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'The Rhenish Greeks'?

Local Government and the Bailout Funds for Municipalities and Counties in German Federal States

Paper prepared for:

Technocracy and Democracy in Times of Financial Crisis

International workshop organized by Hubert Heinelt and Jens Steffek

6-7 March 2014

Abstract

In response to budgetary problems of local government in Germany some federal states *(Länder)* have established bailout funds for their highly indebted local authorities. These schemes commit local governments on a contractual basis to strengthen their own consolidation efforts in return for fiscal aid. The ambitious aim is to reduce short-term borrowing considerably or to eliminate annual deficits completely.

This paper gives a brief overview of the fiscal situation of local government and outlines the structure of the schemes in respect to the amounts and sources of funding as well as the conditions of participation and potential sanctions. Furthermore, the paper explains the motives of the governments of the federal states and considers briefly the problem-solving capacity of the schemes. Because the funds limit the political latitude of local self-government, their consequences for local democracy are finally considered.

1. Introduction

In the current debate about the European debt crisis we are used to hearing one side arguing for additional financial support for countries such as Greece while others call for stricter austerity measures. Similar debates can be observed in some German states where bailout funds (called *'kommunale Rettungsschirme'*) have been established to reduce the debt of local governments – or, more precisely, counties *(Landkreise)* and municipalities. Disregarding the 'city states' of Berlin, Bremen and Hamburg, half of the German federal states have already established such funds.

However, as in the case of the Euro bailout fund it is an open question whether the structural debt problems of German local government can be solved by these funds. Increasing short-term borrowing by municipalities and counties, the prospect that the debt brake will come into effect, and the growing doubts in the banking sector about the solvency of local government have led to the perception on the part of political actors at the federal state level that immediate action is needed.

Due to the high interdependencies between the various levels of government in Germany and particularly the dependency of local government on upper levels of government, it is also difficult for the federal states to leave local governments alone with the burdens of their fiscal problems. Against this background the bailout funds of German federal states are intended to relieve local governments from financial burdens but commit them to strict cost saving.

In the following it will be considered whether the bailout funds are able to solve the financial problems of local government and how they affect local democracy. To answer these questions, (i) the position of local government in the vertical power relations of the political system in Germany (Section 2) and (ii) the financial crisis of counties and municipalities (Section 3) will be briefly outlined. Based on a reflection of the regulatory structure of the funds, the question as to whether they are appropriate to the financial problems of local government (Section 4) shall be discussed. Thereafter, the question will be tackled why the federal states have established the funds (Section 5), and the democratic legitimacy of the funds will be considered (Section 6). The paper ends (in Section 7) with reflections on the problem-solving capacity of the funds.

2. Local government within the federal system of Germany

In legal terms both tiers of local government, i.e. the municipalities and the *Landkreise* to which they belong (for which the English name counties is used in this paper), are subordinated under the *Länder* (federal states).[1] This means that – although Germany has a federal structure regarding the relation between the federal level and the *Länder* – the *Länder* are decentralised unitary political entities. This explains the fact that not only the municipal codes, but also the tasks and competences of municipalities and counties differ from one *Land* to the other. The same applies to the specific and general grants by which the *Länder* support counties and municipalities to fulfil their tasks (see below).

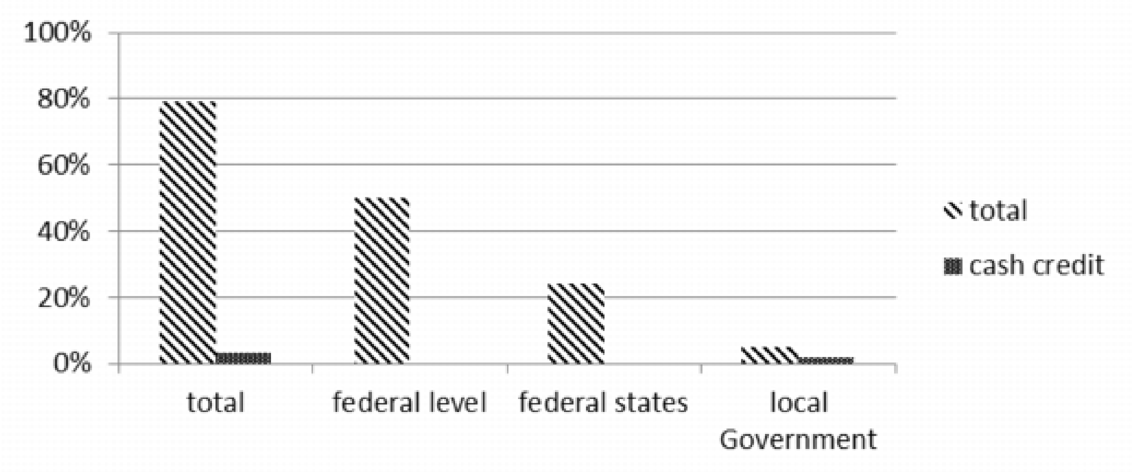
These power relations are related to the fact that the role of the local level is not clearly described in the federal constitution. The only article referring to the local level says that in counties and municipalities there must be a representative body elected by the people (Article 28, Paragraph 1) and *'it must be guaranteed that municipalities [themselves] can decide upon all affairs within their jurisdiction within the general frame of law' (*Article 28, Paragraph 2). Although the wording of the last paragraph leaves room for interpretation, it implies a 'general competence clause' for local government leaving discretion to the local councils to decide autonomously about own or 'voluntary' tasks *(freiwillige Aufgaben).* In addition to such a general competence, German municipalities have the right to levy not only property tax but also a local business tax *(Gewerbesteuer)*. Their second main sources of income are general grants from the federal state government within the state-specific frame of a complex distribution system (mostly based on the number of inhabitants and additional socio-economic indicators) and specific (task-oriented) grants from the federal state government and the federal government.

German counties are funded also in two ways. First, like municipalities counties receive general grants from the state government and task-oriented grants from the state government and the federal government. Second, counties collect transfers *(Kreisumlage)* from the municipalities within their jurisdiction in order to finance their activities. The amount of money the municipalities have to pay is decided by the county council and is mostly dependent on the tax income of the municipalities.

3. Review of the budgetary crisis of German local government

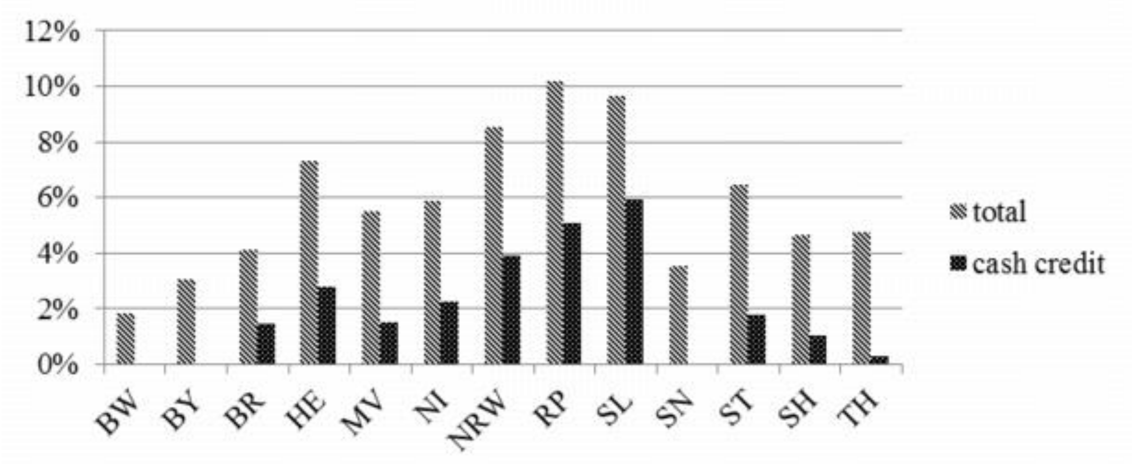
On examination of macro data on the debt of the various levels of government in Germany, it might be concluded that the financial liability of local government is not a severe problem. Only a small part of the public debt is allotted to the local level, whereas the financial liability of the federal level and the federal states is much higher (see Figure 1).

Figure 1. Debt of the federal level, the states and local government in Germany in per cent of GDP in 2011



Source: Own calculation based on Statistisches Bundesamt 2011, Statistisches Bundesamt 2012 and the statistical offices of the federal states.

Figure 2. Debt of local government in per cent of GDP in the German federal states (without the city states Berlin, Bremen and Hamburg) in 2011



Source: Own calculation based on Statistisches Bundesamt 2011, Statistisches Bundesamt 2012 and the statistical offices of the federal states.

* BW: Baden-Württemberg, BY: Bavaria, BR: Brandenburg, HE: Hesse, MV: Mecklenburg-Western Pomerania, NI: Lower Saxony, NRW: North-Rhine-Westphalia, RP: Rhineland-Palatinate, SL: Saarland, SN: Saxony, ST: Saxony Anhalt, SH: Schleswig-Holstein, TH: Thuringia

Nonetheless, a comparison between the German states shows that debt on the local level is an issue (Figure 2). The severe financial problems of local government of the West German '*Krisentrio' ('*crisis trio') *(Holler 2012a, p. 281)*, North Rhine-Westphalia, Rhineland-Palatinate and Saarland, becomes obvious. Recently Hesse joined the 'crisis states' *('Krisenländer').* In contrast, the debt of local government is comparatively low in Bavaria and Baden-Wurttemberg (i.e. the two states in the south of Germany). East German local government started free of debt in 1990 (i.e. after the unification of Germany) but 'caught up' rapidly due to the enormous need for investment, the unsuccessful economic restructuring and comparably large numbers of employees *(Mäding 1996, p. 82)* as well as low tax revenues *(Junkernheinrich and Micosatt 2008)*.

In addition to the regional comparison of total debt, a closer look at the kind of debt also makes the problem obvious. Long-term debt is relatively harmless when used for investments which are profitable in the long run and of use for future generations (pay-as-you-use). In contrast, cash credit or short-term debt is not related to asset values. Such debt – which should (according to regulations in the municipal codes of the *Länder*) compensate short-term variations of income and spending – can be quite meaningful to ensure payments in due time and to equalize tax income. However, there is no doubt that German local government misuse cash credit to finance structural deficits *(Herrmann 2011, p. 10)*. The regional distribution of short-term debt of local government across states is more or less the same as for total debt. North Rhine-Westphalia, Rhineland-Palatinate, Hesse und Saarland are also the 'front runners' in respect to short-term debt *(Junkernheinrich 2011, p. 116)*, whereas short-term debt is hardly relevant for local government in Bavaria, Baden-Wurttemberg, Thuringia and Saxony.

Furthermore in comparison to the federal level and the federal state level budget constraints and supervision authorities immediately limit the scope of action for local actors (see 5.2). Especially the councils suffer from the fiscal crisis of local government as supervision authorities bargain only with the mayor and the treasurer on concrete obligations for cutbacks and local tax and fees policy. In this bargaining processes the transparency and accountability of fiscal policy decreases (Holtkamp 2006, p. 5). Consequently the fiscal difficulties are not only a problem of output legitimacy but also for throughput- and input-legitimacy.

4. The regulatory structure of the bailout funds for local government in German federal states

The regulatory structure of the bailout funds for local government so far implemented in six German federal states can be distinguished in terms of three dimensions – namely (1) the aims, benefits and sources, (2) the criteria for becoming eligible or for being selected for funding and (3) the stipulations for the support granted support.

Table 1. Outline of bailout funds for local government in Germany

federal states	name	in effect from
Rhineland-Palatinate	*‚Kommunaler Entschuldungsfonds (KEF-RP)'*; part of the reform agenda of the state government to improve the financial situation of local government *('Reformagenda zur Verbesserung der kommunalen Finanzen')*	2012
North Rhine Westphalia	*'Stärkungspakt Stadtfinanzen'*	2012
Hesse	*'Kommunaler Schutzschirm'*	2012
Lower Saxony	'*Entschuldungsfonds';* *part of the 'contract for the future' between the state government and the local government associations of Lower Saxony* (*'Zukunftsvertrag'*)	2012
Schlewig-Holstein	*'Konsolidierungshilfen';* *part of the 'act on the consolidation of local government finance'* ('*Kommunalhaushaltskonsolidierungsgesetz'*)	2012
Saxony-Anhalt	'Stark II'	2010

4.1 Aims, benefits and sources

The bailout programmes provide financial support for paying back debt and interest and are focussed on different kinds of debt. While the programme in Saxony-Anhalt is explicitly focussed on long-term debt, the programmes in Lower Saxony and Rhineland-Palatinate cover only short-term debt. No distinctions between these kinds of debt are made in Hesse and North Rhine-Westphalia. Accordingly, the concrete aims of the programmes vary. Some target short-term debt (three-fourths in Lower Saxony and two-thirds in Rhineland-Palatinate), others long-term debt (30 per cent in Saxony-Anhalt) and still others total debt (34 to 46 pro cent in Hesse). Although they focus on a reduction of debt, the programmes in North Rhine-Westphalia and Schleswig-Holstein primarily aim at balancing the budgets of participating local governments in the long term.

The volumes of the funds also differ considerably. However, differing financial sources and periods of funding as well as parallel changes of financial equalisation schemes for local government in some federal states make a comparison difficult.

Table 2. Benefits, funding period and sources

federal states	benefits in total (in million euros)	funding period	sources (in million euros)		
			state	equalisation scheme for local government	own contribution
Rhineland-Palatinate	3,825	2012-2026	1,275	1,275	1,275
North Rhine-Westphalia	5,850	2012-2020	3,500	2,350	-
Hesse	3.200	-	3.200	-	-
Lower Saxony	1.260	2012-2029	630	630	-
Schlewig-Holstein	950/750* (294)**	2012-2021 (2012-2018)**	150*	800*	-
Saxony-Anhalt	513	2010-2016	513	-	-

Sources: *SchusG* (Hesse), *Stärkungspaktgesetz* (North Rhine Westphalia), §14a-e NFAG, (Holler 2012b), (Kommunale Spitzenverbände Rheinland-Pfalz and Landesregierung Rheinland Pfalz 2010).

* In total the measures of Schleswig-Holstein's *'Kommunalhaushaltskonsolidierungsgesetzes'* amount to 950 million Euros. 150 million Euros are from the state budget while most of the funding, 800 million Euros, originates from the state's equalisation scheme for municipalities and counties. Furthermore, it has to be taken into account that Schleswig-Holstein's bailout fund itself comprises only 750 million Euros because 200 million are still dedicated to covering the deficits of local government in a way already existing in the past ('*Fehlbetragszuweisungen'*).

** According to a recent reform the financial support from the bailout fund and its duration will be reduced in favour of the already existing '*Fehlbetragszuweisungen'*. The bailout fund will cover only 294 million Euros in total.

The highest amount of funding is made available by the programmes of those federal states in which local government debt is also highest (Rhineland-Palatinate, North Rhine-Westphalia and Hesse). In contrast, the programmes in Lower Saxony, Schleswig-Holstein and Saxony-Anhalt are of moderate size. However, only in Hesse and Saxony-Anhalt is the full amount of funding made available by the federal state. In the other federal states the local level has to contribute in one way or another to the furnishing of the funds. In the case of Hesse it has to be kept in mind that the federal state government cut 360 million Euro of the amount of the equalization scheme before the bailout fund came into effect.

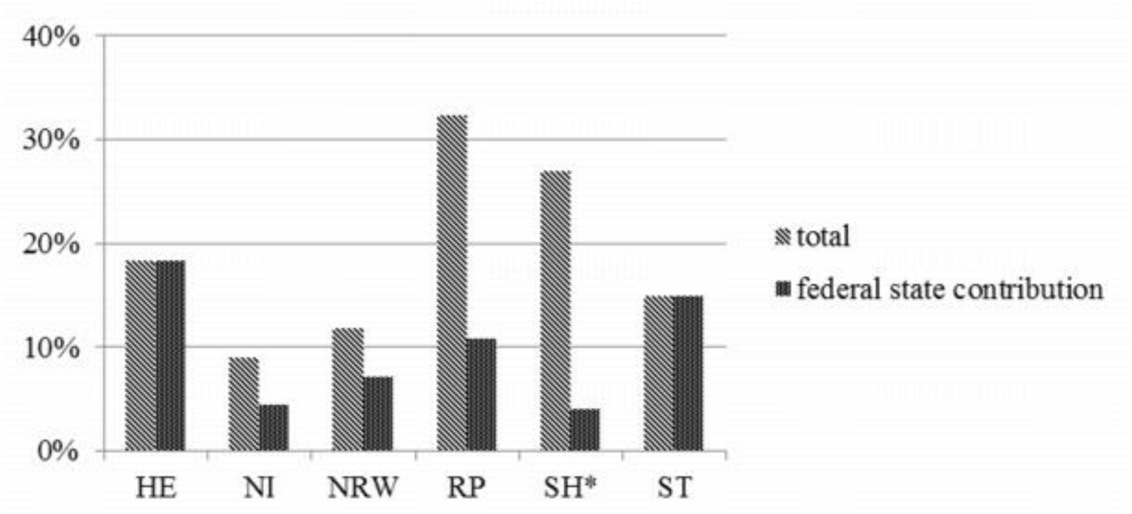
In Schleswig-Holstein the financial support granted by the bailout fund replaces a previously existing support scheme for local government, and introduces a new way of distributing the funding (see *Innenministerium Schleswig-Holstein 2012*).

Therefore, according to the financial sources three versions of bailout programmes can be distinguished:

1. funds fully financed by the federal state (Hesse, Saxony-Anhalt),
2. mixed funds (Rhineland-Palatinate, Lower Saxony and North Rhine-Westphalia) and

3. ‘solidarity funds’ of local government (Schleswig-Holstein) because the funding is mainly derived from the federal state’s equalisation scheme for municipalities and counties.

Figure 3. Benefits of the bailout funds in per cent of the total debt of local government



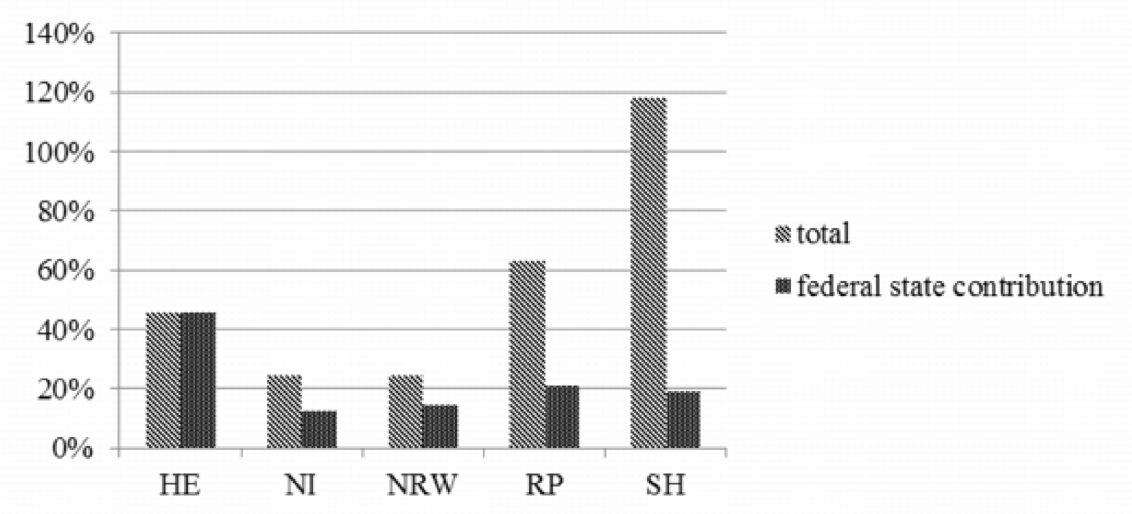
Source: own calculation.

* Including *‘Fehlbetragszuweisungen’*.

Depending on the federal state, together with own contributions (i.e. expenditure cuts) of the participating municipalities and counties (in the case of Rhineland-Palatinate) as well as financial means from equalisation schemes (Rhineland-Palatinate, Lower Saxony, Schleswig-Holstein and North Rhine-Westphalia) between 9 and 32 per cent of the total debt of local government could be reduced by the bailout programmes. However, the financial contributions of the individual federal states cover just a small fraction of the debt of the local level in their boundaries (between 4 per cent in Schleswig-Holstein und 18 per cent in Hesse).

On the other hand the bailout funds cover a considerable proportion of the short-term debt. The exception is Saxony-Anhalt where the fund can only be used to reduce long-term debt. In the case of the other federal states the bailout funds cover between 118 per cent of the short-term debt in Schleswig-Holstein and 25 per cent in Lower Saxony (see Figure 4). Nevertheless, the different sources of the funds have to be considered: Only in Hesse does the financial contribution of the state cover a considerable proportion of the short-term debt of local government (46 per cent) while the financial support in the other states ranges between 13 per cent (in Lower Saxony) and 21 per cent (in Rhineland-Palatinate) of the short-term debt of local government.

Figure 4. Benefits of the bailout funds in per cent of the short-term debt of local government



Source: own calculation.

* Including *'Fehlbetragszuweisungen'*.

The small amount of funding made available by the federal states may create doubts about the effectiveness of the bailout funds. Furthermore, it is questionable whether the financial support is so target-oriented that is really helps those municipalities and counties that are particularly deep in debt to balance their budget.

4.2 Selection criteria and allocation formula

The selection of local governments for support is based in all states on 'need'. However, the concrete criteria differ. Furthermore, a decision of the local council is required to participate in the programmes. Therefore, the programmes determine only the potential beneficiaries.

In this respect the programme in North Rhine-Westphalia is an exception because all municipalities that are heavily indebted according to criteria set up by the state government are obliged to participate.[2] Only they benefit from financial support provided by the federal state while those that participate voluntarily receive support exclusively from the equalisation scheme for local government. In both groups most of the participating municipalities are from the Ruhr area.

In Hesse the selection is based on fiscal indicators which are at the same time the basis for the distribution of the benefits. These indicators are calculated from the average budgetary deficits over the last years and the short-term debt (in Euros per inhabitant). In total, 106 municipalities and counties have been identified as ‘in need of consolidation’ (*‘konsolidierungsbedürftig’*), and of these all except four small municipalities have applied for support *(Hessisches Ministerium der Finanzen 2012)*.

In Lower Saxony municipalities are eligible when they are unable to consolidate their budget by themselves and when their taxing capacity is below average and short-term debt above average. Although Lower Saxony is not among the states in which the short-term debt of local government is particularly high (see Section 3), there has been a steady increase. Therefore, this indicator seems to be reasonable. Furthermore, municipalities have to be willing to amalgamate with others. Amalgamation is not required if it is possible to balance the budget with the help of the bailout fund without resorting to this measure. Currently there are negotiations with about 100 municipalities and counties. Most of the municipalities are part of a county but there are also county-exempt cities (see *Häusler 2011*).

In Schleswig-Holstein municipalities and counties are eligible when they are unable to reduce their financial deficit with own resources and general grants. This is determined to be the case when they were unable to balance their budget five times between 2002 and 2009 and in addition had a debt of at least five million Euros in 2009. These criteria concentrate the support on the four county-exempt cities of Schleswig-Holstein as well as six counties and six larger municipalities. Among the 17 eligible municipalities and counties only one municipality decided not to participate in the programme *(Behörden Spiegel 2012)*. By law half of the funding is dedicated to the county-exempt cities and the other half to the other municipalities and the counties. Within these two groups the accumulated deficit is used as the criterion for the distribution of the funding.

In Saxony-Anhalt all municipalities and counties which have long-term debt are eligible. At the beginning this applied to 252 (65 per cent) of the municipalities. The number has since decreased to 219 due to amalgamation. In 2011, i.e. after the first year of the programme, 103 local authorities (or 40 per cent of those eligible) had submitted an application to participate in the programme. Among them are all three county-exempt cities and some counties so that most of the funding (57 per cent) was already disbursed within one year *(Investitionsbank Sachsen-Anhalt 2011)*.

In Rhineland-Palatinate, too, most municipalities and counties are eligible because all local governments that have short-term debt can participate in the programme. The amount of support is calculated according to the proportion of the total short-term debt of all municipalities and counties, which is relatively high in this federal state (see Section 3).

Consequently, all county-exempt cities and nearly all counties as well as approximately half of the municipalities within counties are eligible. By now more than half of those eligible are participating in the programme. Among them are the twelve county-exempt cities on which the lion's share of short-term debt is concentrated (Boettcher *et al.* 2010, p. 97, Landtag Rheinland-Pfalz 2012).

To summarize, the bailout funds either target a broader group of financially weak local authorities – as in Rhineland-Palatinate and to a somewhat lesser extent in Hesse and Saxony-Anhalt – or they concentrate on a few highly indebted municipalities and counties – as in North Rhine-Westphalia and Schleswig-Holstein.

Table 3. Local authorities participating in bailout funds by federal states

federal states	total number of local authorities	eligible local authorities	participating local authorities
Rhineland-Palatinate	2,330	1,108	ab. 600
North Rhine-Westphalia	426	61	34
Hesse	447	106	102
Lower Saxony	1,046	not specified	ab. 100
Schlewig-Holstein	1,131	17	16
Saxony-Anhalt	369	251	103

4.3 Requirements and sanctions

Participation in the bailout schemes of German states is – as in the case of the European Stability Mechanism (ESM) – linked with particular requirements. Generally, a contract is concluded between the government of the state and the local authorities participating in the programme in which measures to be taken in return for the financial support are stipulated. The contract requires the agreement of the local council. This implies that decisions to cut spending and to increase local fees and taxes formally remain at the local level. The local authorities are obliged to show in periodic reports that they are fulfilling their commitments. Otherwise they face sanctions – such as suspension or revocation of the contract or reclaiming of benefits already paid. Furthermore, the local authorities concerned will be placed under stricter financial supervision by the government of the federal state.

In North Rhine-Westphalia the government and the local authorities do not agree formally on a contract. However the local authority has to present a plan showing how it intends to balance its budget. In case of violation of such a plan the government office for the region *(Regierungspräsidium)*[3] stipulates a deadline by which the defects have to be remedied. If this deadline is not met the state government can appoint a commissioner to take over the tasks of the council and the directly elected mayor or county president, who are the heads of the municipal or county administration as the case may be. However, although this instrument has been sharpened by the bailout fund up to now it is an open question whether it will be used in North Rhine-Westphalia in the context of the new programme (see Section 5.2) because the financial supervision of local authorities by the government of this federal state (as in the case of Rhineland-Palatinate) has not effectively sanctioned the continuous borrowing of local government (Junkernheinrich 2012).

In Hesse an infringement of the agreement with the government is punished by a suspension or reclaiming of financial support, as well as stricter financial supervision. That can escalate until a commissioner is sent to the local authority concerned and the council suspended. The financial supervision of the participating local authorities is carried out by the government offices for the regions. However, in the past the presidents of the government offices for the region (who are appointed by the government of the federal state) have been quite reluctant to sanction local authorities although they have, particularly with respect to short-term borrowing, more legal options to intervene than their colleagues in North Rhine-Westphalia *(Pflock 2001*; see also Section 5.2).

In Rhineland-Palatinate, too, the government and local authorities conclude a contract in which the latter commit themselves to mobilise one-third of the necessary means for the consolidation of their budgets and to use the financial support of the federal state expediently. Otherwise the contract can be suspended or cancelled by the state government.

The contracts agreed by the government and local authorities in Lower Saxony require that all options be used to increase income and to reduce services provided by the local authorities either by law or voluntarily. In addition, amalgamation is required when it will contribute to a more efficient provision of services *(Fuchs 2011)*.

The requirements and sanctions in Schleswig-Holstein are comparatively detailed. Local authorities do not only have to agree on a contract with the ministry for the interior, specifying measures to consolidate their budget. A regulation of the ministry substantiates the requirements in a general form. Accordingly, the measures must have an annual consolidating effect reaching a defined target value, and new voluntary services have to be balanced by additional savings. On the income side fees have to be raised and minimum rates for local taxes and county levies (i.e. the transfers paid by the municipalities to the counties *[Kreisumlage];* see Wohltmann 10) are defined. Annual reporting on the fulfilment of the requirements is mandatory, and in case targets are not met the financial support will be reduced *(Innenministerium Schleswig-Holstein 2012)*.

The scheme in Saxony-Anhalt requires a concept for budget balancing *('Haushaltssiche-rungskonzept')* to be approved by the government. In case the agreed targets are not met interest rates increase or the support is suspended.

It seem that local authorities are not deterred by the requirements and sanctions fixed in the laws establishing the bailout funds. However, it has to be taken into account that the contract between the government and local authorities specifies economic measures that are binding for the local actors for many years. The negotiations between the government and local authorities are usually take place behind closed doors so that in most cases it is unclear whether the agreed measures result from locally defined priorities or from demands of the government.

Furthermore, the bailout funds usually amount to helping the local authorities help themselves because they are based on the assumption that the local financial crisis is caused by local conditions. However, local government debt is a complex problem that only in part results from causes that can be influenced by local decisions. Rather, exogenous reasons – such as institutional and socio-economic conditions as well as the legislation of upper-level governments – are equally or even more relevant (Holtkamp 2007, p. 12, 2010, p. 8). Therefore, helping local governments to help themselves and imposing strict requirements on them will be insufficient to solve their financial crisis.

5. Structural reasons German local government debt and recent developments

Actors at the state level may be well aware of the limited problem-solving capacity of the bailout funds for local government. However, there is a perceived pressure to act resulting, on the one hand, from reform blockades or the 'joint decision trap' of German federalism (Scharpf 1985, 1988, Benz 2009) and, on the other hand, from recent developments in the regulation of the banking sector and the capital market.

5.1 The ‘impossibility’ of reform of local government finance in Germany

To solve the financial problems of local government in Germany a comprehensive reform of their finances would be indispensable. Such a reform would have to address the following problems systematically:

- the volatility of income from local business tax,
- the lack of financial compensation for tasks shifted to local government from upper levels,
- increasing spending for welfare benefits and services which can hardly be influenced by local government because they result from particular local problems as well as obligations laid down by legislation of upper-level government,
- tax reforms of upper-level government at the expense of the local level.

Although political protagonists at all levels of government agree that a fundamental reform of local finances is necessary, the distributional effects of such a reform inevitably lead to a blockade *(Junkernheinrich 2003)*. And we should be aware that there are not only conflicts between the federal, the state and the local level but also between the federal states and among municipalities from rural and metropolitan areas as well as regions undergoing economic changes *(Junkernheinrich 2003, p. 424)*. In addition, there are interest groups (such as business associations, trade unions or the ‘association of tax payers’/‘*Bund der Steuerzahler’*), as well as politicians and bureaucrats linked to particular policy fields, who all advocate their own positions *(Junkernheinrich 2003, p. 424)*. As a result there is a multitude of actors involved in any reform of local finance, and their preferences are not only quite distinct from each other, but have also proved to be quite stable over time

5.2 Problems within the multi-level system of the federal states

However, options for reform are limited not only at the federal level but also at the level of the federal states. The principle of local self-government laid down in the German constitution (Article 28, Paragraph 2) assures the financial autonomy of local government. As a result hierarchical interventions on the part of the federal states are restricted. Nevertheless, through municipal and county codes as well as municipal budget laws the states can define the framework of the budgetary policy of local government. The states have tried to create the conditions for a consolidation of local budgets particularly through reforms of the horizontal power relations between the local councils and the mayors, and through the introduction of a new book-keeping system based on business practice rather than traditional public-sector standards. However, these reforms have not achieved the intended effects (see for example the empirical findings in *Kunz and Zapf-Schramm 1989, Holtkamp 2000, Timm-Arnold 2011; Fudalla et al. 2005, Wyborny 2006, p. 111, Rehm and Tholen 2008, p. 54)*.

Therefore, the prospects of the governing strategy pursued by the German federal states, i.e. setting frameworks, seem to be limited. However, hierarchical interventions are also no real alternative. Intervention is possible in the process of examining local budgets for approval and authorizing credit, in exercising control of debt-ridden local authorities and finally by sending a commissioner to a deeply indebted local authority to assume the tasks of the local council and the mayor or the chief executive of a county. However, the governments of the states are aware of the implementation problems of hierarchical interventions (described for instance by *Pressman and Wildavsky op. 1984*). In the end the state governments have to balance two contradictory goals: If they intervene they have to take the blame when the problem is not solved. This can only be avoided by non-intervention and neglecting the goal of consolidation of local budgets (Pflock 2001, p. 12, Holtkamp 2006, Glöckner and Mühlenkamp 2009, p. 413, Holtkamp 2010, p. 62, Herrmann 2011, p. 10). Accordingly, the threat of sending a commissioner in is not taken seriously by local government. Even in Hesse, North Rhine-Westphalia and Rhineland-Palatinate where the financial problems of local government are most pressing this option is either not used or only used temporarily in some small municipalities (Holtkamp 2006, p. 5, 2007, p. 15, Duve 2008).

Nevertheless, governments of the states have reacted. North Rhine-Westphalia has developed the formally strictest financial control over local government and got role model for other federal states (see *Geißler 2009*). In contrast stricter rules for short term debt are still missing. However, there is no clear correlation between weaker formal regulations for the approval of cash credit and high short-term debt of local government. In Hesse, for instance, which has in formal terms the strictest regulations for the approval of cash credit, the short-term debt of local government is quite high (see Section 3).

Furthermore, local government can make controls difficult by formally privatizing services that were formerly in the public sector, and they can block interventions either by using party contacts to the government of the federal state or by undertaking legal action (Dreßler 1998, Pflock 2001, p. 15, Holtkamp 2006, p. 2). In addition, in time of budgetary crisis the federal states are overloaded in the supervision of local authorities. Therefore, the governments of the states are oriented on negotiations ‘in the shadow of hierarchy’ (Holtkamp 2006), which again depend on a credible threat of sanctions.

In the end, all efforts of the states have failed to induce local governments to consolidate their budgets. Against this background the bailout funds offer an opportunity, on the one hand, to reach an agreement on budget targets with local authorities and, on the other hand, to leave it to them to realize these targets by taking specific local conditions into account. As it is relatively easy for the government to monitor the implementation of the measures agreed in the contracts, the additional expenses of supervision are quite low. Nevertheless, the bailout funds and the related contracts do not really affect the basic challenges of an effective control of local spending. It therefore remains an open question how strict the sanctions will turn out in the end.

5.3 The regulation of the banking sector and mistrust on the capital market

Up to now there is no obligatory rating of local authorities in Germany because the 'partial-use option' applies to them. Although loans are granted according to the 'International Convergence of Capital Measurement and Capital Standards' (Basle II) and the corresponding EU legislation (directive 2006/48/EC and 2006/49/EC) depending on the solvency of the borrower, national legislation can stipulate that credit for local government is to be treated like credit for the whole state *(Rehm and Tholen 2008, p. 89)*. This option has been used by the German federal government. However, this will be challenged by new international regulations (Basle III; see *(Rehm 2012b, p. 427)*. These regulations would not only apply to international banks but also to local saving banks and cooperative banks, which are the main lenders to German local government. Therefore, local authorities as well as the governments of the states in Germany fear that credit for local government will become more expensive *(Glöckner and Mühlenkamp 2009, p. 416, Deutsche Bank 2011, Bundesvereinigung der kommunalen Spitzenverbände 2012, Bundesrat 2012)*.

But apart from the results of the Basle III negotiations there is growing concern on the capital market about the soundness of German local government. Many large banks are reviewing the solvency of local authorities and rating agencies have carried out first studies of the financial situation of local government in Germany *(Haushaltszeitung 4-5, Fitch Ratings 2010, Rehm 2012a, 2012b)*. Nevertheless, against the background of the current debt crisis, German local government is still seen as a relatively 'safe harbour', which results in low interest rates. However, times may change quickly because doubts about the solvency of the public sector in general can easily flash over to local government. Thus, in 2011 – when most of the German federal states established their bailout funds – more and more lenders withdrew from the business with local government, which was not very profitable anyway, or at least tightened their conditions *(Haushaltszeitung 4-5, p. 8, Grunwald 2011)*.

In this situation the bailout funds for local government have an important signalling effect in that they indicate that loans to local government in Germany are not risky because the state level as well as the mutual solidarity of local governments will prevent bankruptcy of any local authority.

5.4 Debt brake and the financial situation of the federal states

Among the five federal states with the highest debt per capita (disregarding the three city states Berlin, Bremen and Hamburg) there are four with a bailout fund for local government (North Rhine-Westphalia, Schleswig-Holstein, Saxony-Anhalt and Rhineland-Palatinate,). A balancing of the budget could not be achieved in any of the federal states with a bailout fund last year. In general, high debt at the state level goes hand in hand with high debt at the local level, which means that financial support from the state is limited where it is needed at the local level. The only exemption is Hesse where state debt is below the average of all German federal states. At first sight this seems to explain why the state contribution to the bailout fund is comparatively high there.

According to the debt brake in the German Basic Law (Article 109, Paragraph 3), which some federal states have incorporated into their constitutions, the budgets of the states have to be balanced from 2020 onwards. Borrowing will only be allowed in exceptional states of emergency such as natural disasters or an extraordinary economic slump. Because the debt brakes of the federal states (as well as at the federal level) do not apply to local government, local politicians fear that the federal states will (further) balance their budget at the expense of the local level *(Sidki 2011)*. Saarland is the only highly indebted state without a bailout fund although there is high debt at the local level; its government argues that it does not have the financial means to help indebted local authorities *(Saarbrücker Zeitung 2012)*. Instead, a debt brake for local government has been introduced.

In the federal states with a bailout fund a different viewpoint seems to be prevalent. There the debt brake is perceived as an additional reason for establishing a bailout fund. The bailout funds are intended to consolidate the local government budgets before the new budget constraints for the states come into force and their scope of action is limited *(Junkernheinrich 2010, 2011, p. 125, Junkernheinrich et al. 2011, p. 238)*.

6. Bailout funds and local democracy

The bailout funds for local government are based on decisions of the parliaments of the states *(Landtage)*. Therefore, the funds and the related consolidation programmes have a high degree of legitimacy because they were established by a representative body elected by the people who are at the same time citizens of the federal state and the local authorities concerned.

Furthermore, in most federal states the funds result from negotiations with the local government associations. Exceptions are North Rhine-Westphalia and Schleswig-Holstein where an agreement with the local government association could not be reached because the contribution required of all local authorities was relatively high, although only a few were eligible for benefits (AG der kommunalen Spitzenverbände NRW 2011, Innen- und Rechtsausschuss SH 2011). Moreover, the programme in North Rhine-Westphalia is the only one which obliges highly indebted local authorities to participate.

In all other cases a decision of the local council is required to participate in the programmes including ratification of the contract on measures for consolidating the budget. It is unclear whether the governments of the federal states insist on this requirement to increase the democratic quality of these agreements. Rather, it seems to be reasonable that the governments are trying on the one hand to circumvent legal problems by means of this formal self-commitment of local authorities and on the other to facilitate compliance of local actors with the contracted agreement.

7. Conclusion: More than a drop in the bucket and no real harm for local democracy?

Against the background of changes in the regulation of the banking sector and the envisaged implementation of debt brakes, the bailout funds for local government have the function of calming down the capital market in favour of local government lending and fostering attempts to balance budgets at the local level. However, the problem-solving capacity of the programmes is limited as rightly argued by Junkernheinrich: ‘You may buy time with such funds, but you will not solve the basic problem’ (Junkernheinrich quoted in: *Haushaltszeitung 4-5* translated by the authors). The requirements for financial support from the federal state may motivate one local actor or another to engage more intensively in consolidating the budget. However, the programmes cannot address the exogenous reasons for the financial crisis of local government in Germany. To solve this crisis it would be necessary to reform local finance, thus solving the problems on the income side. In addition, the tendency to shift tasks and responsibilities from the federal and the federal state level to the local level has to be contained because for many years it has brought local government budget out of balance.

The democratic quality of the funds may not be questions by a number of reasons. First of all they are based on legislation passed by parliaments elected by citizens who are at the same time inhabitants of the affected cities and counties. Furthermore, with the exception of Northrhine-Westfalia and Schleswig-Holstein the funds were also negotiated with the local government association. And finally, again with the exception of Northrhine-Westfalia, the participation is free and based on a decision of the elected council of affected cities and counties and the council has also agree the contract signed with the federal state government. However, the question regarding the democratic quality is more fundamental. It has been addressed by Dahl (1971) already more than 20 years before his pessimistic diagnosis of a 'democratic dilemma' (Dahl 1994). While such a 'democratic dilemma' is resulting under current political conditions out of the fact that 'system effectiveness' may be somehow assured at upper or even international or transnational level by negotiations of governmental and societal actors – but at the expense of effective citizen participation – he recognised already 20 years earlier that citizens at the local level may 'have almost unlimited opportunities to participate in decisions […] – but they have nothing to rule over' (Dahl 1971: 97). Under such conditions the idea of democracy as effective collective self-determination becomes an illusion or pipe dream because local people in highly indebted municipalities or counties and their representative bodies do hardly have any choice or can take just 'decisions over matters of no importance' (ibd.).

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Notes

1 A special kind of territorial unit located at the same level as counties are the so-called county-exempt cities *('kreisfreie Städte').* They perform the roles of both a municipality and a county and thus cover the functions of both.

2 Overindebtedness is defined in paragraph 75 of the local government code of North Rhine Westphalia.

3 Most of the German states have such regional authorities. These authorities are multi-purpose organisations in which the outposts of various ministries of the federal state are united in regions of the states. Only Schleswig-Holstein, the Saarland, Brandenburg and Mecklenburg-West Pomerania do not have such authorities, and Lower Saxony abolished them in 2004.