspects of the labour market and financial services, were also targeted for adverse comment by the Deregulation Commission appointed by the Kohl government in 1987 (*Deregulierungskommission* 1991). Along with privatisation, the problems of subsidisation and deregulation will be considered in Chapter 8. In addition, housing finance is considered in Chapter 7. It simply needs to be emphasised here that they represent some of the major issues in the sphere of government intervention which still remained unresolved at the time of unification. Moreover, budget deficits were already a fairly intractable policy problem, and the reform of the tax structure was only half complete. The hypotheses postulated at the beginning of this chapter have thus been substantiated, and from a budgetary policy point of view unification could not have come at a worse time.

Clearly, then, unification did not pose an entirely new fiscal policy challenge in terms of the already existing predilection for government intervention and history of deficit spending. The difficulties lay elsewhere. Given the huge costs of modernising the eastern economy (already seen in Chapter 1), the obvious needs were for expenditure switching and raising additional revenue to meet these costs. This involved challenging vested interests in the west. For example, the Bavarian farmer with

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an uneconomic small farm and the Ruhr miner working in a sheltered industry both faced the prospect of subsidy cutting. Moreover, federal-coalition politicians fought the first all-German election on a platform of 'no tax increases to finance unification'. Kohl categorically rejected this policy; Waigel said such a policy prescription would undermine economic growth and the vital propensity to invest; Lambsdorff was still concerned with subsidies and saw their reduction as an alternative to increasing taxes, the latter not being a serious policy option (*Die Zeit* 9/91; *Die Welt* 2 March 1993). Particularly in view of GEMSU's generous exchange rate, there could not have been a more inauspicious start to economic union between two such dissimilar economies. As already shown above, tax increases were ultimately introduced. Whereas they were an essential contribution to meeting the costs of unification, they frustrated the process of reforming the incidence and structure of taxation for the rest of the 1990s. Increases in indirect taxation were also inflationary.

Because of the delay in coming to grips with the enormous costs of unification, public transfers to the east were the cause of a serious deterioration in public finances. Three observations can be made with a high degree of certainty. First, public transfers took the general form of social benefits, investment in the infrastructure and the provision of liquidity to firms. They were thus far more extensive than transfer payments in the normal sense, namely unemployment and other social-policy benefits. Secondly, however, the proportion of transfer payments in 1991 was probably as high as 60 per cent of total public transfers (Tietz 1991:224). An alternative way of viewing this distribution of transfers would be to point out that in 1991 they funded one-third of private consumption in east Germany (MRDB 3/92:20). Another estimate further exposes this aspect of transfers. Public investment in the infrastructure was DM 30 billion in 1991 and DM 36 billion in 1992, almost one and a half times as much *per capita* as in the old Länder (Dresdner Bank *Trends* February 1992). But total public net transfers to the east in the 1992 were estimated in the same source as lying between DM 125 billion and DM 145 billion; it was thus shown that these transfers were still largely used for consumption purposes in 1992. Note the wide band of DM 20 billion in the estimate of the magnitude of transfers. This leads nicely to the third and most frustrating aspect of the debate. The quantification of public transfers was made difficult by statistical shortcomings and methodological differences (MRDB 7/91:30 and 3/92:16):

- tax receipts of the Federal government emanating from east Germany can be deducted from gross receipts in order to arrive at net transfers
- net transfers comprise all the services and loans supplied to the east from public budgets in the west
- but the funds provided by the Federal post office and railways, as well as the Treuhand, were not included by the Bundesbank *(ibid.)*
- the burgeoning deficits of the Treuhand in particular could not in any case be assessed precisely
- the sum total of transfers must not be equated with the cost to west German budgets because costs associated with partition had been terminated or were being phased out

Total public net transfers on this basis in 1990 had probably reached DM 67 billion, whereas they may have been as high as DM 140 billion in 1991 and DM 180 billion in

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1992 (Deutsche Bank *Bulletin* July 1991; MRDB 3/92:16). Because it was drawn up earlier, and on a different basis, the AdwF estimate for 1991 was DM 97.5 billion (Tietz 1991:224–5). However, total GNP in the unified Germany in 1991 was DM 2,826.6 billion, while the east's contribution to that total was estimated at DM 195.4 billion (BMWi *Wirtschaft*…1992:33). Hence, the estimated percentage of the east's GNP represented by public net transfers lay between 50 and 70 per cent, with the larger proportion probably being nearer the mark. Indeed, in mid-1991 there was even one estimate that 90 per cent of east German GNP consisted of transfers from the west (IDS *European Report* 355). The numerator in this case was presumably gross transfers as defined above. Nonetheless, the unavoidable conclusion is that public net transfers were of an appreciable magnitude. Public budgets in the west, particularly at the federal level, were inevitably placed under great strain. Belated tax increases and inadequate expenditure switching meant a steep rise in the PSBR.

But the distribution of public transfers must also be considered in a little more depth. In view of the collapse of economic activity in the east, especially in manufacturing, their consumption bias is understandable. However, extensive public aid in the form of investment subsidies and special tax write-offs were again on offer in 1993 (Dresdner Bank *ibid.*). The Federal government alone offered more than forty such promotional schemes (MRDB 8/92:21). Low interest loans were available from the special purpose banks to be discussed in Chapter 7, although examples of this form of assistance were given in Chapter 2. This form of assistance was defined by the Bundesbank as 'interest subsidies' (MRDB *ibid.*). Yet private investment remained totally inadequate. Some disaggregated data will be presented in Table 8.2, but a general indication can be obtained from the relevant economic aggregates. A note of caution is in order: the ratio of gross domestic fixed capital formation to GNP in 1991 was 42 per cent in the east, compared to 21 per cent in the west (calculated from BMWi *ibid.*: 34). But this was due more to the post-GEMSU decline of 45 per cent in the east's GNP than to an expansion in investment (Pilz and Ortwein 1992:27). If the same investment indicator is divided by the number of employees in employment, a totally different estimate is yielded. In 1991, the east's ratio was DM 11,878 per employee compared to DM 21,777 in the west. Per industrial employee in the east, investment was under half of that in the west: £50,000 compared to £110,000 (IDS *ibid.*). Assuming, however, a rise in private investment in the east from DM 52.5 billion in 1991 to DM 73 billion in 1992, it was estimated that this investment gap was slowly being eliminated (Dresdner Bank *ibid.*). Unsettled property claims, bureaucracy and insufficient infrastructure remained the main obstacles to investment (*ibid.*; chapters 1, 2 and 8). Yet the policy debate continued to focus mainly on the convergence of minimum nominal pay rates by 1994, agreed in 1991 (ch. 6). The AdwF, in their Autumn report for 1992, argued that these agreements should be renegotiated, adding that this process of equalisation should be postponed until productivity in the east attained western levels. It will be shown in Chapter 6 that some employers' associations rescinded the agreements in 1993.

Consider next the important nature of the German Unity Fund, Debt Processing Fund, the ERP special-asset fund and the LAG fund. These four shadow budgets incurred a financial deficit of DM 36 billion

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in 1991 (Pilz and Ortwein 1992:160). By far the largest part of this deficit (DM 31 billion) was incurred by the German Unity Fund. By also including the deficits of the three levels of government, Pilz and Ortwein *(ibid.)* show that the total deficit rose to DM 135 billion. The Unity and Debt Processing Funds were established with the express purpose of meeting some of the costs of unification, whereas the ERP fund started life as the depository for the Marshall Aid counterpart funds and the LAG fund was designed to assist in the process of integrating expellees, refugees and war victims into the west (Chapters 1 and 6; MRDB 5/93:43–4). Marshall Aid was preceded by GARIOA, while the LAG was preceded by the Immediate Relief scheme (Wallich 1955:276–9 and 355–6). It will be shown in Chapter 7 that these two funds were also used to form two special-purpose banks (the KfW and Deutsche Ausgleichsbank). Both funds are correctly viewed by the Federal government as assets: they possess a portfolio of DM assets which could be disposed of to finance government expenditure, rather like issuing national debt to finance such expenditure. In this sense, the German Unity Fund also operated as a substitute for the direct issuance of national debt. It is little wonder that Shonfield (1965:278) emphasises how the Germans accepted the KfW without fuss. It was an ideal alternative to direct government involvement, whereas in the Anglo-Saxon world it would probably have caused a furious ideological debate. This writer is convinced that, had the Germans enjoyed the tax revenue from British North Sea oil and gas, they would have formed a permanent special asset (fund) out of the immediate reach of politicians and the German equivalent of the Treasury. As it is, one can only guess about the purposes to which this revenue was put.

The Debt Processing Fund *(Kreditabwicklungsfonds)* performed a fundamentally different role. Indeed 'processing' — or 'management' —are euphemistic translations of *Abwicklung* which means 'to wind up'. Hence, this fund acted as a debtor for the 'equalisation' of claims arising from the currency conversion under GEMSU and public-sector debts of the former DDR. ('Equalisation' *(Ausgleich)* in this context is another euphemistic translation. It refers to balancing assets and liabilities; a direct analogy may be drawn with the German judicial practice *(das Vergleichsverfahren)* of writing down debts to a level which will keep an enterprise commercially viable.) A similar equalisation of claims fund—*Ausgleichsforderungen*—had arisen from the 1948 currency reform (Wallich 1955:70). After all, the reform threw the banks' balance sheets into even greater disarray than writing off the Nazi government's debt. Hence, the Bundesbank still shows DM 8.6 billion of this 'equalisation' fund on the asset side of its balance sheet (MRDB table III[1]). Estimates of the accumulated debt of the Debt Processing Fund were DM 26 billion in 1991 but DM 70 billion in 1992 (iwd2 11/92). Yet the financial deficit of the fund in 1991 was posted as only DM 1 billion (Pilz and Ortwein *ibid*.). This is the fundamental difference from the funds outlined in the previous paragraph. The Debt Processing Fund cannot be regarded as a 'special asset' *(das Sondervermögen)*. In effect, the Federal government either issued treasury discount paper through the Bundesbank or borrowers' notes to domestic and foreign banks (MRDB 3/93: table VIII(7)). Such securities added to the total (accumulated) national debt without, however, providing the government with revenue from which goods and services could be purchased.

Large financial deficits and a

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significant accumulation of public-sector debt will therefore characterise at least the first half of the 1990s. Public debt could reach over 50 per cent of GNP by 1995—a level regarded as critical in some quarters. As already indicated, however, an element of crystal-ball gazing is implied by the assumptions made about the magnitudes of national debt and GNP. Three sources illustrate the assumptions about the numerator and denominator used in calculating the estimated ratios. They are the *Economist* (4 April 1992), the FT (2 September 1992) and the OECD (*Economic Survey* 1992:42–3). They respectively estimated that national debt in 1995 would be DM 1.8 trillion, DM 2 trillion and DM 1.9 trillion. These estimates, as a proportion of GNP, represented 51.4 per cent in the case of the *Economist,* but 50 per cent in the other two cases. The FT was referring to three levels of government in unified Germany, plus the German Unity, Debt Processing and ERP funds. The Treuhand was added by both the *Economist* and OECD, the latter also including DM 62 billion for the accumulated debt of the east German housing stocks. Surprisingly, the debts of the federal railways and post office were excluded in all three cases, presumably on the grounds that by 1995 they may be partially privatised (see Chapter 8). Nonetheless, all three definitions of national debt did not strictly correspond to the full extent of Germany's public-sector debt in the chosen base year of 1991.

Although the actual development of debt in the 1990s was uncertain, a number of important policy issues were closely related to the assumptions and dispositions involved in its assessment. The first thing to note is that it is possible to calculate the implied percentage growth in GNP by 1995, given that the united-German GNP in 1991 was DM 2.826 trillion. The *Economist,* whose data were from the IfW, in effect predicted a 4.4 per cent average annual growth rate, the OECD 6.1 per cent and the FT 7.2 per cent. Allowing for the 1992/93 recession, the *Economist* possibly made the most realistic estimate. (The average annual rate of economic growth achieved since 1980, for example, was 5.4 per cent). The assumption that the budget deficits which led to an increase in debt would have produced economic expansion is, however, at heart a Keynesian concept. Financing the deficit itself is less important than the role of the budget deficits in managing aggregate demand. Moreover, even an annual growth rate of 4.4 per cent became increasingly unlikely given the depth of the recession engineered by the Bundesbank's policymakers (see Figure 8.13). (Short-term interest rates and inflationary pressure had both been increasing since 1989—Figures 4.2 and 4.4b). This, of course, reveals the basic policy stance of the Bundesbank: the size of the numerators in the debt/GNP and budget deficit/ GNP ratios is of paramount policy importance. High public deficits were axiomatically assumed to be inflationary. The consequent decline in the denominator as a result of deflationary monetary policy was a transient phase. Finally, the OECD estimated that the annual cost of servicing the national debt of DM 1.9 trillion would be about DM 150 billion, which meant 3.9 per cent of the implied GNP in 1995.

Compared to other industrialised market economies, however, a national debt ratio of 50 per cent by 1995 would still be quite tolerable for Germany herself. Table 3.1 contains data which facilitate such a comparison. It will be seen that there are data for three years: 1980, 1989 and 1992. This period thus respectively covers the mid-year of the recession caused

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by the second oil shock, the year prior to GEMSU and a post-unification shock year. Data for 19 market economies are reported. Notice the wide dispersion of the ratios: in 1992 Luxembourg's ratio was 6.4 per cent, whereas Belgium's was 132.9 per cent. Although these two economies differ in size, note that the debt/ GNP ratios do not seem to have played a role in their trade and monetary unions. Only three economies could demonstrate a secular reduction in the ratio: Luxembourg, Norway, and the UK. (North Sea oil and gas tax revenue, privatisation and council-house sales affected the course of national debt in the UK; Norway enjoyed similar tax revenue. There was a sharp increase in the UK's PSBR from 1993.) Although Germany's ratio deteriorated during the supply-side era, by 1989 the Bundesbank was able to show that it was well below the weighted average for the G7 industrial economies (MRDB 8/91:35). This average was 58.6 per cent, even though Germany's ratio was reported as being 43.4 per cent in the Bundesbank's data.

There is also another relativity of some note in Table 3.1. In 1992 Ireland and Italy, as well as Belgium, had ratios of over 100 per cent. Greece's ratio was 87.1 per cent. The ratios of Canada and the Netherlands were 79.1 per cent, while the ratios of Denmark, Japan and the USA all lay above the 60 per cent mark. Hence, all these economies had worse ratios than the 50 per cent forecast for Germany in 1995. It was probably historical factors which started the alarm bells ringing within Germany itself. But would 50 per cent be intolerable *per se*? Indeed, was the 50 per cent alarm bell almost a red herring? Japan is Germany's most important trade rival, but Japan was 10 percentage points above this 'critical' watershed. The Netherlands and Belgium are often seen as members of the fast stream towards European (or

Table 3.1 National Debt as a percentage of GNP/GDP

Country	*1980*	*1989*	*1992*
Germany[1]	32.5	41.1	42.0
Austria	37.2	56.6	52.6
Belgium	79.9	130.7	132.9
Canada	44.7	69.6	79.1
Denmark	33.5	58.0	61.6
Finland	13.8	15.0	27.7
France	37.3	46.6	48.5
Greece	27.7	76.1	87.1
Ireland	78.0	125.1	108.8
Italy	58.5	98.8	107.8
Japan	52.0	70.2	60.9
Luxembourg	13.8	8.5	6.4
Netherlands	45.9	79.7	79.1
Norway	55.9	43.1	45.8
Portugal	37.1	71.2	62.7
Spain	18.5	43.2	48.0
Sweden	44.8	47.7	50.3
UK	54.6	37.4	38.5
USA	37.9	54.0	60.5

Source: BMF *Finanzbericht* 1992:302 and 1993:313 (author's translation)

Note: [1]1980 and 1989: West Germany only

DM!) monetary union, although sight must not be lost of the fact that the EC was authorised under the Maastricht treaty to grant exemptions from both the 60 per cent debt/GNP and the 3 per cent PSBR/GNP ratios (Chauffour *et al.* 1992:263). In the last analysis, assuming the treaty or its equivalent were introduced during the 1990s, Germany would no doubt qualify for such exemptions on the grounds that unification was an atypical occurrence *(ibid.)*. This would be particularly likely when the Federal government inherited the Treuhand and other debts in 1995. While this exception would probably be permitted under EMU's fiscal harmonisation rules, however, the method by which part of the deficit is financed would have to be

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changed: that component of public transfers financed by indirect taxes would be disallowed *(ibid.)*. Moreover, the mounting German deficits in 1993 were also caused by recession in the western part of the economy. However, there are also several of Germany's important trading partners in an 'over 55 per cent' list which could be derived from Table 3.1. Is it suggested that they too are heading for economic instability as a result of their national debt ratios? Finally, the prediction for the united-German gross debt/GNP ratio in 1993—only three years before the Maastricht 'final assessment' on EMU—was 44 per cent (see the source of Table 3.1). Even if the treaty's EMU provisions are not implemented, it is pertinent to ask whether there is a really intractable debt problem. In short, there were far more important economic indicators for Germany herself. Above all, her future competitive position was related to factors which were a far cry from her national debt ratio—see, for example the trade section in Chapter 8.

The argument thus far has been confined to the assumption of a debt/GNP ratio of about 50 per cent in 1995. Sight must not be lost of the fact that a continued rise in tax revenue and expenditure switching will be necessary to achieve that goal. Moreover, only the post-unification implications for Germany have been considered. In the debate on the international costs of German unification, it was hypothesised that a significantly higher debt/GNP ratio would ultimately affect bond yields in Germany and, consequently, long-term interest rates generally. Such a chain reaction would be initiated by the complex interaction of several variables. This is because the principal determinants of long-term interest rates in Germany are:

- the domestic inflation rate
- domestic monetary policy
- bond yields in important bond markets abroad
- the DM/US$ exchange rate
- the public-sector budget deficit in Germany

It can be said immediately that the debate about the likely future course of bond yields generally focused on an annual minimum PSBR of DM 150 billion. This was equivalent to 5.3 per cent of the united-German GNP in 1991. Similarly, the maximum assumed PSBR was DM 200 billion, or 7.1 per cent of the united-German GNP in 1991. This latter PSBR would produce a national debt of DM 2 trillion in 1995, the DM 1 trillion mark having already been reached around the time of GEMSU.

Figures 3.10 and 3.11 encompass the variables referred to in the previous paragraph. The first thing to note—because of its effect in the bond market—is the decline and subsequent recovery in the DM/US$ exchange rate during 1990 and the first half of 1991 (Figure 3.10). There is generally a lagged pattern of a falling US$ (appreciating DM) leading to an increase in demand for German bonds, thus depressing the average annual yields on newly issued bonds. This process reflects comparative rates of return in international bond markets. Similarly, the Bundesbank's short-term interest rates, which are analysed in the next chapter, are a good proxy for the stance in monetary policy. These rates were increased in response to both the rise in average annual yields on newly issued bonds and the increase in inflationary pressure (see Figures 3.10 and 3.11, but note that bond yields are proxied here by the nominal rate of return on all newly issued bonds; in Figure 7.6a the yield on all bonds in circulation is considered

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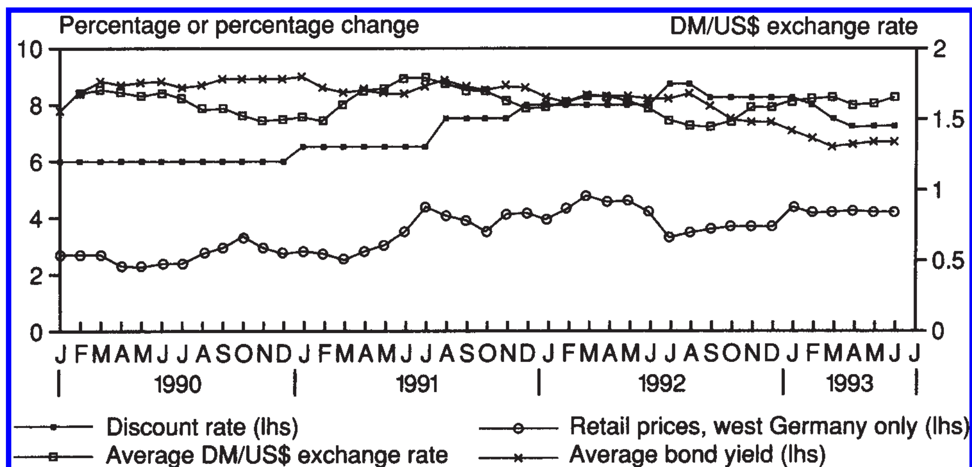

Figure 3.10 Inflation, Interest and Exchange Rates

Source: MRDB VI1/VII6/IX7/X9

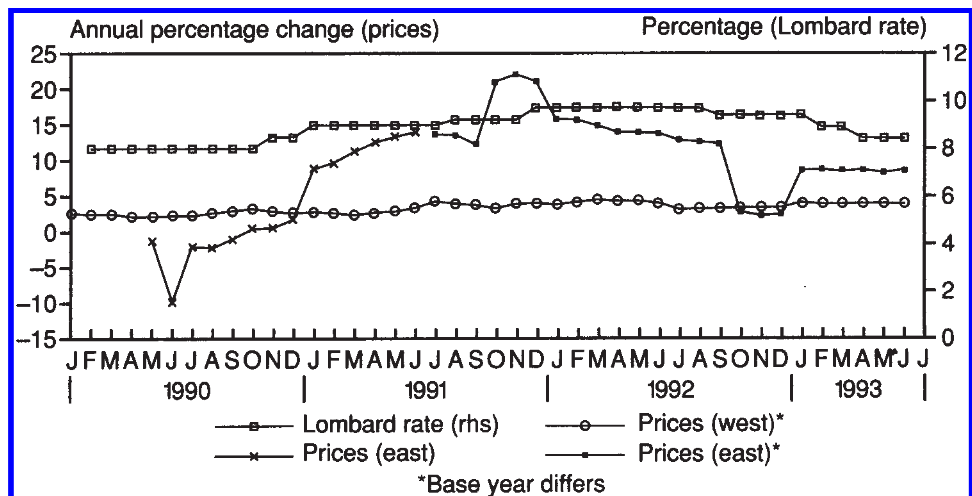

Figure 3.11 Price Inflation and Interest Rates

Source: MRDB VI1/IX7/IX10

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more appropriate). Inflation in the west was typically considered by the Bundesbank policymakers to be the more critical indicator, although it will be shown in the next chapter that they probably overreacted on this basis. Following GEMSU, on the other hand, long-term interest rates were initially affected by market expectations of long-term inflation (Chauffour *et al.* 1992:257). It can also be seen from Figure 3.11 that the removal of subsidies in the east seriously exacerbated the upward pressure on prices. Finally, the inflationary pressure emanating from the increase in VAT in January 1993 can be seen in both figures.

Because of the importance of the PSBR in these linkages, it is apposite to consider its implications in a little more depth. Since the analysis is about to turn to monetary policy, it is also appropriate to recall that the Bundesbank has consistently viewed deficit spending with a great deal of apprehension. After referring to a PSBR equivalent to about 5.5 per cent of the united-German GNP, the Bundesbank stated that 'deficits of such an order can be considered tolerable in the exceptional situation that arose as a result of German unification' (MRDB 7/91:30). If maintained over an extended period, however, they would pose risks to domestic and external stability. Even more specifically (MRDB 8/92:28):

> Continued massive subsidisation of capital investment in united Germany gives cause for concern in terms of anti-inflation policy and monetary policy…the east German economy is being virtually insulated from interest rate effects.

Given the 'massive' tax concessions and subsidies introduced by Erhard during the recovery and reconstruction of the West German economy, there are elements of a double standard at work here. More examples of double standards will be given in Chapter 8 when, for example, privatisation is discussed. One aspect of the debate is nonetheless beyond doubt: the probity of the Bundesbank's approach to inflationary pressure, even if it meant generating a recession in west Germany and internationally, was a parameter of modern economic affairs.

The Bundesbank would not be prepared to finance budget deficits by central bank credit. As will be seen in the next chapter, public authority securities are used in the main by the Bundesbank policymakers to manage the money market. However, if the deficit is financed principally by long-term bonds, any increase in bond yields would almost certainly be matched by increases in the Bundesbank's short-term rates. There was indeed every intention to fund a major part of the deficit in this way and public bond sales soared in 1990–1 (see Figures 7.4d and 7.8a). Since there is a correlation in Germany between the trends in government borrowing and bond yields, increases in short-term interest rates were on the cards (see, for example, Figures 4.2 and 4.4b, but also note again that increasing interest rates and inflation preceded the fall of the Berlin wall). There was, in fact, an appreciable period when short-term rates were higher than long-term ones (Figure 3.10). In addition, the interest payments by the Federal government alone—set to increase at 1990 rates by over 70 per cent to DM 61 billion by 1994—would clearly rise even further if bond yields increased in the meantime. There were two mitigating factors: in 1990, personal savings were running at a record DM 200 billion and, at the turn of 1990/91, German domestic bonds were particularly attractive to foreign investors again. Such foreign purchases fluctuate wildly—the previous high influx had been during the period of extremely low interest rates, and low-cost

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government borrowing, in 1986. As a prelude to what will be said around Figures 4.4b, 4.4c and 4.6b, and to put the Bundesbank's views on government borrowing into a wider perspective, it is also important to note that the market for bonds is Germany's dominant securities market (see Chapter 7). For these and other reasons, it requires sophisticated handling (Bayerische Landesbank, *Money and Capital Markets,* May/June 1991):

Between the autumn of 1990 and February 1991, a falling dollar caused foreign investors to pile into German bonds…the dollar's recovery (subsequently) prompted foreigners to dump German securities on a large scale. In contrast to similarly abrupt reversals in the past, however, the latest sell-off did not push up bond rates. On the contrary, the average yield dropped to 8.42 per cent, although the market had to absorb the securities dumped by foreigners. In January…[it had been] 9.17 per cent…foreign investors are still playing a prominent role [but] can be expected to provide the bond market with relief whenever the DM appreciates against the dollar and major European currencies.

It will be seen in the *Finanzplatz Deutschland* section of Chapter 7, however, that German bonds soon regained their attractiveness for foreigners.

At the domestic level, the Bundesbank set out to curb what it saw as the profligacy of government. During the GEMSU negotiations, it adopted its usual firm stance over budgetary policy. Above all, this stance was typified by its insistence that borrowing to fund unification should be minimised. More preferably, existing spending plans should be pruned; as a last resort taxes should be raised. Put in a slightly wider context, this meant that strict spending controls were necessary, and that East Germany's tax system should be speedily brought into line with the West's as soon as possible. Experience following GEMSU was to stiffen further the resolve of the Bundesbank that EMU would have to evolve on the basis of economic convergence and an unambiguously anti-inflationary monetary policy conducted by an independent central bank.

Other firm budgetary guide-lines were drawn up by the Bundesbank for GEMSU (MRDB 7/90). Above all, meeting budget deficits by means of direct recourse to lending by the State Bank was ruled out by GEMSU. Under the East German regime recourse to this bank (in its capacity as central bank) had been possible. At the same time, the public authorities in the GDR were obliged to deposit their liquid funds with the Bundesbank (pursuant to section 17 of the Bundesbank Act), and to issue government paper primarily through the Deutsche Bundesbank, or otherwise in consultation with it. In addition, the borrowing authorisations for the public authorities of the GDR were limited by GEMSU to DM 10 billion for the second half of 1990 and DM 14 billion for 1991. It is also interesting to note the views of the Bundesbank on some of the other aspects of public borrowing analysed above. First, the German Unity Fund was established, thus shifting the borrowing needed for substantial financial assistance to the GDR to a new special fund of the Federal Government, with the debt service burdens (distributed over a fairly long period) being shouldered by the Federal and Länder Governments. Next, the total net borrowing requirements of the central, Länder and local authorities in the Federal Republic (including the German Unity and the ERP Special Funds), together with the GDR, were estimated at just over DM 80 billion in 1990 and about DM 100 billion in 1991; this would correspond to about 3.5 per cent of the common nominal

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national product 1991. From the outset, the ERP Special Fund played a crucial role in promoting economic activity in eastern Germany (MRDB 8/92:24). Between 1990 and 1992, ERP lending programmes tripled, reaching DM 13.28 billion in 1992 (*ibid.:* 25). Net new borrowing for this fund alone was over DM 10 billion in 1992. This meant that the fund developed into an off-budget deficit item, whereas prior to its unification-related expansion it had been principally a revolving fund.

This general increase in the PSBR was attributed mainly to the initially small tax-raising powers of the GDR, the 'start-up finance' for the pension and unemployment insurance funds, and the structural adjustment measures in the GDR. Most of the expenditure of the GDR budget to be financed by borrowing was to serve consumption purposes. It was recognised that it would not be possible, at least for the time being, to apply the basic principle of budget legislation—that is, to limit borrowing normally to the amount of capital expenditure. How some of this all turned out in practice was discussed above. The decision to re-unite was obviously a political one, but it can be concluded that the Bundesbank took a very firm line over GEMSU.

The strong growth in public-sector deficits had a vigorous expansionary impact on business activity in western Germany and (*via* increasing imports) in the other western nations, too (MRDB 6/91:25). These increasing imports, caused mainly by the lack of appropriate capacity in the east, in turn caused a current-account deficit in January 1991, followed by a trade deficit in April. It was not just this enormous shift in demand within Germany itself which brought about this untypical current-account deficit, but also the cyclical downturn in foreign demand. There was no reflection on the competitiveness of German industry (*ibid.* —but see the trade sections of Chapter 8). Nonetheless, the weakening DM was raising inflationary pressure and the Bundesbank policymakers would not view such developments with equanimity.

At the international level, the united-German PSBR, along with her unusually high rates of price and wage inflation, were expected to place the bond markets under strain. Since 1979 the DM had dominated the ERM because shadowing the Bundesbank's interest-rate policy was considered to be the best method of ensuring low inflation. But the west German annual inflation rate of 4.8 per cent in March 1992 meant that seven of the ten member countries had lower inflation rates; moreover, Germany's PSBR was about 6 per cent of GNP (*Economist* 2 May 1992). Consequently, the Bundesbank's council raised interest rates to record levels. This had the effect of reassuring the bond markets that inflation would be reduced, and German yields on public bonds outstanding fell to an average annual of 6.33 per cent by mid-March 1993—the lowest level since 1988 (MRDB 6/93:25–6). Borrowed long-term funds were thus markedly cheaper than their multi-year average. In real terms, this rate of return was just 2.5 per cent, a level previously known only in the early 1960s and the mid-1970s; it is also worth noting that the real rate of interest on the same basis had not been negative for forty years *(ibid.)*. Short-term interest rate policy also kept long-term government bond yields lower than in other ERM member countries. In the meantime, however, high short-term interest rates in Germany had driven some ERM members out of the system and the widening of the permitted fluctuation band for most of those who remained meant floating exchange rates in all but name. The general view was that a lower German PSBR would

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have enabled the Bundesbank's council to cut interest rates earlier. (An alternative would have been to revalue the DM. This would have dampened inflationary pressure in Germany by lowering import prices. Indeed, as early as Autumn 1990 there had been a surge in inflation due to a rise in imported crude oil prices. But other ERM members did not find a realignment an acceptable policy option.)

Yet a high German PSBR, together with the need for the Germans to refinance the outstanding debt, had been expected to have a more direct effect on the bond markets. For example, Holtham (*Guardian* 18 November 1991) assumed that the German PSBR in 1991 would be 9 per cent of GNP, or DM 254.34 billion. Such a ratio was twice as high as the most profligate time of the Reagan era. German predictions of a decline to 3 per cent of GNP by 1995 were not accepted, since this implied only interest payments on outstanding debt would have to be met by that date. (Recall that a PSBR of more than 3 per cent of GDP would not have met the Maastricht treaty goal.) Wage inflation in the east was held to be a significant determinant of the borrowing requirement. This was because the income of the unemployed, pensioners and *Beamte* (see Chapter 6) were indexed to the general wage level. Moreover, the higher the rate of wage inflation in the east, the longer it would be necessary to maintain investment subsidies. On 'reasonable assumptions', therefore, 'the debt/GNP ratio would exceed 60 per cent within five years adding perhaps 0.75 to 1 per cent to German bond yields'. Notice that such a debt/GNP ratio would require special exemption for Germany from the second stage of the Maastricht common-currency agreement, again assuming that the treaty's implementation is a realistic proposition.

In short, it would seem that the Bundesbank's determination to act against wage and price inflation, along with a lower PSBR due to higher tax revenue, meant lower post-unification bond yields than might otherwise have been expected. The Bundesbank increasingly preferred a lowering of government expenditure because it feared the effect of tax increases on wage inflation. Significantly, its president in 1993 co-authored a book entitled *State Debts—Endless*?. The basic message was that interest rates would have been much lower if public borrowing and spending had been genuinely curbed (*Guardian* 29 April 1993). High interest-rate levels had been maintained in order to attract foreign capital and compensate for the growing current account deficit. These arguments echo what was said following the first two crude oil price shocks. More generally, they demonstrate why the next chapter is exclusively concerned with monetary policy.

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