Local authority Debt – Problems and Solutions

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I. Preamble

The extent of public debt and the resultant risks have become a topic of ever growing public interest in recent years. The financial and economic crisis effectively accelerated the trend of increasing public debt and enhanced the poor budgetary state of local authorities. The precarious budgetary situation has in some cases imposed massive limitations on the scope for decision-making by local authorities. However, such scope is fundamental to ensuring that local authority autonomy can actually function in its capacity as a cornerstone of government and society[1]. Thus, local authority debt affects a key aspect of the German federal state and a solution is essential.

This essay outlines the fundamentals of how the functions of local authorities are financed (II) and the current state of debt (III) before the causes of local authority debt are examined in more detail (IV). Finally, potential approaches on how to solve the local authority debt problem will be presented (V).

II. Financing of local authority functions

According to section 28 paragraph 2 Basic Law[2] Municipalities as well as associations of municipalities must be guaranteed the right to regulate all local affairs on their own responsibility ("Selbstverwaltung"). The guarantee of self-government extends to the bases of financial autonomy. However, this does not include the authority of the municipalities to levy their own taxes.

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1 cf. *Wieland*, Der Anspruch der Kommunen auf eine angemessene Finanzaustattung, in: Schliesky/Ernst/Schulz (pub.), Die Freiheit des Menschen, Festschrift Schmidt-Jortzig, 2011, p. 221 et seqq.

2 Basic Law ("Grundgesetz") for the Federal Republic of Germany, as amended by the Act of 11 July 2012 (Federal Law Gazette I p. 1478).

Local authority functions are financed via four channels: through tax receipts (a), through levies (b), through compensation payments for the transfer of specific functions by the Länder (c) and through general redistribution of federal state financial resources (d).

(a) While local authorities are generally unable to levy their own taxes, they do receive an apportioned share of income tax (section 106, paragraph 5 Basic Law) and turnover tax (section 106, paragraph 5a Basic Law) as well as tax revenue from real property and trades taxation (section 106, paragraph 6, sentence 1, clause 1 Basic Law). Municipalities (or associations of municipalities) are also granted tax revenues from local taxes on consumption and expenditures (section 106, paragraph 6, sentence 1, clause 2 Basic Law) and have the right to establish the rates ("Hebesatz") at which taxes on real property and trades are levied (section 106, paragraph 6, sentence 2 Basic Law).

Although the Basic Law grants the Federation and the Länder an exclusive mandate to legislate on matters of taxation, there is one possibility for a local authority to levy municipal taxes: Section 105, paragraph 2a of the Basic Law assigns sole authority with respect to local excise taxes to the Länder. Consequently, the municipalities are permitted to establish by-laws for the levying of municipal taxes, provided that they are granted the right to establish such by-laws by the respective constitution of their Land and by legislation governing municipal charges. The local authority then has absolute sovereignty over these taxes. However, in terms of the income of the local authorities, these municipal taxes are of no practical relevance.

(b) Contributions and fees are other sources of income for local authorities, although these do not usually give rise to any positive balance, because contributions and fees are generally levied specifically for the purpose of recovering expenses[3]. Moreover, sociopolitical factors dictate that the contributions and fees levied are often lower than those needed to actually cover expenses. Investments in private companies, the disposal of assets and municipal borrowing are also governed by strict limits imposed by municipal codes and municipal budgetary law.

(c) For these reasons, local authorities are mostly reliant on financing from their respective Länder. They receive this financing when the Länder provide a mandate to the local authorities to perform certain functions, which in turn

3 cf. *Siegel*, Einführung in das Kommunalabgabenrecht, JuS 2008, 1071.

obliges the Bundesland to bear the costs[4]. Such 'principles of relation' (Konnexitätsprinzip) anchored in the constitutions of the Länder are aimed at protecting the autonomy of the local authorities.

(d) The fourth source of financing for local authorities is that of the redistribution of federal state financial resources ("Finanzausgleich"; section 106, paragraph 7 Basic Law). Such redistribution of finances may either be mandatory (sentence 1) or optional (sentence 2). Within the framework of mandatory financial resource redistribution, local authorities are entitled to receive a certain percentage of the federal state's total revenue from federal and state taxes, specifically income tax, corporation tax and turnover tax; this percentage is set by the respective legislative body of the Land. The Länder may also decide whether and to which extent taxes levied on a federal state level are to be transferred to the local authorities.

III. Current debt

As of the end of 2012, local authority debt totaled €135 billion[5]. €47 billion of this, representing 35 per cent of the debt, is attributable to municipal borrowing ("Kassenkredite")[6]. Municipal borrowing has grown massively in recent years and shows the strain that local authority financing is under. These loans, which are actually only intended to cover short-term liquidity bottlenecks, have since been used repeatedly to cover shortfalls in financing for long-term functions over a longer period of time.

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4 cf. by way of example, section 71 paragraph 3 of the Baden-Württemberg State Constitution.

5 Please note that this debt situation does not concern all local authorities, nor does it affect all local authorities to the same extent. cf. Bertelsmann Foundation, Municipal Finance Report 2013, p. 60 et seqq. (http://www.bertelsmann-stiftung.de/cps/rde/xbcr/SID-12603459-2027BC37/bst/xcms_bst_dms_38670_38671_2.pdf, document as present on 24 October 2013)

6 cf. Overview by the Federal Statistical Office, Debts of Local Authorities and Local Authority Associations 31 December 2012; https://www.destatis.de/DE/ZahlenFakten/GesellschaftStaat/OeffentlicheFinanzenSteuern/OeffentlicheFinanzen/Schulden/Tabellen/SchuldenGemeinden_311212.html;jsessionid=74700E4BF936D80A97FA6B8465DFD9B5.cae3 (document as present on 24 October 2013)

IV. Causes

The causes of local authority debt are complex and occur in towns, cities and communities in very specific combinations. Disregarding specific local circumstances relating to the generation of debt, there are certain common points of reference that can be identified as applying to all local authorities affected by the debt issue. These include not only the growth in the number of functions performed and the associated growth in expenditure (a) but also a certain element of responsibility on the part of local authority supervision (b) and certain counterproductive consequences arising from the debt ceiling ("Schuldenbremse") (c).

(a) The range of devolved functions performed by the local authorities has grown continuously. This concerns functions where the state continues to assume responsibility for their performance as well as those where the state transfers responsibility in full for the performance of these functions to the local authority, regardless of whether the state continues to play a supervisory role in their performance. Despite this, the financial resources provided to the local authorities by their respective Länder for this larger range of functions continues to decline[7]. Should the revenues needed to perform required functions not be sufficient, it becomes necessary to borrow the required money.

This problem is particularly apparent with the constantly rising social security expenditure. The decision of the Federal Legislature prior to the Federalism Reform to transfer responsibility for the execution of social security legislation to local authorities has proven particularly catastrophic for these local authorities. The Federation and the Länder were very happy to transfer these functions to the local authorities, not least because it provided a way to create new social security benefits with no impact upon the state budget[8].

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7 cf. Bertelsmann Foundation, Municipal Finance Report 2013 (http://www.bertelsmann-stiftung.de/cps/rde/xbcr/SID-12603459-2027BC37/bst/xcms_bst_dms_38670_38671_2.pdf) and also the earlier Bertelsmann Foundation, Municipal Finance and Debt Report Germany, 2008 (http://www.wegweiser-kommune.de/themen-konzepte/finanzen/download/pdf/Finanzreport.pdf) – documents as present on 24 October 2013.

8 *Schoch/Wieland*, Finanzierungsverantwortung für gesetzgeberisch veranlasste kommunale Aufgaben, 1995; *Wieland*, Der Anspruch der Kommunen auf eine angemessene Finanzaustattung, in: Schliesky/Ernst/Schulz (pub.), Die Freiheit des Menschen, Festschrift Schmidt-Jortzig, 2011, p. 221 et seqq.

According to the principle of relations specified in section 104a, paragraph 1 of the Basic Law, the Federation and Länder are responsible for bearing the expenditure arising from the performance of their functions. As the Länder are generally responsible for the execution and enforcement of federal laws as per section 83 of the Basic Law, they must ordinarily also bear the costs for the provision of social security benefits, which are governed by federal legislation. The only exception – as per section 104a, paragraph 3 of the Basic Law – is when federal laws grant financial benefits to be partly or fully borne by the Federation under the wording of the law. This combination of the specified laws has enabled the Federal Legislature to create new social security benefits, with the local authorities being the duly commissioned agent for these functions.

The consequence of the transfer of functions to local authorities under federal law was that the Federation did not need to give much consideration to the financial consequences of the continued expansion of the social welfare system. Demands issued by local authorities to be financially compensated for the additional functions and financial expenditure borne by them as a result of federal legislation have been easily fended off by the Federation on the basis that financial policy does not allow for direct financial relations between the Federation and local authorities. The Länder in turn have been able to argue that the principle of relations in their respective state constitutions did not apply because the Federal Legislature was responsible for the transfer of functions, not the State Legislature.

This unfortunate state of affairs was remedied in the form of a regulation prohibiting the transfer of functions from the Federation to local authorities introduced into the Federalism Reform in section 84, paragraph 1, sentence 7 of the Basic Law. However, this does not change the fact that previous assignments of functions from the Federation to the local authorities continue to apply. Whenever benefits are increased in the relevant federal legislation, the local authorities will continue to bear the financial consequences.

(b) Local authority supervision plays a key role in municipal debt control. Supervisory bodies are responsible for supervising all of the local authorities' actions ("Rechtsaufsicht"). This includes supervising compliance with the regulations in municipal ordinances governing redistribution of financial resources[9], which is a key element of municipal debt control. Approval by the

9 The requirements imposed on budget management are codified in all local authority ordinances. Refer by way of example to section 93 of the Gemeindeordnung Rheinland-Pfalz.

supervisory authority concentrates on budgetary by-laws with the associated budgets. The aim is to ensure that local authorities are able to perform their functions with a balanced budget. If this is not the case, the local authority must present a budget recovery plan illustrating how it will return to a balanced budget in the medium term. If the planned measures are not sufficient, the supervisory authority has the power in extreme circumstances to suspend the local authority's right of autonomy and appoint a commissioner to manage the local authority's business in place of the politically elected representative until the budget is in order again. The local authorities affected are then in a state of provisional administration.

The role that local authority supervision holds in the control of local authority debt is ambiguous. While it does make an important contribution, the effectiveness of local authority supervision in ensuring fiscal discipline among the local authorities has noticeably declined. This is due in part to the political pressure exerted upon local authority supervisory authorities – despite their being formally independent[10]. There are also purely practical reasons to be considered. A supervisory authority can only function effectively if the process concentrates on a small number of manageable problem cases. As the number of unbalanced budgets has grown, the supervisory authority's personnel resources have become stretched[11]. Finally, the attitude of the municipal supervisory bodies does account for part of the responsibility for the financial situation of the local authorities. On the other hand, some supervisory bodies have simply been overly generous and on the other hand, some supervisory bodies have been enforcing dramatic extensions of the rates ("Hebesätze") and thereby cutting the autonomy of the municipalities.[12]

(c) The structural deficiencies of the municipal budgetary management system were further amplified by the 'debt ceiling' imposed by section 109, paragraph 3 of the Basic Law[13]. As a result of the ban on generating new debt in

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10 *Junkernheinrich*, Kommunalverschuldung: zur Transparenz und Rückführung kommunaler Schulden, in: Gernert/Konegen/Meyers (pub.), Nachhaltige Kommunalpolitik – ein Anforderungsprofil, 2010, 175 (194).

11 Rehm/Tholen, Kommunalverschuldung – Befund, Probleme, Perspektiven, 2008, 67 et seq.

12 cf. *Holtkamp*, 20 Jahre Haushaltskonsolidierung unter Aufsicht, in: Bertelsmann Stiftung (pub.), Städte in Not, 2013, 40 et seq.

13 The 'debt ceiling' in section 109, paragraph 3 of the Basic Law obligates the Federation and Länder to reduce their new debt starting from 2011. From 2020 onwards, the Länder are no longer permitted to incur debt. Some Länder (Berlin, Bremen, Saarland,

normal economic situations, the states are prevented from generating revenue by means of borrowing to flexibly perform their financial functions. This gives rise to pressure to adapt the expenditure accordingly.[14]

Local authorities may not explicitly be mentioned in the sovereign debt provisions in the Basic Law, but they are affected by them. The Länder are leaning towards passing on the debt ban to their local authorities, for example by transferring high-cost functions to local authorities or by reducing financing provided in the context of the redistribution of federal state resources. Therefore, unless appropriate measures are taken to counter this, the budgetary situation in the local authorities will continue to worsen[15].

V. Perspectives

Since local authorities in Germany do not have the possibility of increasing taxes, they do not have many ways of addressing their poor budgetary situation. They can either increase the rates ("Hebesätze") or refrain from performing voluntary functions. Both of which is not acceptable from a democratic point of view and besides, it would not contribute substantially to the solution of the debt problem.

Reacting to the growth in social security expenditure, the Federation has increased its financial commitment in this area, in particular by providing relief in the provision of social assistance to old-age pensioners and persons with a reduced earning capacity, by increasing its commitment in the development of child care for children below the age of three, and by means of a range of other measures. The Federation has thus demonstrated a willingness to contribute decisively and in the long term towards improving the financial situation of the local authorities. However, the rise in municipal expenditure will only be slowed by the financial commitment offered by the Federation.

The dramatic rise in debt of the local authorities has made it necessary to seek other means of relief. Municipalities will only be capable of regulating all local affairs on their own responsibility when they have enough revenues

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Sachsen-Anhalt and Schleswig-Holstein) will be receiving consolidation support due to their particularly difficult budgetary situations.

14 Cf. *Groh*, Schuldenbremse und kommunale Selbstverwaltungsgarantie, LKV 2010, 1.

15 cf. Commerzbank, Auswirkungen der Schuldenbremse auf die kommunale Ebene, 2012 (https://www.firmenkunden.commerzbank.de/files/brochures/_de/studie_schuldenbremse.pdf, document as present on 24 October 2013).

at their disposal. Since their responsibility for deciding and organizing their own functions as well as their ways to increase revenues are limited, they depend to a large extent on the Federal State and on the Länder and to their inclination of refraining from passing on their own charges. Furthermore, a direct financial relationship between the Federation and local authorities should be established for all functions that the Federal State has conveyed on the municipalities before the Federalism Reform.[16]

16 Cf. *Wieland*, Neuordnung der Finanzverfassung nach Auslaufen des Solidarpakts II und Wirksamwerden der Schuldenbremse, 2012, 38 (http://www.wegweiser-kommune.de/themenkonzepte/finanzen/download/pdf/Wieland_Finanzverfassung_2012.pdf document as present on 24 October 2013)

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COMPARATIVE STUDIES ON VERTICAL ADMINISTRATIVE REFORMS IN CHINA AND GERMANY

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