Fiscal sustainability in the modern state

I. Challenge

In Germany, discussions are also under way about shifting from a short-term budget perspective to a sustainable long-term fiscal policy. The points of departure for these discussions that took place both in the scientific community and among public managers were the steady increase in public debt, the resulting interest expenditure and the considerable financial strain implied by the need to fund social programmes. Especially in the latter field, there is the risk that, owing to demographic change, the financial burdens on the public budgets will increase even further. The aging population and the related financial burdens are a major challenge for policymakers and are the decisive cause for the concern about fiscal sustainability. A sustainable fiscal policy is to ensure that future generations will have an adequate scope for fiscal policy decisions in spite of the existing burdens originating from the past. Since demographic change and especially the decline in the active population accompanying the aging of the population will most likely adversely affect the dynamism of the Germany economy, in the long run, prompt fiscal policy action is needed to maintain the foundations of economic growth.

II. Concept of sustainability and related policy objectives

The term of sustainability is nowadays largely understood to mean ‘sustainable development’. This means a development of society meeting the needs of the current generation without depriving future generations of the means for meeting their needs (intergenerational equity). The concept originated in environmental and resource economics where sustainability, as opposed to overexploitation, is characterised by a use of resources that ensures their long-term availability.

Fiscal sustainability means that an adequate scope for fiscal policy decisions is preserved in the long term. Apart from budgetary aspects, fiscal sustainability is to take into account economic, ecological and social concerns relevant for the future.

The German Council of Economic Experts[1] defines public budgets as sustainable, "if current public revenue and future public revenue extrapolated on the basis of the law as it stands are sufficient to cover all payment and expenditure obligations[2]." A sustainable fiscal policy is to avoid long-term burdens on the budgets in order to have leeway for short-term corrective action or timely adjustment to structural changes.

III. Verification of sustainability

There are several methods and quantitative indicators for evaluating the sustainability of fiscal policy. First insights can be obtained by means of indicators such as the annual revenue deficit. A better way of verifying sustainability is, however, to consider public expenditure and revenue trends over a given period, e.g. 30 or 40 years. To do so, a long period must be used for evaluation and a comparison must be made between the relevant figures of a reference year and the figures obtained for the final year of the period.

A number of quantitative indicators have been developed for verifying the sustainability of current fiscal policy. One method closely follows the methods largely used at present for planning and analysing current budgetary policy, i.e. methods similar to the traditional measurement of explicit debt (OECD Model). Another method is based on more theoretical approaches whose primary objective is the measurement of the burdens and distributive effects of fiscal measures at the microeconomic level (concept of 'intergenerational balance'). More recently, approaches have been developed that combine elements of both methods, i.e. the similarity to conventional budget analysis and the theoretical foundation. This includes the 'sustainability gaps' set by the Council of Economic Experts as well as the 'sustainability gaps' used by the European Commission in its annual review of stability programmes.

A particular fiscal policy is considered as sustainable, if, as a result of its long-term pursuit, the debt to GDP ratio at the end of the period under review is not higher than at present in spite of fiscal burdens expected to materialise during that period. Accordingly, a fiscal policy that does not meet these requirements during a long-term increase in expenditure or decline in revenue is not sustainable. The concepts do not include any information about the potential reduction in a fiscal imbalance. Identifying the potential ways of redressing such imbalance is a policy programme. The necessary reduction of current primary revenue deficits may be

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1 The Council of Economic Experts assists with the Federal Government's work by submitting annual appraisals of the overall economic trend in Germany.

2 2003-2004 annual assessment report of the Council, item 439….

achieved by increasing public revenue in the form of raising taxes and / or social security contributions; the alternative option are public spending cuts. Both options have identical effects under the model calculations that ignore the behavioural response of individuals to changes in the tax and social security ratio.

IV. Current situation as to fiscal sustainability in Germany

Currently, public budgets in Germany do not fully reflect the sustainability requirement. The future primary balances forecast by extrapolation on the basis of the law as it stands and of fiscal and social policy programmes already adopted will be insufficient by far to cover the obligations under total outstanding public debt.

Calls for a sustainable fiscal policy are not an invention of our age. Based on the lessons learnt during a long historical development of public budgeting in Germany, both Germany's national constitution and the constitutions of the German states include provisions which impose borrowing limits to be respected by fiscal policy. At the federal government level and in most states, the principle is that public borrowing may not exceed capital expenditure / investment (Art. 115 German Constitution). In addition, there is a fiscal policy obligation to take into account the requirements of overall economic equilibrium (Art. 109 German Constitution). These rules have been compounded by European Union legislation designed to avoid excessive public deficits (Art. 104 EC Treaty).

Nevertheless, it became ever clearer, especially in the years 2002-2006, that there is scope for improving both the national mechanisms for restricting indebtedness and the European rules for securing fiscal stability. Although, strictly speaking, borrowing should be the exception, it has become established practice to borrow even at times when economic development is favourable. Net new borrowing, which reached considerable proportions in recent years, has led to an increase of the outstanding federal debt of €917 billion at year-end 2006[3]. Behind social expenditure, the interest burden resulting from that indebtedness has become the second-biggest item in the federal budget. Interest expenditure has come to largely exceed capital expenditure; considered arithmetically, nearly 20 % of federal tax revenue is tied up by this expenditure item and is not available for proactive policy measures. There is no real retirement of outstanding debts. This alone is a considerable encumbrance on future generations. Other serious burdens result from the social security system.

[3] The aggregate outstanding debt of federal, state and local government in Germany reached nearly €1.5 trillion at year-end 2006.

Nevertheless, some approaches towards achieving fiscal sustainability in Germany have emerged. In 2005, the Federal Government published for the first time a report on fiscal sustainability, which furnishes information about the repercussions of demographic change on fiscal policy and points out ways to counteract adverse developments on a timely basis. Information about the medium and long-term perspectives in specific policy areas is provided in further reports on individual issues:

- Report on the public service retirement benefit programme,
- reports on the statutory pension insurance programme for employees and on a similar programme for farmers,
- subsidy report and
- public finance report.

Other institutions e.g. the Council of Economic Experts, the Bundesbank (Germany’s central bank), the EU and the European Central Bank make contributions to the study of fiscal sustainability.

In general terms, the following challenges for fiscal policy action have been identified and to some extent already been acted upon: reduction in public debt, balancing of the budget in the medium term, continued reduction / abolition of subsidies and strengthening of tax base by the abolition of tax privileges, an improvement in the tax structure and the development of more efficient tax assessment and collection processes. Furthermore, the Federal Government intends to improve fiscal policy by allocating more resources to meeting future challenges, e.g. education, research and innovation. Social security systems are to be so designed as to absorb the adverse effect of demographic change. Reforms under way in the field of statutory pension and health insurance need to be continued. This also includes strengthening company pension and private annuity schemes.

V. The role of the Bundesrechnungshof

In the course of its audit of federal financial management, the Bundesrechnungshof has manifold opportunities to bring its audit findings to bear and to advise Parliament and the Government. We inform about particularly important findings and conclusions in our annual report. Moreover, we uses our audit findings to provide advice especially to the Appropriations Committee of the German Parliament in connection with legislation that is important for fiscal policy and with individual programmes having a major bearing on the budget. Finally, the Bundesrechnungshof’s President also provides testimony as an expert on major proposed legislation.

There are three recent examples that can serve to illustrate our role in promoting the transition from short-term budgetary policy to long-term a long-term sustainable fiscal policy:

- With our annual findings on fiscal policy trends, we take full stock of the medium term development of federal public finance. We analyse and evaluate key data and ratios of the federal budget also with respect to the constitutional borrowing limit and against the background of the European Stability and Growth Pact. Apart from past financial years, the current financial year and the developments forecast for the medium-term financial planning period are looked into. In our most recent report, we acknowledged the improvement of federal revenues but also pointed out the persisting structural problems in the expenditure budget. Due especially to the continuously unfavourable budget structure which is characterised by a large portion of social expenditure and interest expenditure in the budget total, we perceive the need for further major consolidation efforts.
- During the public hearing of the German Parliament’s Appropriation Committee on the Budget Support Act 2006, we gave testimony on the budget consolidation strategy of the Federal Government. In doing so, we endorsed the Federal Government’s intention to achieve fiscal sustainability for the entire public sector by increasing revenues and cutting expenditures. The Federal Government’s strategy of consolidating the public budgets to free up funds for capital expenditure to promote growth and employment is in line with our recommendations. We held that the steps included in the Budget Support Act 2006 were suitable, in principle, to reduce the structural imbalance of revenues and expenditures. .

- In a hearing before the Federal Constitutional Court in proceedings aimed at enforcing a judicial review of the constitutionality of the 2004 federal budget, the Bundesrechnungshof’s President testified as an expert on issues of the current borrowing limit and the need for reform of the relevant constitutional provision. Based the lessons learnt from auditing federal fiscal trends, we advocated steps to better enforce those constitutional provisions that are designed to limit borrowing. To ensure fiscal sustainability for the whole public sector, borrowing for the purpose of covering revenue deficits should be renounced at least in times of normal economic development. Moreover, to enhance inter-generational equity, the concept of capital expenditure as a yardstick for the borrowing limit should be defined more narrowly.

These examples show that we exert influence by providing expert advice on necessary fiscal policy decisions to be taken by the Government and, where appropriate, also support unpopular decisions of the Government e.g. the VAT increase by three percents in early 2007. We pointed out in public that this decision was necessary in terms of fiscal policy and thus endorsed the government’s strategy of budgetary consolidation, thereby assuming an unaccustomed role.

VI. The role of EUROSAI in Europe

The problems of fiscal sustainability are similar in many European countries and have an international scope. Last but not least, the expedient design of the tax system is an important element of a sustainable fiscal policy. Today, it is no longer conceivable to make tax policy without consistent integration into the European and international environment. For this reason, the VI EUROSAI Congress decided to carry out a coordinated audit of tax subsidies, which is open to participation by all members of EUROSAI. 17 EUROSAI members actually take part in this coordinated audit. The objective is to improve the sharing of lessons learnt between EUROSAI members and to enhance the cooperation with academic and research institutions.

The Working Group will submit a report on its findings and conclusions to the VII EUROSAI Congress in 2008. However, current developments already indicate that agreement is likely to be reached to the effect that, apart from quantitative consolidation, the reduction of subsidies can make a contribution to the ‘qualitative’ consolidation of public budgets. As a matter of principle, new subsidies should only be given in the form of direct financial assistance and no longer in the form of tax privileges. Subsidy schemes whose introduction was based on conditions prevailing in the remote past but are no longer in line with current conditions should be reduced or abolished; new and existing financial assistance schemes should always be subject to a time limit. This is to permit a verification of results. Whenever possible, tax subsidies should be converted into the direct financial assistance. Furthermore, ‘windfall profits’ arising when the activities to be encouraged would also be undertaken without public subsidies must be prevented.

VII. Outlook

During the first half of 2007, the Federal Republic of Germany holds the presidency of the ECOFIN Council. The German Federal Government considers long-term fiscal sustainability a major challenge. It intends to work towards improving ‘fiscal quality’, aiming at a future-oriented restructuring of public budgets in favour of expenditure that will enhance productivity and innovation in order to create momentum for growth and employment. These objectives are to be accomplished in close cooperation with the other EU Member States, especially by Portugal and Slovenia which will hold the subsequent presidencies. In its monthly report, the European Central Bank also stressed the fact that "it is critical to the success of financial policy strategies to fully take account of the sustainability aspect".

Although the decisive steps designed to solve the problems caused by the lack of fiscal sustainability need to be taken by the governments, the SAIs can nevertheless bring their influence to bear by providing expert advice and testimony. We consider this a worthwhile initiative in the context of our audit and advisory mandate with respect to German federal financial management. We will make ourselves heard where necessary and endorse policy decisions to enhance fiscal sustainability.