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Consolidating Germany's Finances: Issues in Public Sector Spending Reform

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ABSTRACT/RÉSUMÉ

CONSOLIDATING GERMANY'S FINANCES: ISSUES IN PUBLIC SECTOR SPENDING REFORM

While the German federal fiscal system has been successful in promoting a high standard of living even in regions whose economic capacity is low, tensions have emerged. *Firstly*, it has been difficult to ensure a sustainable fiscal policy, and the size of the overall deficit makes it difficult for the automatic stabilisers to operate freely. *Second*, overlapping responsibilities between governments and the financing of public spending programmes via inter-governmental transfers provide individual governments with little incentives to contain costs and demand. *Thirdly*, social spending often discourages a higher utilisation of labour. Furthermore, public expenditure is going to have to cope with increasing pressure due to the substantial deterioration of the old-age dependency ratio projected for the next years and decades and the continuing fiscal burden associated with reunification. Hence, continuing the process of fiscal consolidation and improving the quality of government spending remains one of the most pressing policy challenges in Germany. Spending pressures are likely to persist, due to the continuing fiscal burden associated with reunification and the substantial deterioration of the old-age dependency ratio projected for the next years and decades. This paper highlights major structural sources shaping public spending and presents options for public sector spending reform.

JEL Classification:H5, H77.
Keywords: Fiscal policy, federal fiscal relations, East Germany, domestic stability pact, social assistance, education, health care.

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LA RÉFORME DES DÉPENSES DANS LE SECTEUR PUBLIC : PRINCIPAUX ENJEUX

Le système budgétaire fédéral allemand est parvenu à promouvoir un niveau de vie élevé même dans les régions à faible potentiel économique, mais des tensions sont apparues. *Premièrement*, il s'est révélé difficile de maintenir une politique budgétaire viable et l'ampleur du déficit total ne permet guère de laisser jouer les stabilisateurs automatiques. *Deuxièmement*, le chevauchement des compétences des différentes administrations et le financement des programmes de dépenses publiques par des transferts inter-administrations n'incitent guère les responsables à maîtriser les coûts et la demande. *Troisièmement*, les dépenses sociales découragent souvent une utilisation accrue de main-d'œuvre. De surcroît, la forte dégradation du taux de dépendance des personnes âgées prévue dans les prochaines années et décennies mais aussi le fardeau budgétaire persistant lié à la réunification engendreront des pressions grandissantes sur la dépense publique. Par conséquent, les tâches les plus pressantes des pouvoirs publics en Allemagne demeurent la poursuite du processus d'assainissement budgétaire et l'amélioration de la qualité des dépenses publiques. Les pressions sur les dépenses vont probablement perdurer, étant donné la charge budgétaire persistante associée à la réunification et la forte dégradation du taux de dépendance des personnes âgées prévue pour les prochaines décennies. Ce document met en lumière les grands déterminants structurels de la dépense publique et présente des options pour la réforme des dépenses du secteur public.

Classification JEL : H5, H77.
Mots clés : Politique fiscale, relations fiscal fédéral gouvernemental, Allemagne de l'est, le pact de stabilité interne, aide sociale, éducation, soins de santé.

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CONSOLIDATING GERMANY'S FINANCING: ISSUES IN PUBLIC SECTOR SPENDING REFORM

by

Eckhard Wurzel[1]

1. The German federal fiscal system is based on budgetary autonomy of the different layers of government while simultaneously attaching a high importance to realising broadly equal living conditions across the federation. The latter is reflected in both a high degree of co-operation and revenue sharing between the authorities and a generous transfer system to promote social cohesion. While the system has been successful in promoting a high standard of living even in regions whose economic capacity is low, tensions have emerged. *Firstly*, it has been difficult to ensure a sustainable fiscal policy, and the size of the overall deficit makes it difficult for the automatic stabilisers to operate freely. *Second*, overlapping responsibilities between governments and the financing of public spending programmes via inter-governmental transfers provide individual governments with little incentives to contain costs and demand. *Thirdly*, social spending often discourages a higher utilisation of labour. Furthermore, public expenditure is going to have to cope with increasing pressure due to the substantial deterioration of the old-age dependency ratio projected for the next years and decades and the continuing fiscal burden associated with reunification.

2. After highlighting in the second section major structural forces shaping public spending, the remainder of this chapter presents options for public sector spending reform. The third section reviews policy initiatives designed to improve the effectiveness of resource allocation within the public sector. These include new public management methods, mechanisms of funding across government levels, and Germany's domestic fiscal stability pact. The last section examines important aspects of improving efficiency within selected areas, and in particular those that are attracting increasing attention in the current policy debate: improving the incentive structure in the social assistance system, raising the effectiveness of schooling and fostering efficiency within the health care sector. The section proposes options for further enhancing public spending effectiveness.

Federal fiscal relations and main forces shaping public spending

Federal fiscal relations promote a high degree of equality in living conditions

3. Germany is a federal state, with the federal government (*Bund*), the states (*Länder*) and the communities (*Gemeinden*) in principle enjoying budgetary autonomy. In practice, however, fiscal autonomy of sub-central governments is highly restricted, and complex institutional arrangements are in place designed to promote inter-governmental co-operation, co-ordination and revenue sharing. While federal fiscal relations are largely based on the desire to create broadly equal living conditions across the federation, resource allocation often lacks discretionary flexibility and is subject to inefficiencies.

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1. This paper was originally produced for the *OECD Economic Survey of Germany* published in January 2003 under the authority of the Economic and Development Review Committee, and has been slightly extended. The author is Head of the Germany/Austria Desk in the Economics Department. He is indebted to Jorgen Elmeskov, Mike Feiner, Manfred Huber, Val Koromzay, Howard Oxley and Andreas Wörgötter for their valuable comments. The part on health care reform benefited substantially from intensive interaction with Soeren Mattke. Special thanks go to Margaret Morgan for technical support and Diane Scott for technical preparation.

4. The federal government is assigned by the Constitution responsibility for matters considered to be of relevance for the whole country. The *Länder* are responsible for all tasks which are not explicitly attributed to the federal government. Major competencies comprise the education and university systems and health services. Also, administrative responsibilities belong to a considerable degree to the states. This holds, for example, for income tax collection, although the legislative power is in the hand of the federal government. The communities are attributed the right to control local matters such as road construction, school building, public transport and the provision of social assistance. However, in practice the situation is not so clear because responsibilities overlap. For example, all three layers of government and the social security system perform tasks with respect to health care: the federal government sets the legal conditions, the health funds finance operating costs for hospitals, the *Länder* finance hospital investment and regulate hospital capacity, and the communities provide local health care services. Table 1 provides a picture of the effective distribution of spending across levels of government.

5. Sub-central layers of government have very little power in raising own taxes,[2] but in any case revenues from individual taxes are overwhelmingly shared between the various layers of government. Superimposed on this primary system of tax sharing is a secondary redistribution system, deriving from the constitutional objective to broadly equalise living conditions across regions. This equity objective is achieved through a complicated redistribution system (see *Germany Survey 1998* for details) involving both vertical transfers from the federal government to the states and horizontal transfers between the states. Similar arrangements exist between the states and the communities. Special vertical transfers from the federal government go to the new states and are devoted to foster the catch-up process of eastern Germany ("Solidarity Pact"). Moreover, certain spending projects are co-funded between the federal government and the *Länder* and the *Länder* and the communities. Net of tax sharing, transfers from the federal government to the states alone account for more than 1.7 per cent of GDP.

6. The states are also directly represented in the second chamber of Parliament (*Bundesrat*), involving them in the federal legislative process (Box 1). The major instrument for policy co-ordination between all levels of government combined is the Financial Planning Council (*Finanzplanungsrat*), comprising the Ministers of Finance of the Federation and the *Länder*, the Federal Minister of Economics and representatives of the communities. The council exchanges assumptions about the economic and financial development and makes recommendations on the budgets of the federal, state and community governments.

Box 1. **Basic legal principles for budget formation, execution and control**

The federal government tables its draft budget to Parliament on an annual basis. After the first chamber of Parliament has decided on the budget, the Second Chamber (*Bundesrat*), which represents the federal states, has the right to demand changes to the budget or can reject it. Such objections, in turn, can be rejected by the first chamber with a two-thirds majority. As a rule, the states aim at influencing the budget process prior to its adoption by Parliament without rejecting it in the *Bundesrat*. Based on the legislated budget, each federal ministry is responsible for budget execution in its own domain. If the execution deviates from the budget law, the Minister of Finance is obliged to restore congruency, except in exceptional cases. To the extent exceptional spending over-runs exceed certain thresholds the budget committee of the Parliament needs to be informed.

An independent Court of Auditors examines whether the government's budget execution did conform with the pertinent legislation. In particular, the Court investigates whether resource allocation has not been wasteful. In the past the Court has highlighted spending programmes where this condition was not met. The Court's report provides the basis for parliament's decision to discharge the federal government for the respective fiscal year. A similar system applies to the federal states.

2. The major exception is the business tax, whose receipts mainly accrue to the communities, which set local rates as a multiple of a basic rate.

Table 1. **Functional spending by layer of government, 1998**[1]

Percentage of total

	Federal government	Social security	States	Communities	All
Public security	10.2	-	60.9	29.0	100
Law enforcement	3.5	-	96.5	-	100
Schools and pre-schools	0.0	-	71.9	28.1	100
Universities	9.6	-	90.4	-	100
Other education	23.4	-	38.8	37.8	100
Research and development outside universities	69.7	-	28.3	2.0	100
Culture	3.4	-	48.2	48.5	100
Social security	18.9	71.0	4.3	5.7	100
Health, sports, recreation	15.3	-	38.5	46.2	100
Housing and area planning	7.5	-	25.1	67.4	100
Nutrition, agriculture	30.7	-	66.1	3.2	100
Energy, water, financial aid to enterprises	66.8	-	26.9	6.3	100
Transport, communication	44.0	-	28.0	28.0	100

1. Intergovernmental transfers netted out.

Source: Federal Statistical Office; OECD.

Main forces affecting spending

7. Spending grew rapidly in the first half of the 1990s, largely driven by new demands associated with German reunification (Figure 1). Social spending was boosted when the elaborate western German social security system was fully extended to the east, and work provision and training measures were established on a large scale to cushion labour shedding. The wage bill for civil servants surged, on impact due to a larger government sector in eastern Germany, and over the first years of the 1990s on account of buoyant wage increases.[3] Government investment accelerated sharply immediately after reunification. Inter-governmental transfers surged, both for investment and consumption purposes, and aid was extended to enterprises to cope with the comparative disadvantages associated with the transition of the eastern German economy. Large inflows into retirement, a secular trend to increase health care spending, persistently high unemployment rates and repeated massive unforeseen shortfalls in tax revenues added to the stress on fiscal balances. In the process, social charges on wages surged, widening the tax wedge on labour (see Chapter I above). The general government deficit increased, peaking at a ratio of 3.4 per cent of GDP in 1996. Debt levels rose rapidly at all levels of government, in particular in the new states. Inherited debt stemming from the GDR contributed to this process.

8. Consolidation measures adopted in response by the federal government and the sub-federal authorities comprised spending restraint in a number of fields.[4] In particular, over the last decade government employment was reduced substantially. The strongest reduction occurred in the new states, although on a per capita basis public sector employment in the east is still significantly higher than in the west. This action led to a rough stabilisation of the nominal wage bill after 1995, but did not suffice to reduce it (Figure 1).[5] Governments also responded by cutting down their outlays for investment. This was particularly pronounced by the communities, which account for roughly two-thirds of government investment. Since 1994 the new states and communities are reducing their investment outlays dramatically, although the level per capita still exceeds the one in the west.[6] On the other hand, there have been phased reductions since 1999 in income and business taxes, and these add to the budgetary pressure. In sum, at present the general government deficit comes close to the three per cent deficit limit of the Maastricht Treaty. Among the problems this presents is that there is little scope for the automatic stabilisers to work.

9. The federal government has reinforced its commitment to balance the general government budget in the medium term. Further fiscal medium-term targets concern reductions in the debt, tax and spending-to-GDP ratios. However, with a deficit of around 3¾ per cent of GDP there is little scope for the automatic stabilisers to operate, and further negative growth shocks could easily push the deficit up further.[7] Caution is warranted regarding the progress in reaching a zero balance. Substantial further income tax cuts are already legislated to be phased in from 2005, and the government has decided to bring forward these cuts into 2004. The rapid increase of the deficit in 2001 and 2002 illustrates the budgetary risks associated with tax reductions that are not financed via cuts in expenditures. Similarly, the effectiveness of tax cuts with respect to stimulating economic activity is likely to be reduced if cuts are effectively deficit- financed or

3. See OECD (2001*a*).

4. See OECD *1996a* and the following issues.

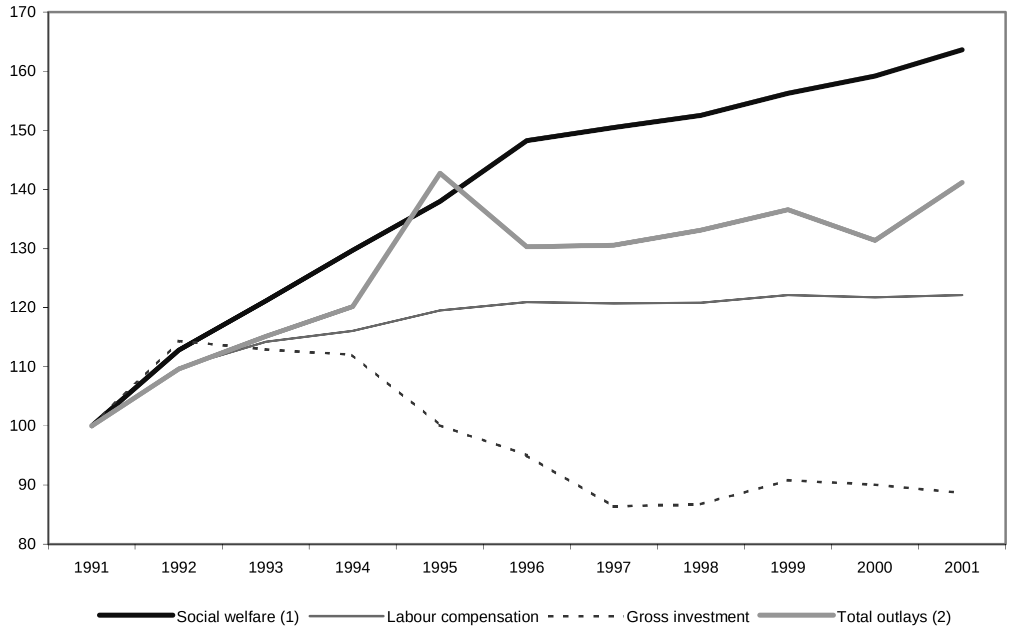
5. Applying the somewhat broader concept of the public sector, which in addition to the general government sector also includes government-owned companies, the reduction in employment is less pronounced.

6. The reduction in infrastructure is less pronounced, however, as the national accounts figures suggest. Certain entities, which traditionally belonged to the government sector are now allocated in the enterprise sector, reflecting privatisations, spin-offs from the budget and revisions in national accounts standards. Hence, a considerable share of infrastructure investment is made outside the government sector.

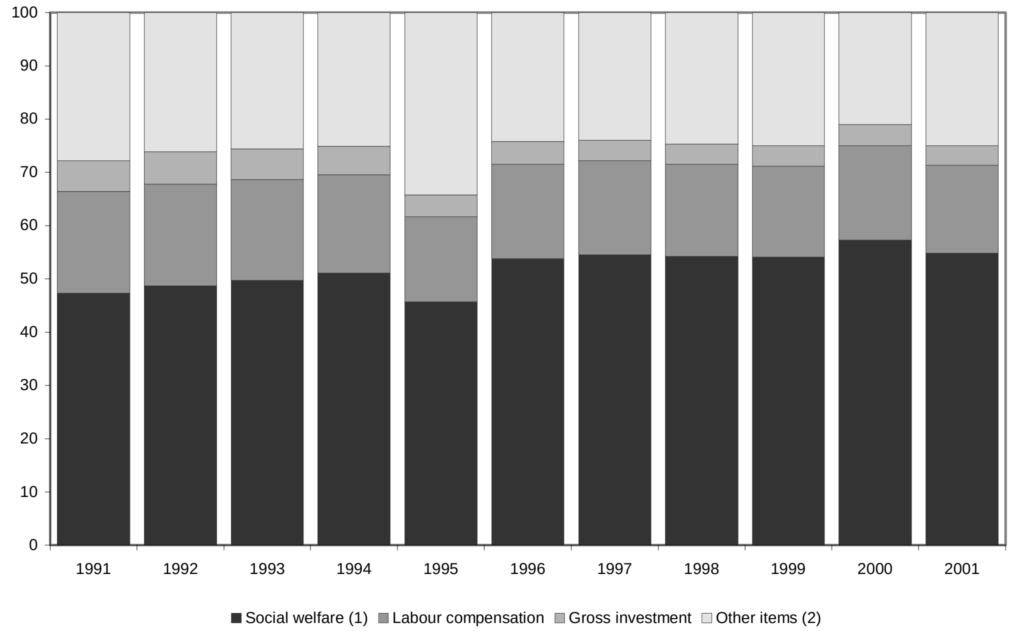
7. See OECD (1999*a*) and Van den Noord (2000).

Figure 21. Trends in general government spending

A. Nominal, 1991 = 100



B. Per cent of total outlays



1. Both benefits and benefits in kind.
2. In 1995 debt relating to unification was taken over by the federal government. This was recorded as a flow in the national accounts, boosting temporarily general government spending.

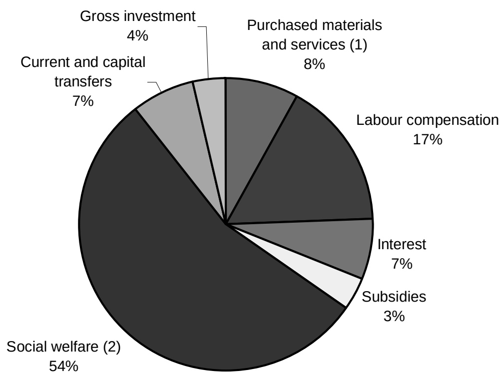
Source: Federal Statistical Office; OECD.

subsequent tax increases are to be expected to prevent the deficit from rising**.** Hence, further tax reductions -- in addition to those that have already been legislated in the recent past -- should only be implemented if they are embedded in a public sector spending reform reducing government outlays. Furthermore, larger-than-expected revenue losses and smaller revenue gains associated with already implemented or forthcoming income tax reductions and tax increases, respectively, cannot be excluded, given the large degree of uncertainty surrounding tax estimates. The unforeseen collapse of corporate income tax revenues in 2001 and the lack of its recovery in 2002 is an example. It is also not yet clear to what extent certain recent policy initiatives -- such as the measures against VAT tax fraud and cost containment measures in the health care system -- will be effective in generating savings.

10. Hence, continuing the process of fiscal consolidation and improving the quality of government spending remains one of the most pressing policy challenges in Germany. Spending pressures are likely to persist, due to the continuing fiscal burden associated with reunification and the substantial deterioration of the old-age dependency ratio projected for the next years and decades. At present social welfare spending accounts for more than 50 per cent of general government outlays. Indeed, on a net basis (with taxes on social security transfers taken into consideration) social spending in Germany in terms of GDP ranks second in the OECD, behind Sweden. Some 17 per cent of the general government budget is spent for compensation of public-sector employees. Gross investment and subsidies account for 4 and 3 per cent, respectively (Figure 2). This composition indicates that for fiscal consolidation to be successful, streamlining social spending is unavoidable. In seeking areas for consolidation, public investment is too small to contribute much but, in any case, cutting here could have adverse consequences for the growth potential of the German economy. This is notably the case for the new states, where empirical studies suggest that substantial infrastructure investment is important to improve the framework conditions for sustainable growth.

Figure 22. General government spending by type, 2001

Per cent of total outlays



1. Net of the increase in non-produced goods.
2. Both benefits and benefits in kind.

Source: Federal Statistical Office; OECD.

Managing public sector spending

Public resource management is becoming more flexible

11. Some changes have recently been introduced in the general government sector to improve the quality and cost efficiency of public services. Working time flexibility has increased in recent years. In the federal administration, working time can be shifted over days, weeks and months, depending on the tasks performed. The share of part-time employment has risen over the last decade. An element of performance-related remuneration has been established in some administrations, paying a premium on top of the basic salary. However, the system governing the remuneration of civil servants still precludes the functional and regional variation of wages, apart from a differential between the new and the old states.[8] These restrictions should be lifted to give the public authorities more flexibility in adapting the appropriate level and composition of the labour force and improve work incentives.[9]

12. New management principles are also being introduced with respect to cost accounting, although other OECD countries have gone further. Up to now budget plans account for revenue and expenditure flows only, without assessing the costs of administrative services. In the federal administration, an accounting framework for assessing and controlling the costs of services is being developed (*Kosten- und Leistungsrechnung*), and in 1998 new legislation on budgeting principles (*Haushaltsgrundsätzegesetz*) became effective allowing the federal and the states' administrations to record operating outcomes in terms of business-like balance sheets that also take into account the use of assets.[10] The introduction of a cost accounting and controlling framework for public sector services at various levels of government should be reinforced.

13. The federal court of auditors as well as the *Länder* courts in their annual reports have stated repeatedly that public sector spending has not sufficiently been subjected to evaluation. In response, the Minister of Finance now requires some form of evaluation of all administrative measures. The ambition to increase public sector spending effectiveness would be enhanced when outcome-oriented evaluation methods are applied. Within this framework the costs of a project are assessed against its impact on the targeted population. This entails estimating the costs and the benefits of the action taken over a long-term horizon. The case of applying active labour market measures (ALMPs) as reintegration instruments for the unemployed stands as an example for the potential usefulness of outcome-oriented evaluation methods. Job provision and training schemes have a long tradition in Germany, and are being applied on a large scale in eastern Germany since the beginning of the 1990s.[11] Although the immediate budgetary burden implied by these measures is high, regional labour offices have only recently been obliged to release statistical information on placements that allow some inference about the success of such schemes in terms of re-integrating the unemployed into the primary labour market.[12] More comprehensive micro data sets tracking participants in ALMPs are now being prepared that allow econometric evaluation of the effectiveness of different programme schemes. The usefulness of more systematic evaluation is illustrated by the investigations by the Federal Court of Auditors about the effectiveness of placement activities by the

8. For example: public sector employment regulations imply that university graduates having studied law are automatically advantaged in their career advancement over other graduates. This even holds for administrations such as the Ministry of Finance, the Ministry of Economic Affairs or the Deutsche Bundesbank.

9. See also Shim (2002).

10. See Bundesministerium der Finanzen (2002*a*).

11. See OECD (1999*a*) and (2001*a*).

12. Existing evaluation studies by academic researchers on the effectiveness of active labour market measures in Germany are almost exclusively based on surveys stemming from other sources.

Federal Labour Office, which instigated a vigorous public debate about the Office's institutional structure and performance. As a consequence, a consensus has developed that far-reaching reform of the employment service is necessary (see Chapter IV below).

14. The need to base public sector resource allocations on outcome-oriented *ex-ante* and *ex-post* evaluation becomes particularly visible in the new states. Key aspects of the infrastructure endowment in eastern Germany have substantially improved, thereby removing bottlenecks to growth. Deficiencies remain, however, which could seriously affect the attractiveness of the new states as a business location.[13] This is true, in particular, for certain regional transport networks, for which the communities are responsible. Apart from establishing new networks there appears to be a need to rehabilitate existing ones that were run down at the time of the GDR and have not yet been replaced.[14] Early action would be necessary to avoid further decay that raises the overall fiscal burden for the communities. However, over much of the 1990s the new states and communities devoted a declining share of their revenues to investment. Moreover, the capital stock of the public sector was over-proportionately expanded in fields whose importance for fostering growth appears to be subdued, such as infrastructure for social and cultural services and the central administration. To remedy this situation, priority schedules for government spending need to be established that are based on assessments of future costs and benefits.

Funding principles do not always promote allocative and cost efficiency

15. The contribution of the federal government to co-financed activities totals almost 1 per cent of GDP (€19.2 billion in 2002).[15] Part of these funds are passed on by the states to the communities. In addition, the *Länder* co-finance projects of their communities with their own resources. Overall, co-financed spending accounts for a sizeable share of total public expenditures. Broadly, three schemes involving the federal government can be distinguished. "Joint Fiscal Tasks" (*Gemeinschaftsaufgaben*) are jointly decided by the federal government and all states, and cover fields such as university construction, subsidies for the purpose of improving the regional economic structure and financial aid for research and development. "Investment Aid" (*Investitionshilfen*) can be granted for major investment projects by the *Länder* or communities for the purpose of averting economic disequilibrium, equalising differing economic capacities or promoting growth. Finally, grants for the "Disbursement of Funds" (*Geldleistungsgesetze*) support social transfers by the *Länder* and may be implemented at the request of the federation (Table 2).

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13. See OECD (2001*a*). Also, Deutsches Institut für Wirtschaftsforschung, Institut für Weltwirtschaft an der Universität Kiel, Institut für Arbeitsmarkt- und Berufsforschung, Institut für Wirtschaftsforschung Halle, Zentrum für Europäische Wirtschaftsforschung (2002).

14. For an example of replacement investment required in a medium sized eastern German city see Pohl, (2002). In the case under consideration, it has been estimated that 23 km of the road network would have to be renewed each year to meet road security standards. At present, replacement investment proceeds at a renewal rate of 7 km per annum.

15. By comparison, general government investment spending accounts for 1.7 per cent of GDP (2001).

Table 2. **Federal transfers to the *Länder* 2002**

Million euro

Co-financing schemes								Other compensation	
Joint Tasks				Financial Aid for Investment		Disbursement of Funds			
University construction	1074	Education and research	556	Communal road construction and transport	8421	Education benefits	997	Federal supplementary transfers	14579
Regional economic structure	1001			Construction of social housing	678	Residence benefits	1707	Other items	4358
Agricultural structure and coast protection	933			Modernisation of residential buildings	6	Other social benefits	213		
				Area development	399				
Total	3008		556		9502		2917		

Source: Federal government; OECD.

16. In several respects co-financed schemes do not appear to be well geared to achieve allocative efficiency and to control costs. Sub-central governments are likely to opt for spending projects as long as the benefits perceived exceed their own -- partial -- budgetary costs, even if the total costs of the project are large relative to its social value. The incentive to act in this way increase the larger a share the federal government or a state assumes. As far as the federal government is concerned, in most schemes its financial contribution amounts to some 50 per cent of the project costs, but in some fields financial participation totals up to 90 per cent of the total. Moreover, joint participation of both the federal government and the *Länder* in local spending projects -- notably in the area of city development -- implies that the communities' own contribution is reduced to a relatively small fraction. To the extent co-financing is conditioned on a certain minimum size of a spending project, as is often the case, the incentives for over-spending increase.

17. Similarly, splitted responsibilities across different administrations appear to seriously impede suitable programme evaluation and control. Auditors criticised that the different administrations focussed only on narrowly defined aspects, preventing comprehensive programme evaluation.[16] Differing objectives might further impede a coherent evaluation strategy. Simultaneously, co-financing has been found to be administratively costly with significant resources being devoted to the co-ordination process.

18. While in theory co-funding might be warranted to the extent that the provision of local services generates benefits for residents of other localities, in view of the high administrative costs and potentially serious adverse incentives the volume of co-funding should be scaled down. Funding of lower levels of government might be reached by revising their share in tax revenues. Such reform could include widening the tax raising competencies of local governments so as to achieve a higher degree of congruency between revenue and spending responsibilities. Efforts should also be made to internalise spill-overs of local services via co-operation between local governments or public institutions or the merging of local authorities.

19. To the extent co-financing is considered to be an important instrument in the future, the full costs associated with spending programmes in the selection, planning and evaluation stages need to be taken into consideration, and this includes financial flows over time. The fact that follow-up and maintenance costs associated with co-financed investment are not co-financed reinforces the importance of this comprehensive approach. For example, in one instance communities have been criticised by the responsible state auditor that their failure to properly maintain bridges implied more expensive renewal costs at a later state. While the former type of spending was not co-financed by the state, the latter was.[17]

The Revenue Equalisation System and the Solidarity Pact with the new states

Reform of the inter-state equalisation system still leaves scope for further improvements…

20. New legislation, that will become effective in 2005, reforms Germany's inter-state fiscal equalisation system, which transfers tax revenues from the wealthier to the poorer states.[18] The initiative was a response to complaints by donating federal states that transfer obligations would unduly burden them. Moreover, the Federal Constitutional court in a recent ruling demanded clarification of the link

16. See Bundesbeauftragte für Wirtschaftlichkeit in der Verwaltung (1998).

17. See Hessischer Rechnungshof (1999), Bemerkungen 1999.

18. For an outline of the system see OECD (1998*a*). For a summary of the reform see Bundesministerium der Finanzen (2002).

between the degree of agglomeration and financial needs.[19] The system has also been criticised to produce disincentives for regional governments to develop their tax base.[20] Tax receipts of the communities will be given a higher weight in the new system, such that the states with relatively small revenues of their communities receive relatively larger equalising transfers.[21] Also, a number of measures have been legislated so as to reduce the transfer burden of the donating states and associated disincentives for policy makers to develop their tax base. In particular, a "premium" will be introduced designed to reward states whose increase in tax receipts -- measured against the year before -- exceeds the average revenue increase of all states combined.[22] The volume of vertical transfers by the federal government (*Bundesergänzungszuweisungen*) will be increased, securing that no state will be left with a less favourable position in the redistribution system.

21. The higher weighing of community taxes appears to be a more realistic assessment of the states' financial endowments. It is not clear, however, whether the introduction of the premium will have the desired incentive effects for regional policy makers. A permanent above-average increase in the level of a state's tax revenues -- generated for example by a shift from public consumption to infrastructure investment -- would imply a transitory premium for one year only. This effect might be too small to trigger a policy response. Generating lasting rewards would require lifting revenue growth -- rather than the level -- in a durable way above the average. Moreover, the fact that the assessed discrepancy between the financially strong and weak states has been widened, on account of the higher weight attached to community revenues, tends to increase the system's marginal effective taxation of revenues. Overall, the changes in the incentive structure should be relatively modest, and the system remains highly complex.

22. Hence, earlier recommendations to increase the incentive structure of the equalisation system remain valid. In particular, the federal government should make more use of equalising lump sum transfers. This would entail designing transfers for each state so as to fill part of the gap between the state's revenues and finance needs for a base year, without adjustment to reflect the actual growth performance over a multi-annual period.[23] This would allow reducing the rates that govern variable transfers offsetting the states' own tax revenues on an annual basis. Moreover, regional governments could be given more

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19. For investigations regarding the link between agglomeration and financial requirements see OECD (2001*a*). More generally, the Constitutional Court also demanded to clarify the principles on which transfers within the equalisation system are based.

20. Studies show that the marginal effective taxation of additional income tax revenues implied by the revenues equalisation system can come close to or exceed 100 per cent. See Huber and Lichtblau (1998); Fenge and Weizsäcker (2001). Baretti *et al* (2000) found evidence that high effective tax outflows implied by the equalisation system impact negatively on the states' tax collection. Berthold *et al* (2001) found a negative relation between equalising transfers and the states' relative growth performance. See Berthold *et al. (2001)*. Theoretical analysis by Söllner (2001) suggests that a high marginal burden of the inter-state transfer system might imply disincentives for growth-oriented policies of the states even if policy makers focus on maximising votes rather than revenues. See also OECD (1998*a*) and (2001*a*).

21. At present the equalisation system adds in only 50 per cent of the communities' tax revenues for the purpose of establishing the area states' finance endowments prior to redistribution. (Among Germany's 16 *Länder* there are the three "city-states" Hamburg Bremen and Berlin. The remaining states are "area-states".) This will be increased to 64 per cent. Indeed, empirical evidence suggests, however, that this rule disadvantaged low-density areas because they produce smaller revenues per inhabitant than agglomerations. Moreover, in the new system the weighting scheme for inhabitants of the communities will be changed. See OECD (2001*a*); Fehr (2001).

22. The *Länder* to which the premium accrues deduct 12 per cent of their above-average increase in revenues from their revenues assessment base.

23. See OECD (1998*a*). A "lump sum" system of this type of vertical transfers to the regions has recently been adopted by Spain.

scope in generating own tax revenues. For example, they could be allowed to incorporate a surcharge into a reformed -- and correspondingly reduced -- income tax schedule.[24] For more local autonomy in setting tax rates to be meaningful the equalisation system needs to be adapted such that discretionary changes in local tax parameters are not neutralised by offsetting inter-governmental transfers. This suggests computing equalisation transfer positions on the basis of notional rather than actual revenue, disregarding changes in local tax rates. Some countries, such as Denmark, Finland and Spain have incorporated such provisions.

… and so does the new "Solidarity Pact" for the new states

23. The major share of federal government transfers to the new states is based on the "Solidarity Pact" (*Solidaritätspakt,* SP), which is in force since 1995. The SP has a volume of €10 billion annually (DM 20.6 billion, 0.5 per cent of GDP in 2001) of which about two-thirds are available unconditionally and the remainder is earmarked for investment expenditures.[25] Initially, the SP was conceived to expire without replacement after ten years, at the end of 2004. But with growth in the new states stagnating at a low level and the economic convergence with the old *Länder* stalling, a consensus developed that special funding for eastern Germany should continue for the purpose of infrastructure investment. Eventually, a new arrangement -- the Solidarity Pact II -- was negotiated between the federal government and the new *Länder*, which forms a supplement to the inter-state fiscal equalisation system. The SP II will be effective for 15 years, coming into force at the beginning of 2005 and terminating at the end of 2019.

24. The SP II contains two baskets. Within the first one the new states obtain annual lump sum payments by the federal government (*Bundesergänzungszuweisungen*, BEZ), distributed across the *Länder* on a per capita basis (Figure 3). The purpose of the provision is to fund infrastructure investment and to compensate for the weak financial endowment (*kommunale Finanzkraft*) of the eastern German communities.[26] While the agreement specifies that the transfers be used so as to foster the recovery of the new states, funds are not formally earmarked for investment, in contrast to the corresponding provision of the present Solidarity Pact. Each state is obliged, however, to present for information annual "Progress Reports" to the inter-governmental Financial Planning Council that show the use of the funds and the state's fiscal stance. The second basket of the SP II refers to investment of the federal government out of its own budget. The government committed itself to target a spending volume of some €50 billion between 2005 and 2019 in favour of the new states in terms of investment or further investment aid to the new states.

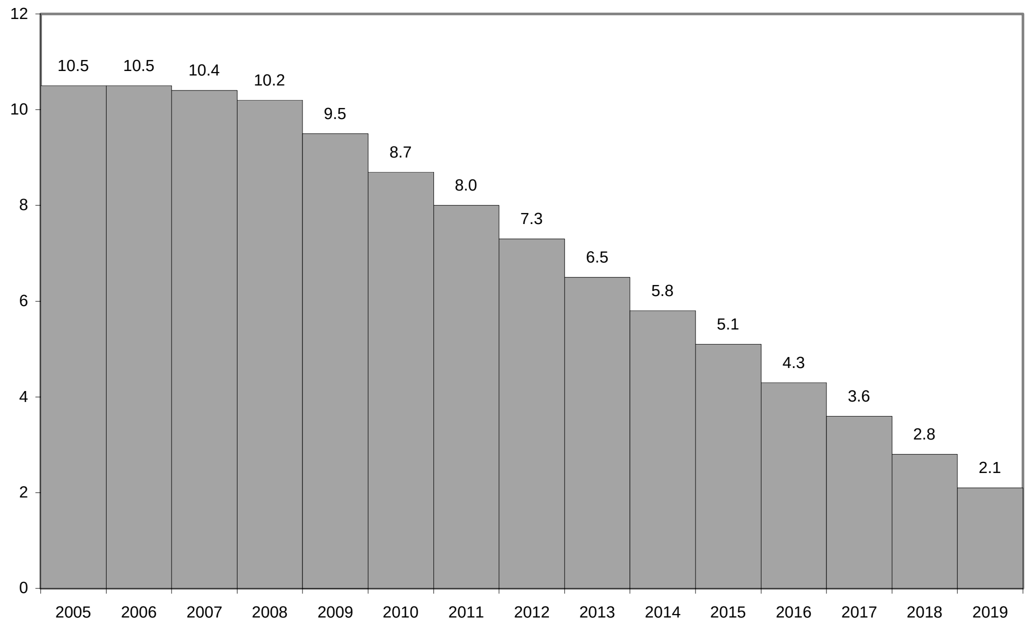
24. This has been repeatedly suggested in the German policy debate. See for example the statement of the Scientific Council of the Ministry of Finance: Wissenschaftlicher Beirat beim Bundesministerium der Finanzen (1992).

25. The earmarked part is granted by the federal government within the framework of the Investment Promotion Law Recovery East (*Investitionsfoerderungsgesetz Aufbau-Ost*).

26. In the first year (2005) the lump-sum payment equals the level of the predecessor scheme (SP I). Thereafter the transfers are mildly digressive until 2008. From 2009 onwards transfers are reduced by €0.8 billion (DM 1.5 billion) annually, until the scheme exhausts in 2019 (see Figure III.SP). See also: Ragnitz (2001).

Figure 23. The Solidarity Pact II with the new states

Unconditional transfers to the new states, bln euro



Source: Federal government.

25. In the future, the scope for non-entitlement spending of the new states will be narrowed from both the revenue and the spending side. From the revenue side, the new states need to cope with the fact that transfers originating from the SP II are digressive over time. Also, the admission of new members to the EU makes it questionable that aid from EU structural funds remain unabated.[27] From the spending side, there is a risk that certain categories of entitlement spending will play a larger role in the future than they did in the past. In particular, outlays for retired civil servants -- whose share is small yet in comparison to the one of the old states -- are set to increase.[28] This reinforces the need to re-orient the spending priorities of the new states and communities in favour of such projects that are most likely to reduce bottlenecks to GDP growth, notably in the area of transport. Immediate action along these lines is important: the capacity of the new states to generate revenues needs to be raised before the digressive phase of the SP II sets in. Hence, steps should be taken to incorporate into the SP II incentive mechanisms in favour of growth-enhancing investment. The following points could help in this respect:

- It is not clear whether the earmarking of transfers in the first Solidarity Pact has improved resource allocation in favour of investment. Giving it up is unlikely to be a loss. On the other hand, the Progress Reports required in the SP II are too general to support the efficient allocation of grants given to the new states for investment purposes. Instead, the new states should be required to make the Progress Reports a detailed instrument for policy analysis. This would entail, as a binding obligation, outcome-oriented *ex-ante* and *ex-post* evaluations of infrastructure investment projects that make transparent for what reason certain projects are pursued and others not. In this setting, funding by the federal government would be made conditional on the presentation of appropriate evaluation schemes rather than on the type of project chosen.

27. See Rosenfeld and Kronthaler (2002).

28. See OECD (2001*a*). See also Seitz (1999).

– By its nature the SPII is only concerned with determining the transfers to the states as an entity, while a large share of the required public investment in infrastructure falls into the responsibility of the communities. Hence, provisions need to be made to insure that an adequate share of the SP II funds are passed on from the *Länder* governments to the communities. In the same vein, funding of the communities should be linked to outcome-related project evaluations.

– In the past, aid to the new states has repeatedly been extended, and resisting demands for aid appears to be politically difficult. Establishing a reliable medium-term finance framework that is incentive-compatible should embrace that transfers are phased out as agreed in the SP II. This is also important in view of the fact that the additional fiscal burden associated with Germany's demographic "population ageing" is projected to surge over the next 15 to 20 years.

The domestic Stability Pact is an important step towards a sustainable spending path

26. Given budgetary autonomy of the different layers of government, fiscal consolidation at the general government level requires inter-governmental co-ordination. This necessity is reinforced by the provisions of the Maastricht treaty, relating to the general government, to obey the 3 per cent deficit limit and balance the budget in the medium term. According to the constitution the budgeted deficit of the federal government must not exceed federal investment spending, and similar "golden rules" are also contained in most constitutions of the *Länder*. While the purpose of the rule is to prevent deficit spending that is not considered to be economically useful, it is not designed to cap deficits in absolute terms. Linking the deficit to government investment is also subject to some draw-backs, such as broad budgetary definitions of investment and the fact that more and more infrastructure investment is being made outside the government sector.[29]

27. The federal government and the states agreed on new legislation, which specifies that both parties, including the communities, should aim at balanced budgets. Moreover, the inter-governmental Financial Planning Council (*Finanzplanungsrat*, FPR*)* is attributed the tasks to make recommendations on how to accomplish or restore fiscal discipline and monitor whether the authorities' spending and budget balances evolve in line with the targets set and the requirements of the EU Stability Pact. Violations will not be subject to sanctions, however. Based on this legislation the FPR agreed on spending caps for 2003 and 2004, stipulating that the states (including the communities) limit expenditure growth to 1 per cent annually, and the Federal government reduces expenditures by 0.5 per cent (see Chapter II above).

28. The agreement is a significant attempt to incorporate the EU consolidation targets into Germany's federal fiscal system. Other federalist countries in Europe, such as Austria, Spain and Switzerland, have also introduced rules for the purpose to contain the deficits of the central and sub-central governments. It is an open question, however, whether without enforcement mechanisms commitments will be met. In Austria, whose federalist structure resembles Germany's in important respects, all three layers of government recently agreed on sanctions in case of a party's non-compliance with negotiated budgetary targets.[30] Moreover, the provision to aim at balancing the budgets in the medium term might not be specific enough to secure lasting discipline of the parties involved. This includes the risk that fiscal policies over 2003 and 2004 might be biased towards one-off measures, which do not link fiscal consolidation to public sector reform.

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29. On a national accounts basis, for seven out of 11 years since 1991 the general government deficit has exceeded gross investment. Also, the rule does not cover investment in human capital, which importantly impacts on an economy's longer-run growth potential.

30. See OECD (2001*b*).

29. Hence, the FPR should promote lasting budgetary improvements based on public sector reform. Moreover, the agreement should be supplemented by a medium-term consolidation rule that comes into operation once the goal of balancing the budgets has been attained. Experience within the OECD indicates that in cyclical downswings a rule requiring budgets to be balanced might not be obeyed, which in turn can impair the credibility of the consolidation strategy. More appropriate would be a rule -- as adopted in Switzerland by some Cantons and legislated for the federation -- requiring the budgets to be balanced over the cycle. In view of the secular deterioration of Germany's old age dependency ratio structural surpluses to pre-fund ageing related spending increases should be aimed at. Such a rule would allow automatic stabilisers to work freely, but against the background of a reduction in the debt-to-GDP ratio in the longer term.[31]

30. For the implementation of the domestic stability pact the technical ability of the governments and the Financial Planning Council to monitor and control the evolution of the budgets is of high importance. A complex system of intergovernmental transfers tends to make it more difficult for each individual government to foresee the implications of financial interactions on revenues and spending. Hence, reducing the variety of inter-governmental transfer schemes -- notably opaque programmes of co-financing -- would raise the success chance of a domestic stability pact.

31. Efficient and timely controlling of both individual and consolidated budgets of all layers of government also requires that identical and appropriate accounting standards be utilised across all governments involved. While finance plans are based on identical standards, it should be secured that consolidated budgets by government level can be transformed into the national accounts standard, which is the reference for the EU stability pact.[32] This condition is not yet fully met. Provided budgetary accounting frameworks are standardised across the federation generating national accounts compatible information should not pose particular problems, with the possible exception of the phasing of particular revenue items. A base for the continuity of the budget process exists already at the federal level, where medium-term budget projections were introduced many years ago. Financial plans covering a horizon of five years (*Finanzplan*) are prepared every year together with the budget and include a considerable amount of detail. Multi-annual finance plans are also prepared by all state and local governments.

Selected spending programmes

32. This section outlines important pending issues in some selected areas that are increasingly attracting attention in the current policy debate: improving the incentive structure in the social assistance system, raising the effectiveness of schooling and fostering the efficiency of the health care sector.

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31. For Germany, estimates by the OECD Secretariat suggest that an increase in the output gap by 1 percentage point leads to a counter-cyclical fluctuation of the general government deficit by some ½ per cent of GDP. Hence, with the structural budget held in balance GDP growth would have to fall by some 6 percentage points for the actual balance to hit the 3 per cent deficit limit of the Maastricht treaty.

32. While national accounting aims at making transactions explicit domestic administrative accounting systems are more oriented towards managing budgets in terms of cash flows received and paid. Hence, both systems differ in several respects. Some spending or revenue items -- such as privatisations -- affect the deficit of public sector households in administrative terms while leaving them unaffected in the national accounts. Furthermore, some items -- such as tax allowances for families with children -- appear (implicitly) on the revenue side in administrative budgets but are explicitly recorded as transfers in the national accounts, and *vice versa*. Also, administrative budgets allocate expenditures and revenues to certain periods in accordance with the associated cash payments or receipts while national accounting is based on the "accruals" principle.

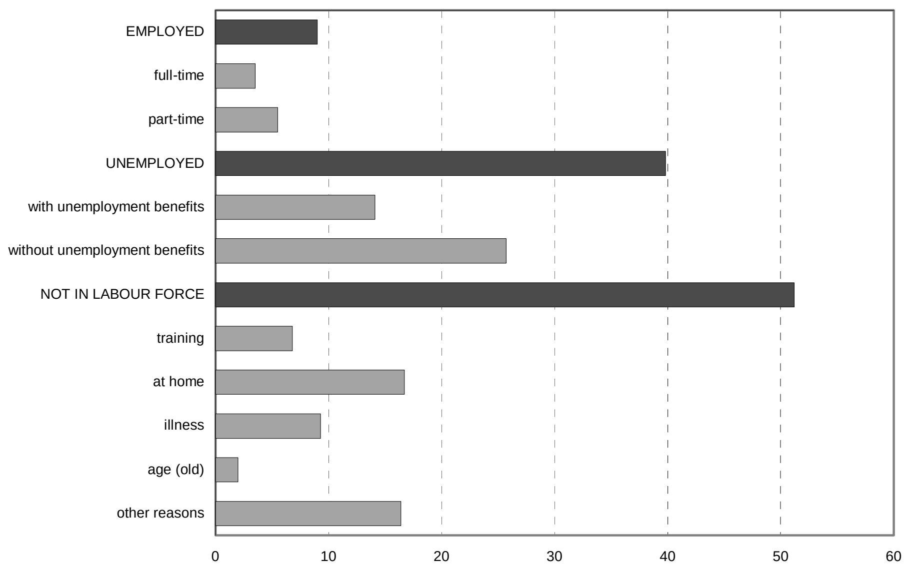
Provision of social assistance can be made more incentive compatible

33. The present system of social assistance benefits has been attacked on grounds that it maintains high unemployment of low-qualified workers. The main argument is that high transfer withdrawal rates over a considerable gross income band make work at low wages not worthwhile, thereby preventing the creation of a low-wage sector. Moreover, overlapping responsibilities for the provision of social assistance on the one hand and -- likewise means-tested -- unemployment assistance on the other hand appear to hamper effective job placement.

34. Social assistance for income support (*Laufende Hilfe zum Lebensunterhalt*, HLU) is extended to all persons, working or not, whose income from other sources falls below a certain subsistence level.[33] At the end of 2000 some 2.7 million persons received HLU, of which some 37 per cent are not employed but classified as able to work.[34] The classification with respect to work ability rests in the first place on the recipients' own assessment. Hence, the share of persons able to work can be expected to increase if employment conditions improved and incentives for labour force participation were increased (Figure 4).[35]

Figure 24. The labour market status of social assistance recipients, end of year 2000

Percentage of persons aged 15-64



Source: Federal Statistical Office.

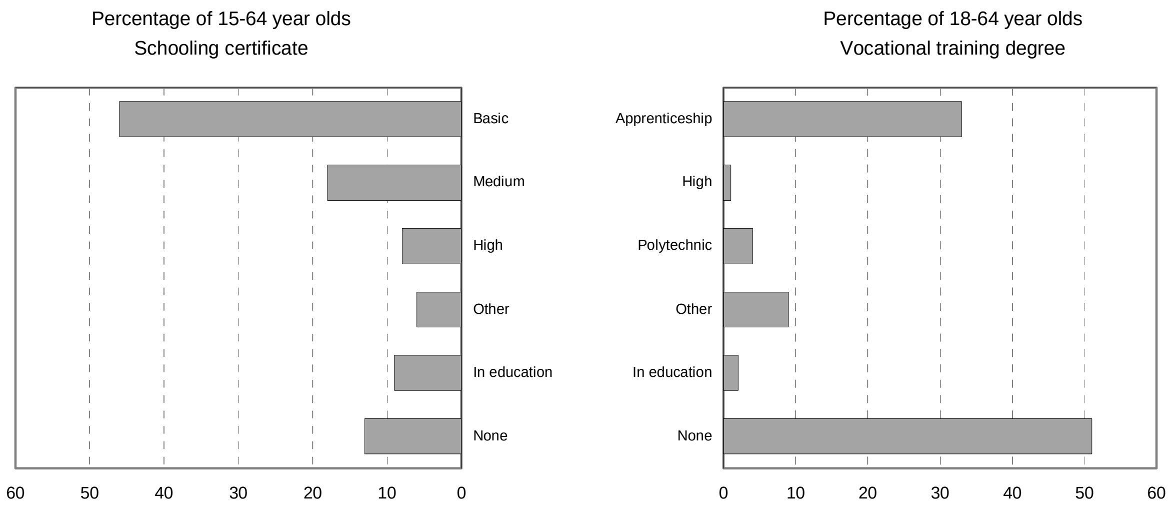
33. Besides social assistance for income support (*Laufende Hilfe zum Lebensunterhalt*) there is also support in special circumstances (*Hilfe in besonderen Lebenslagen*), which is mainly paid for the re-integration of handicapped persons and for exceptional health care needs. Over 2000 some 1.5 million received this type of social assistance. In addition, at the end of 2000 some 0.35 million persons received assistance benefits as asylum seekers.

34. Not employed persons who are not able to work comprise those caring for children or sick relatives, sick persons, and persons which cannot work on account of disability. See Haustein (2002).

35. Benefits are usually paid in cash and comprise a basic component, assistance for housing expenses and aid for one-off expenses such as household effects or removals. The number of HLU recipients trended upwards from some half a million at the beginning of the 1970s to some 2.9 million in 1997, excluding asylum seekers.

35. HLU recipients are relatively low-qualified: More than 50 per cent do not have a vocational degree, and even more than 10 per cent have no school degree. Among those with a formal qualification basic education is prevailing. Hence, to employ social assistance recipients the wage distribution would have to be spread out sufficiently to accommodate their low productivity (Figure 5).

Figure 25. Highest educational attainment of social assistance recipients, end of year 2000



Source: Federal Statistical Office.

Overlapping responsibilities hamper efficient job placement

36. Some 10 per cent of social assistance recipients receive simultaneously unemployment assistance (Alh), which also provides means-tested income replacement for unemployed persons whose eligibility for receipt of unemployment insurance benefits is exhausted. While both types of benefits are of potentially indefinite duration, Alh is more generous and extended at a fixed replacement ratio of previous earnings. Alh is administered by the Federal Labour Office and financed by the federal government while the communities are responsible for the administration and financing of social assistance. The dichotomy of the two systems is associated with inefficiencies. Firstly, the fact that means-tested benefits, based on different rules, are processed by two different layers of administration increases administrative costs. It also raises the bureaucratic exposure of the recipients of both types of benefits, who have to deal with two separate administrations. Secondly, for both types of benefits the budgetary costs for each administration fall short of the full costs, which might have a negative impact on job placement efforts by the labour office on the one hand and the communities on the other hand. Finally, there is an incentive by each layer of government to shift the respective financial burden to the other layer. The communities have an incentive to induce participation of unemployed social assistance recipients in work provision schemes, offered by the federal Labour Office, which re-establish eligibility for unemployment benefits. On the other hand, by lowering unemployment assistance benefits the federal government can effectively shift part

of its financial obligations to the communities.[36] The federal government has established a commission, which will make proposals about how the two systems can be integrated.

37. Overall, this suggests to combine unemployment assistance and social assistance into one single means-tested social assistance benefit, as it has been proposed recently by a task force on labour market reform commissioned by the government (*Hartz* Commission, see Chapter IV). In fact, half of the OECD member countries do not have separate unemployment assistance benefits. To the extent that the provision of social assistance is left with the communities, the reform would imply that a large financial burden is shifted from the federal government to the communities, and this would have to be matched by a reallocation of tax receipts to the local level.[37] The mode of funding should preserve incentives for the communities to integrate the unemployed into the primary labour market. This suggests that the social assistance outlays should not be reimbursed via unrestricted transfers from the federal government. Instead, transfers could be put on a predetermined lump sum basis.

Incentives to take up employment are low…

38. Non-employed recipients of HLU, who are able to work are obliged to accept job offers, and non-compliance can be sanctioned by a reduction in benefits of 25 per cent. However, enforcement of this provision appears to be low while marginal effective tax rates associated with the withdrawal of HLU when earnings rise are high. Indeed, over an earnings range extending over more than €700 HLU is withdrawn at rates between 85 and 100 per cent. As a consequence, in combination with other relevant provisions of the tax-benefit system, and without subsidised wages, net incomes of different types of families hardly increase with gross earnings over a broad income band relevant for low paid part-time and full-time occupations (Figure 6, solid lines).[38] Also, depending on family composition, the level of social assistance benefits comes close to collectively bargained wages in certain occupations, notably within the service sector. Hence, there is little incentive to take up low-paid employment. Indeed, employment shares have been found small in collectively bargained wage groups that are relatively close to benefit levels.[39] Overall, these features are likely to define effective wage floors that prevent the wage distribution from spreading so as to generate significant employment opportunities for the low-qualified. Indeed, in contrast to other major economies the German wage distribution has not spread out, despite rising unemployment among unskilled workers.

36. In 1999 the federal government abolished the eligibility of certain groups of unemployed to receive unemployment assistance benefits without prior receipt of unemployment insurance benefits. This implied higher social assistance outlays for the communities.

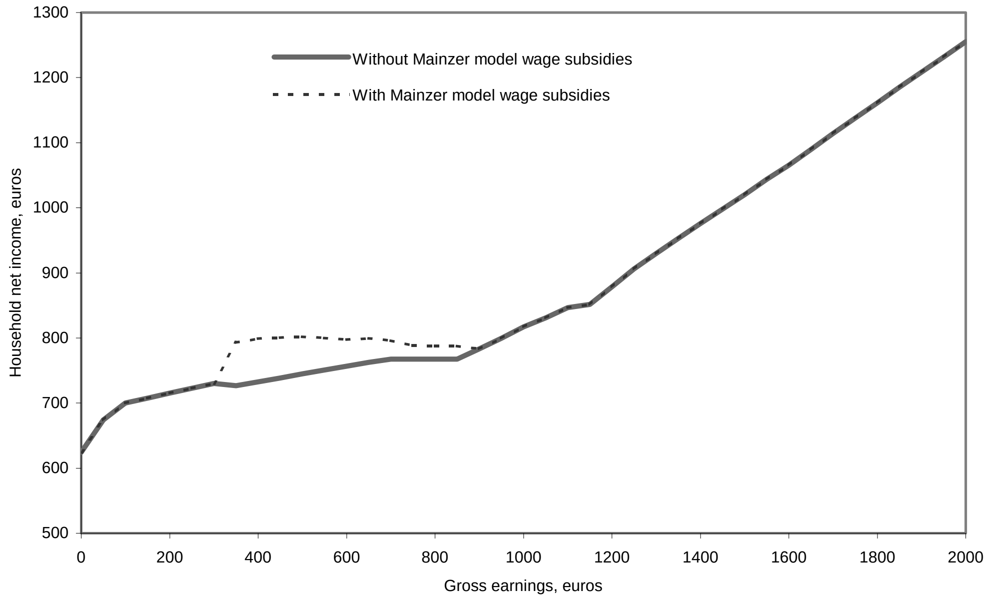
37. See Huber and Lichtblau (2002).

38. The net incomes have been derived from the ifo data-base of the tax and benefit system.

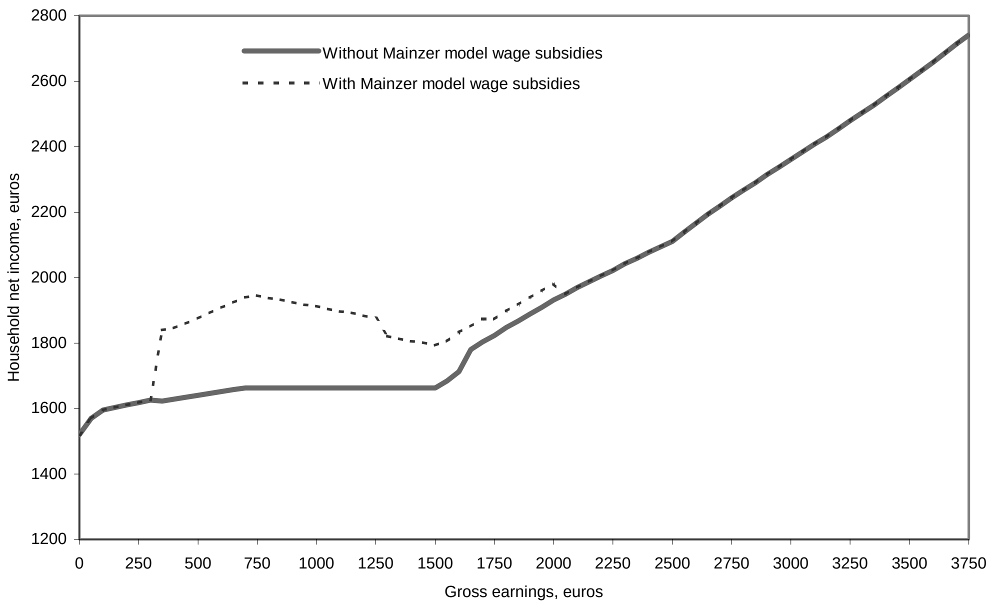
39. See Sinn *et al.* (2002).

Figure 26. Effects on net income of the tax and transfer system

A. Single person, working



B. Couple with 2 children, 1 person working



Source: Ifo Institute for Economic Research.

… and need to be improved

39. To stimulate employment in the low wage sector, the government has recently introduced wage subsidies (MM) accruing to employees (see Box 2). The government has estimated that application of the MM could increase employment in the low-wage sector by some 20 000 to 30 000 persons.

Box 2. **The Mainz Model for employment promotion in the low-wage sector**

Since mid-2000 experimental wage subsidisation schemes have been introduced in selected regions in the new and the old states so as to promote employment of the low-qualified in the low-wage sector (see Germany Survey 2001). The "Saar Model", implemented in some regions of the Saarland and Saxonia, subsidises the employers' social security contributions. The "Mainz Model", implemented in some regions of Rhineland-Palatinate and Brandenburg, subsidises the social security contribution of the employees. Eventually, the Mainz Model (MM) was established -- in a modified version -- in Germany overall in March 2002.

Recipients need to work for at least 15 hours per week, at wages that are collectively bargained or meet the local norm. Employees who have been in regular low-wage employment prior to the introduction of the scheme do not qualify for the benefits, unless they change employer. Persons who have been in small jobs (jobs with less than 15 working hours per week) are eligible for the benefits if they make a transition into regular employment. Singles and married couples receive benefits over a gross earnings band spanning from €325 to €897 and €1 707, respectively. Within this bracket benefits are gradually withdrawn. In addition, there are digressive child allowances of up to €75 per month. The maximal period of support is 36 months. The scheme is set to be terminated in 2006.

40. For very low gross earnings the MM implies an increase in net pay, which should raise incentives to accept work in this income bracket. However, the scheme does not remedy the fact that the transition into employment of social assistance recipients is associated with very high marginal effective tax rates. On the contrary, the main shortcoming of the MM is that over a considerable income band it produces marginal effective tax rates that exceed 100 per cent. This is due to both the scheme's own high withdrawal rates and its interaction with the HLU schedule. Regarding the latter, the employees' social security contributions, including MM benefits received, are subject to the social assistance withdrawal schedule. For families with children, the reduction in child benefits adds to this adverse effect (Figure 6, dotted lines).

41. While persons who were already employed on low-wage jobs prior to the introduction of the MM do not obtain the support, they face an incentive to quit the present job and take up low-wage employment with another employer so as to qualify for the scheme. Past experiences with job substitutions associated with a regime shift in the taxation of minor employment indicate that such effects might be significant.[40] Hence, the introduction of the MM might lead to a re-allocation of labour, which could imply higher budgetary costs of the scheme than assumed by policy makers.

42. In view of the scheme's high marginal effective tax rates it appears not well suited to foster the transition into low wage employment, and should be modified. Instead, withdrawal rates of social assistance would have to be lowered substantially and/or wage subsidies would have to be introduced such that overall remuneration increases with gross earnings. Simultaneously, the implied fiscal costs would have to be limited. Both conditions are difficult to combine. For example, if the withdrawal rate of social assistance benefits were fixed at 50 per cent over the entire phase-out range, recipients with a guaranteed monthly income of €1 500 would still receive benefits at monthly gross earnings totalling €3 000 (€1 500 times the inverse of the withdrawal rate). This is more than average gross earnings in Germany.[41] Hence, means to reduce the effective taxation of labour at the low-wage end of the wage distribution need to be

40. See OECD (2001*a*).

41. See Steiner (2002).

complemented by further reform of the tax and benefit system that fosters job search of the unemployed and dismantles barriers to labour force participation.[42] Important elements of such reform would be:

- Social assistance benefits should be cut substantially for recipients who are able to work but reject job offers. The budgetary effect of such a policy is likely to manifest itself not only in terms of lower outlays in case of non-compliance with the obligation to accept employment but also via reductions in the duration of non-employment spells. Indeed, empirical evidence elsewhere suggests that reductions in income replacing benefits imposed in cases of non-compliance with job search requirements can significantly reduce unemployment duration. There is also evidence that the credibility of implementing sanctions in practice plays an important role for the readiness to pick up employment.[43] In line with these findings, some OECD countries, including Denmark, Switzerland and Australia, have tightened eligibility criteria in recent years and closely monitor job search activities.

- Unemployment assistance should no longer be granted indefinitely. Instead, it could be collapsed into social assistance once the two systems are integrated.

- Eligibility conditions for unemployment insurance benefits should be revisited in favour of fostering job search. At present, unemployed aged 59 and older can receive unemployment insurance benefits over an extended period of three years without job search requirement. Effectively, this provision constitutes a measure for early retirement, and has been utilised by employers to reduce their labour force at the expense of the Federal Labour Office.[44] It should therefore be abolished. More generally, the appropriateness of extending eligibility periods for unemployment benefits with age needs to be revisited. In a similar vein, subsidies granted if older employees reduce their working time (*Altersteilzeit*) provide an inventive for effective early retirement and should be abolished. Also, the acceptability criteria in the unemployment insurance scheme should be tightened and non-compliance with job search requirements sanctioned (see Chapter IV below).

- The system of active labour market measures (ALMPs) needs to be revised. Empirical evidence indicates that general work provision and training schemes, while being costly, have not been effective in raising re-employment probabilities for the primary labour market and appear to be associated with significant lock-in effects.[45] Other problems include a considerable circularity between different programmes, potentially high dead-weight costs and

42. For a comprehensive account of the German social transfer system more generally see Von Loeffelholz, Bernd Fritzsche and Günter Köpp (1997).

43. Various micro-econometric studies -- while not focusing explicitly on sanctions -- found that exits from unemployment cumulate around the exhaustion point of unemployment benefits. See Wurzel (1993); Hagen and Steiner (2000). There are some recent studies available that focus on sanctions. Recent econometric work for Switzerland, which exploits information by *Kanton* on how strict potential sanctions in cases of non-compliance with job search requirements are implemented in practice, suggests that unemployment duration falls with the credibility of announced action. This result holds even for unemployed who are not yet on social assistance benefits because their unemployment insurance benefits did not yet exhaust. See Lalive *et al.* (2002),. Simulation experiments within a macro-framework for the Netherlands suggest that benefit sanctions might have welfare effects that might be more pronounced than reducing replacement rates. The main effect originates from the threat of penalties, not because the penalty is actually imposed. See Boone and van Ours (2000).

44. Survey information suggests that 20 per cent of the registered unemployed do not want to accept employment. In the first place this group consists of older persons. See Brenke (2002).

45. See OECD (1999*a*) and OECD (2001*a*).

crowding out of private sector activity. Moreover, efficient placement in training programmes has apparently been impaired by the vested interests of the providers of such schemes (see chapter IV below). Hence, a large share of the work provision and training schemes presently applied should be phased out, which would generate substantial savings. Experience in other OECD countries indicates, however, that ALMPs can support the transition into the primary labour market if they are designed to foster job search and associated with intensive profiling and counselling of the unemployed as well as the monitoring of search activities.[46] Redesigning ALMPs in Germany along these lines should be combined with the scheduled reform of the Federal Labour Office (see Chapter IV below). Moreover, reform should also establish a high degree of congruency for each public sector authority involved between the financing of unemployment-related transfers and ALMPs. This would create financial incentives for the respective administration to foster programme designs that support best the transition into the primary labour market. In some OECD countries ALMPs are utilised by the communities to test the willingness to work of social assistance recipients. While such an approach might also be an option for Germany, it has been suggested that the communities should offer employment opportunities to all HLU recipients who are able to work.[47] However, such comprehensive provision risks creating another ALMP-industry under the umbrella of the communities, with similar adverse outcomes that have been observed with the present system.

Education

Secondary education

43. German spending per student on upper secondary education exceeds the OECD average by some 60 per cent.[48] However, educational outcomes -- as measured in terms of basic competencies of students aged 15 by the OECD international PISA study -- fall significantly short of the OECD average.[49] Moreover, a domestic PISA study, conducted in winter 2001/02, shows a wide variation in students' average competence levels across the *Länder*, which are autonomous in organising the school system and determine the schools' curricula.[50] The study shows that the performance of the school system cannot be equated with the level of resources devoted per pupil. Indeed, the federal state that ranks lowest in all competence fields tested spends most per student. Overall, this suggests considerable scope to raise the efficiency of German secondary education.

46. See Martin (2001).

47. See Sinn *et al.* (2002).

48. A significant share of spending accrues to schooling within the dual vocational training system.

49. OECD (2001*c*). For a summary of key results and a discussion of various aspects of the PISA study in Germany see also Schleicher (2002). Prenzel (2002). Hohlmeier (2002). Lüdeke (2002). Stange (2002). Ochel (2002).

50. The variation found in students' average competence levels across the *Länder* amount to about one to one and a half school years in high schools. The German PISA study is supplementary to the international one, and has been commissioned by the education ministers of the German *Länder*. Its goal is an assessment of pupil performance individually by states. Overall, 50 000 pupils were tested. For 14 out of the 16 federal states test results are available for the full programme. For two states, Hamburg and Berlin, the response rates were too low for these two to be included into the general evaluation. They have been included, however for the high school section, where the response rates were sufficiently high.

44. The PISA results point to some institutional factors that appear to be relevant for increasing performance overall while limiting the impact on attainments of the students' socio-economic background. Many of the countries that performed well in international comparison have been shifting education policy and practice away from a focus on inputs -- the resources, structures and content of schooling -- towards a focus on learning outcomes. With this approach schools are attributed the authority for organising their own programmes and are held responsible for them. Also, in several well performing countries the extent of educational differentiation between schools is limited. In Germany schools are subject to tighter regulation than in almost any other country within the OECD. They have no freedom to select teachers and very little discretion in disposing of their funds. As a rule, differentiated schools group students by level of performance, and teaching is subject to detailed curricula leaving little scope to develop educational paths that might improve learning outcomes. Moreover, mandatory country-wide uniform educational targets against performance can be assessed have not been established.[51] The lack of uniform educational standards along with the high variation in average educational performance across states are also likely to impair the mobility of employees with children.

45. This suggests reform introducing a more outcome-oriented regulatory framework, which sets nation-wide standards for schooling attainments, to be tested on a regular basis. For this end centralisation is needed with respect to the determination of the targets. One option to achieve this would be to reallocate the competence to set such targets to the federal level. Simultaneously, schools should be given more freedom in determining their own programmes of how to improve learning outcomes. The flexibility across educational paths should be increased and more weight put on individual coaching of students. Incentives to deliver high quality education could be improved if the salary scheme for public sector employees were opened for performance-related remuneration, and schools obtained the right to choose teachers. Within this framework government funding of schools should be linked to educational outcomes relative to the benchmark.

46. Other features of the German school system suggest reform. Annual schooling time per year in Germany falls markedly short of the OECD average, in particular over the first years of schooling. This is largely attributable to the fact that the supply for full-day schooling is very limited, in contrast to several other countries, which score higher in the PISA study. For example, scheduled schooling per year for a nine-year-old pupil totals 752 hours in Germany while the OECD average stands at 829 hours. For youths aged 14, scheduled annual hours amount to 914 in Germany as opposed to the OECD average of 944.[52] The government recently decided significant financial aid to support the establishment of full-day schooling.[53] Also, the relatively low performance in Germany often occurs on the back of insufficient control of the German language. Regarding the socio-economic composition of the students, supplementary analysis carried out by the German *PISA-Konsortium* indicates that the high heterogeneity of the German population with respect to its immigration status is a primary factor relating to low scores.[54] The language deficiency is also associated with negative externalities for school children of non-immigrant families in the same classes. Compulsory language tests and compensating compulsory language training is

51. There is a standing conference of the states' ministers for education (*Kultusministerkonferenz*), whose tasks *include inter alia* setting common standards that secure the congruency of school certificates across the states.

52. See OECD (2002*a*).

53. The programme aims at supporting the establishment of 10 000 full-day schools by federal aid totalling €4 billion between 2003 and 2007.

54. The German *PISA-Konsortium* has carried out supplementary analysis of the PISA data sets with respect to the socio-economic composition of the test participants. See Deutsches PISA-Konsortium (2001). For a summary see: http://www.mpib-berlin.mpg.de.

therefore necessary to improve the general trainability of students with immigrant background. More generally, efforts need to be made to foster their integration into the school system.

Tertiary education

47. In recent years Germany's universities have increasingly come under criticism of being expensive while not well adapting to changing demands for new skill profiles. Indeed, cumulative costs per tertiary studies are in the upper range within the OECD. Effective durations of studies are relatively long, explaining most of the cost overhang (Figure 7). This is attributable to both the fact that up to now the statutory minimum duration for Germany's first tertiary ("type A") programme[55] is relatively long and that the system contains few incentives for efficient delivery and utilisation of university services. Competition between universities is hindered by federal and state laws and regulations, public universities are not allowed to charge fees (apart from a minor contribution), and the incentives for university teachers to deliver adequate teaching and research were weak once tenure has been granted. New legislation has been implemented that addresses some of these issues. Universities have obtained the option to offer bachelor and master programmes whose duration match the international standard. Moreover, performance oriented remuneration schemes have been introduced for university teachers, and the new carrier path of a junior professorship has been established.

48. While these measures are welcome steps in the right direction, further reform is required, to increase the allocational efficiency of the university system. Tertiary studies with a shorter duration should be introduced on a broad scale. Indeed, reducing the minimum length of tertiary education programs can go some way to improve the overall supply of labour with tertiary education. Within the OECD countries which offer only long first tertiary education programmes generally have significantly lower graduation rates than countries that offer shorter tertiary programmes.[56] Long study periods tend to discourage investment in education unless they are matched by proportionate gains in productive capacity that are reflected in subsequent remuneration. In general, the latter condition does not appear to be matched, suggesting that studies may become less focussed once they are stretched. Indeed, within the OECD Germany belongs to the group of countries with the lowest (private) return on tertiary education, and this relates largely to the long duration of studies.[57] Moreover, reform should quickly move on implementing a higher degree of competition between universities. In this setting, universities should get the right to levy tuition fees. This would prevent students from considering tertiary education as a free resource and contribute to improving the financial endowment of tertiary education. Student fees would also serve to reduce potentially large subsidies to students with wealthier family background, who tend to choose education of longer duration. To mitigate potentially adverse distributional impacts for students stemming from low-income families, Germany's student support system could be suitably adjusted. Funding of universities out of the general government budget should be linked to the universities' performance, and this requires a re-enforcement of quality control.

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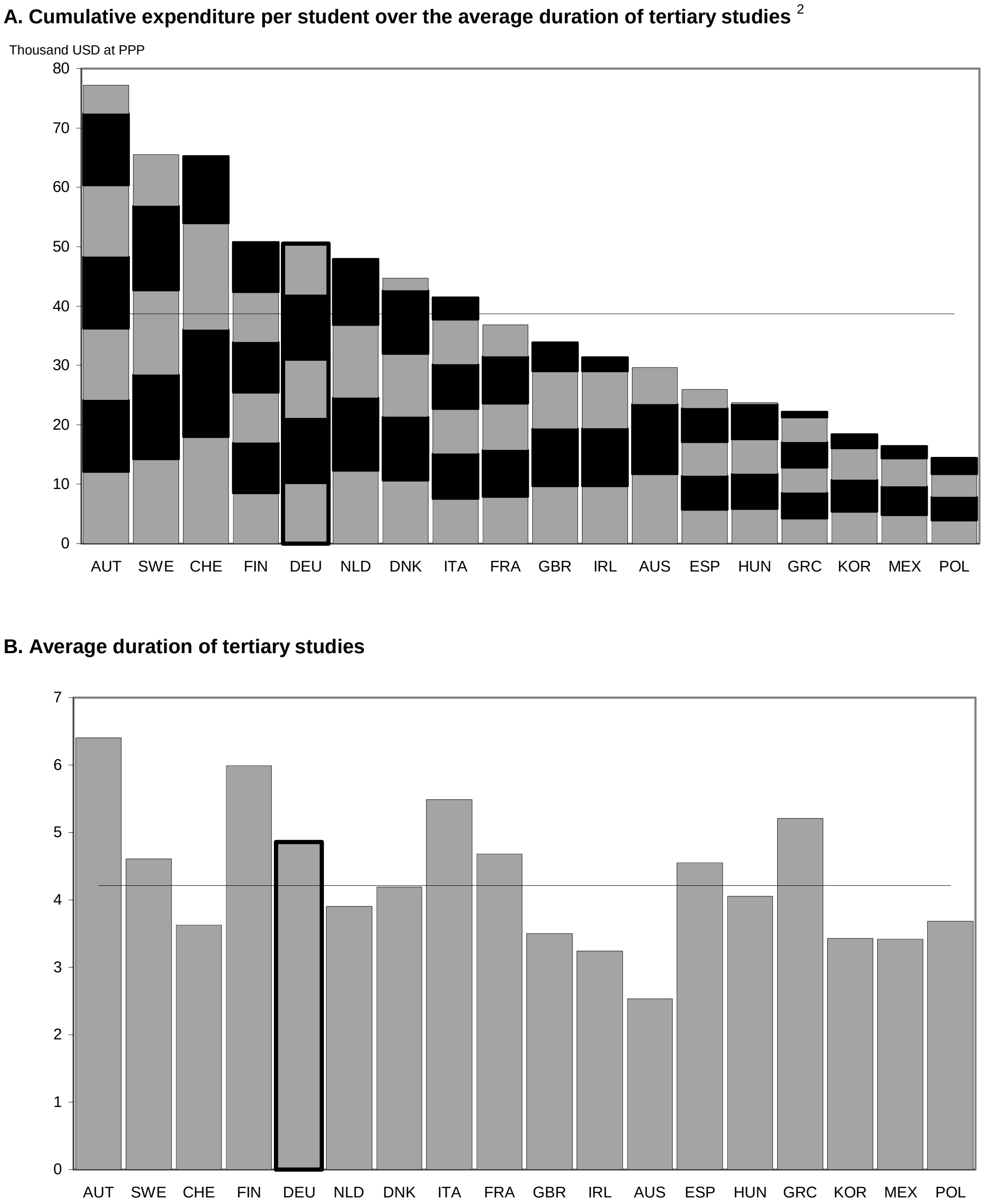
55. In the OECD's classification tertiary type A programmes are more theoretically oriented, such as the German *Diplom* or the Master's degree in the United States. Tertiary type B programmes are more occupationally oriented leading to direct labour market access. In Germany they comprise politechnical tertiary education (*Fachhochschulen*).

56. See OECD (2001*d*).

57. See "Investment in human capital through post-compulsory education and training" in OECD Economic Outlook 71.

Figure 27. Costs and duration of tertiary studies, 1999 [1]



1. Countries are ranked in descending order of the cumulative expenditure per student. The horizontal line is the average of the countries in the graph.
   Public and private institutions except for GRC, HUN, ITA, POL, CHE which are public only.
   Duration of tertiary studies refers to the 1995 academic year for AUT, DNK, FRA, KOR, MEX, NLD, ESP, CHE.
2. Each segment of the bars represents the annual expenditure per student. The number of segments represents the number of years, on average, that a student stays in tertiary education.

Source: OECD *Education at a Glance 2002.*

Aspects of current health care reform

49. Health care spending in Germany accounts for some 10½ per cent of GDP, up from 6.3 per cent three decades ago. Outlays surged in the 1990s when the western German health care system was extended to the new states.[58] In addition, some segments of health care provision, such as the pharmaceutical sector, experienced recurring disproportionate growth. The introduction of the long-term care insurance also contributed to raising outlays as spending on some items were previously accounted elsewhere. The increase in spending implied a sharp increase in wage-based contribution rates over the last decades, which was reinforced by the comparatively weak growth of the contribution base in the new states and low growth in earnings since the second half of the 1990s. Between 1991 and 2002 alone contribution rates in the old and the new *Länder* increased from 12.2 and 12.8 per cent of the wage base, respectively, to 14 per cent. Since the beginning of the 1990s, the health insurance system exhibited the strongest increase in contribution rates within the social insurance system overall (Figure 8).[59]

114. Within the OECD Germany belongs to the countries with the highest spending-to-GDP ratio, behind the United States and Switzerland (Figure 8). Public health care spending amounts to eight per cent of GDP, mainly financed by a compulsory insurance system that consists of both public sector and private insurers, with the former covering around 90 per cent of the population (see *OECD Germany Survey 1997*). While the infrastructure of and the access to health services is excellent, various indicators of health status -- such as “potential years of life lost”, and life expectancies -- place the performance of the health care system in the medium range within the OECD.[60] With utilisation of health care services relatively high, the system appears to contain significant efficiency reserves.[61] In the future the demand for health care services is likely to increase further substantially, mainly due to both expanding technological possibilities in medical treatment and population ageing. As many other countries, Germany now faces the difficult political question, whether to accept the disproportionate increase in health spending and to find ways to finance it or to restrict spending growth. This decision might imply quite different policy responses, even if in both cases policies to encourage the efficient use of the allocated resources remain desirable.

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58. See OECD (2001*a*).

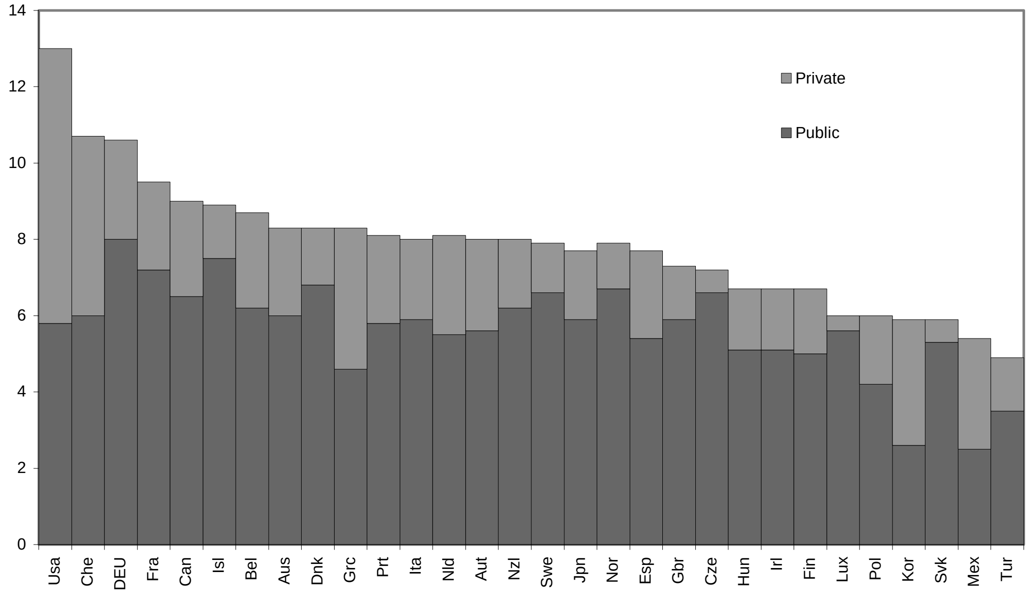
59. In contrast to the pension system the health insurance system did not benefit from the proceeds of the ecological tax levied since 1998.

60. The measure “potential years of life lost” (PLYL), represents the shortening of life expectancy due to avoidable disease.

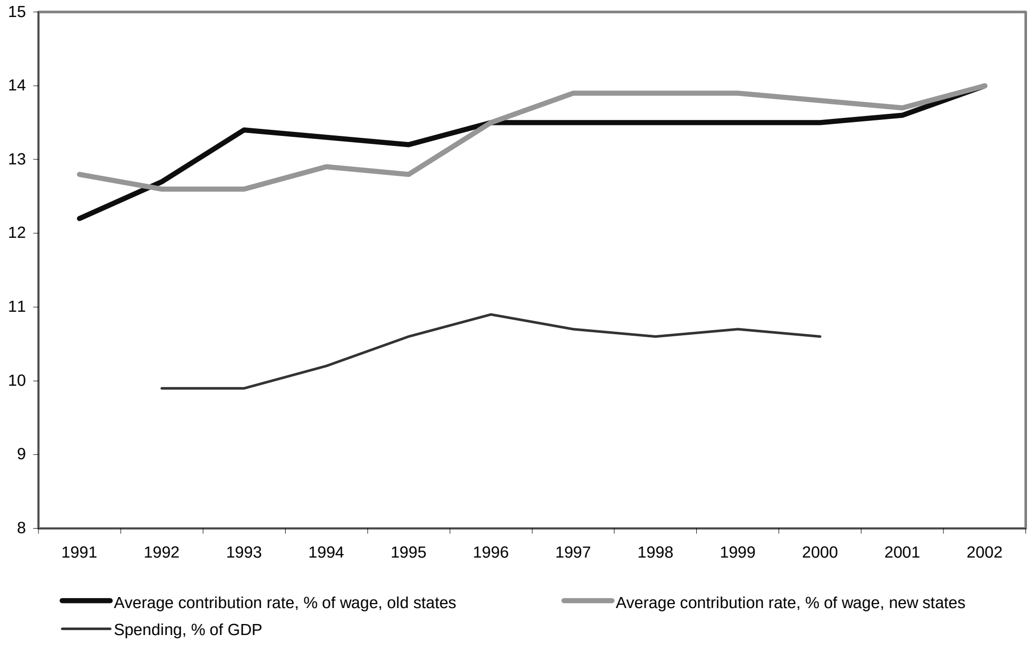
61. In 2000 the number of practising physicians per thousand of population was 3.6 in Germany as compared to the OECD average of 2.9. In acute-care hospitals beds per thousand of population stood at 6.4 as opposed to 4.3 on average, and the average length of stay in acute care totalled 9.6 as opposed to an average length of 7.4. The number of countries for which averages are computed varies with data availability. See OECD (2002*c*).

Figure 28. Health care spending and contributions

A. Health care spending, % of GDP, 2000[1]



B. Germany: health care spending and contributions



1. 1999 for Lux. 1998 for Swe, Tur. Refer to OECD *Health Data 2002, Sources and Methods* for details of concept variations across countries.

Source: OECD *Health Data 2002 (4th edition);* Federal Government.

115. The main response of the government to rising cost during the 1990s was the introduction of sectoral budgets that were allowed to grow at the same rate as the assessment base of the social insurance system. While such budget caps are designed to create stable contribution rates, they proved problematic in practice. For example, the sectoral budget for outpatient services caused an increase in health care service units as physicians individually attempted to maintain their income levels under the fee-for-service payment rules.[62] This volume response has raised concerns about quality of care and access of the socially insured. The Physician Association voluntarily replaced the sectoral budget with budgets on the individual practice level, which are also subject, however, to significant shortcomings. Several other measures were taken to hold health contribution rates constant, including steps to introduce cost-reducing elements of competition into the health care system without compromising the system's equity objectives (see Box 3). Reform needs to continue, however, as several new mechanisms are not yet fully in operation and can be improved by adaptations of the institutional setting.

Box 3. **Basic features of the German health care system**

Germany follows the social insurance model for the provision of health care, which is characterised by:

- *Compulsory coverage* for most employees, apprentices, pensioners and those on social benefits with income beneath a threshold level by non-profit public sector health funds (*Gesetzliche Krankenkassen*, GKV). Dependants are automatically insured so that the system covers about 90 per cent of the population. The funds are financed by contributions from employers and employees and they account for nearly a half of all health expenditures including cash benefits to the sick. Until 1997 consumer choice as to which health fund to join was quite restricted.
- The system is *self-governing*, with incorporated bodies representing health funds, doctors and hospitals negotiating important aspects of health policy. The legislative competence for health care policies is allocated to the federal level. The *Länder*, are mainly responsible for securing inpatient care, and this includes hospital capacity planning and investment.
- The *solidarity principle* is a key aspect of this statutory health system with contributions linked to gross wages (up to a limit) without reference to health risk and with household dependants co-insured without additional contributions.
- *Voluntary health insurance for those with income above a statutory level and for the self-employed*. They may stay in the statutory system or opt out to private health insurance in which case they no longer pay contributions to the system. Once having left the statutory system it is almost impossible to return.
- *Co-existence of private risk-based health insurance with the solidarity-based statutory system*. For those who opt out of the statutory system private health insurance is available with premiums based on risk profiles. Insurance rates for young people are much lower than in the compulsory system and insurance companies compete actively for young clients in particular. Over the last years, private insurers considerably raised premiums for the older insured and increased their old age reserves.
- There is for all intents and purposes *freedom of choice* of physician and hospital in both the compulsory and private systems and rationing of health services has been steadfastly avoided.

For further detail on the German health care system see OECD (1997).

116. Budget caps for pharmaceuticals proved politically difficult to enforce and have been replaced by collectively negotiated agreements on spending volumes between the regional doctors' associations and the

62. Under the system of sectoral budgets total service volume increased by an estimated 32 per cent for the "blue collar" (*RVO*) funds and 51 per cent for the substitute funds between 1988 and 1995 (global budgets came into effect 1989). See Mattke (2001). A surge in physicians opening up private practices in anticipation of a law that limited the possibility of opening new practices during that period may have contributed to that increase.

health funds to control the increase in spending.[63] In the absence of sanctions in case of non-compliance the new arrangement proved unsuitable to resist the pressure in spending: pharmaceutical expenditures surged in 2001 growing by some 11 per cent per insured. The government responded with new legislation (*Arzneimittelausgaben-Begrenzungsgesetz*) requiring pharmacists to supply cheap generic drugs instead of higher priced medicines, provided the prescribing doctor does not exclude such substitution. The doctors' prescription practice is subject to peer review. Generic drugs that qualify for substitution need to be priced within the lower third of the price distribution of the generic medicine. Other requirements also need to be met such as comparable packaging size. While inducing a larger use of generic drugs might go some way in containing pharmaceutical expenses the new regulation might not be robust enough against avoidance strategies by pharmaceutical producers and health care suppliers. There is some evidence that pharmaceutical producers are considering marketing responses that aim to reduce the substitutability of medicines by lower priced generics such as the creation of new packaging sizes and the introduction of highly priced generic pharmaceuticals, which shift upwards the lower third of the pharmaceutical price distribution.[64] However, there is no evidence that such responses have indeed been taken. Moreover, shifting to generic drugs might only result in a one-off reduction in the price level of drugs without affecting the underlying growth of expenditures for drugs. Hence, further action is required so as to economise spending on medicine. Pharmacies could be allowed to discount nationally set maximum prices, as is the case in the Netherlands. In this system, allowing chains of pharmacies to develop could stimulate price reductions. Also, the peer review of the physicians' prescribing practice could be strengthened by referring to external benchmarks rather than average prescription practice, as is the case in the present system.

117. As regards hospitals, new legislation has been passed that foresees replacing the present payment system by DRG related payments, under which hospitals receive a fixed amount per admission for a given diagnosis (diagnosis related groups, *diagnosebasierte Fallpauschalen*) by 2003. The payments are based on national historic cost. Compared to the present system, which is based on a mix of therapy related fees (*Fallpauschalen*, *Sonderentgelte*) and *per diem* rates (*Pflegesätze*) combined with overall budgets based on negotiated activity levels, a DRG system can increase the efficiency of pricing hospital services.[65] In particular, DRG payment creates incentives to cut the average length of hospital stays, and this could become particularly relevant for Germany, which has the second longest average length of hospitalisation within the OECD. [66] The DRG system is also likely to increase competition for patient flows, because it is intended to fully replace the currently pre-negotiated activity levels. To make the transition to the DRG system a success, particular care should be taken to insure that efficient systems of cost information and for monitoring the quality of services are in place.[67]

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63. Until recently, the regional doctors' associations (*Kassenärztliche Vereinigungen, KVs*) have been subject to statutory regional collective budgets for spending on pharmaceuticals (*Arznei- und Heilmittel*). The volume of the budgets was adjusted annually in accordance with certain rules fixed by law. If collective spending on pharmaceuticals exceeded the budget, the health insurers reduced the remuneration for the doctors, paid to the relevant KV.

64. See Pharmahersteller hebeln das Sparpaket aus, Frankfurter Allgemeine Zeitung 2 April 2002.

65. See the special chapter on the German health care system in OECD (1997).

66. See for example OECD (2001*b*). In Austria, the average duration of hospital stays has declined since performance-related remuneration for hospitals was introduced in 1997. While this has contributed to dampening the cost increase in the hospital sector, the trend increase in the number of hospitalisations was reinforced with the share of day admissions rising.

67. Indeed, reservations have been raised by hospital associations that it would hardly be possible to establish the necessary infrastructure by 2003.

118. The 1997 Survey concluded that an efficiency-oriented health care system requires establishing a basis for the health funds to evolve into active purchasers of health services from suppliers on behalf of the patients, rather than remaining passive financers of health care services. Two preconditions have been established that would allow for this development: first, since 1997 the insured have the right to freely select their statutory insurance fund; second, insurance funds are now permitted to negotiate the terms for the provision of medical services selectively (individually) with groups of providers in addition to the collective contracts. In practice, however, selective contracting is almost never used, but collective contracting with the doctors' association remains the dominant model. Indeed, effectively exercising the first option would require sizeable investments by the insurance funds in information technology and human capital. To make this option worthwhile the range of admissible product differentiation would have to be widened. In particular, more scope would need to be given to the insurers to offer contracts to patients who accept a limitation of their choice of physicians and hospitals in return for lower insurance premia. Elements of such contracts could be gatekeeping, *i.e.* the requirement that a primary care physician authorises all speciality and hospital care, or preferred provider arrangements, *i.e.* the restriction of coverage to selected physicians, who discount their fees in exchange for a higher certainty in patient flows. Strengthening the gate keeper function of general practitioners could foster the integration of the health care system overall helping to reduce costs. Indeed, allowing for this type of managed care has introduced a certain degree of competition between insurances for statutory health care services in other OECD countries such as the Netherlands. Moreover, the health funds could be given some scope to compete on the basis of health service provision. One option would be to specify a voluntary part of the health care services in which there would be room for manoeuvre by the funds in specifying content and competition. Also, making selective negotiation between individual insurers and health care providers viable suggests dropping the dominant role of the doctors' association in determining the terms of health care provision rather than permitting a coexistence of collective and selective contracting. Supplementary measures should also be taken to encourage more efficient resource utilisation on the demand side. For example, a more systematic approach should be considered to requiring co-payments by health care consumers so as to reduce precipitate demand for services.

119. The introduction of free choice of health funds in 1997 was intended to encourage the funds to compete for members on the basis of administrative efficiency, but has rather led to competition among funds for better risks.[68] This left the regional health insurance funds (*Allgemeine Ortskrankenkassen*, AOK) with a worsening risk profile and increasing contribution rates, which in turn was considered undesirable by policy makers. Widening the scope for the health funds to offer differentiated services along the lines outlined above would therefore be an important step to improve the consistency of the present regulatory framework of the German health care system. Moreover, in order to avoid adverse selection of the insurance funds a mandatory risk adjustment system for health insurers (*Risikostrukturausgleich, RSA*) was introduced in 1994. While the parameters of the system were subject to consecutive adjustment, the RSA is not yet equipped to effectively equalise risks across insurers, rendering risk selection a profitable strategy for the individual firm. At present, transfers between insurance schemes are based on demographic characteristics of the insured that explain only a small fraction of the variance in health care costs. Moreover, since January 2002 a reinsurance scheme compensates for cases with health expenditures exceeding a certain threshold.[69] Incorporation of clinical information is vital, however, to

68. New, mainly enterprise-based insurance funds, which traditionally insured a low-risk population used their historically low contribution rates to attract better risk.

69. In the Netherlands empirical analysis suggests that risk compensating transfers to insurers based on global variables such as age, gender and location explain some 2½ per cent of the annual variation in health care expenditures. This is less than one-fifth of the predictive power that has been estimated to be attainable. In contrast, limited inclusion of additional information on the health status would have raised the predicted part of the variance to three-fifths of the attainable maximum. See Van Vliet and van de Ven (1992).

adequately capture the risk structure of the insurance pools. Hence, the system would need to be developed further so as to make risk selection by insurers less profitable.[70]

120. A major reform effort was the introduction of so-called disease management programs (DMP) for chronic disease care in 2002. Under those programmes, an advisory body of the corporatist actors defines requirements for care standards that are then issued as regulations by the federal government. Those regulations serve as guidance for funds to develop contract based comprehensive service arrangements with health care providers, setting a floor for such arrangements. Participation in DMPs will be voluntary for qualifying patients. So far, DMPs for two conditions have been proposed and up to five may be added. The DMPs are meant to address several problems of the health care sector in Germany. First, they intend to encourage better integration of care for chronically ill patients. Second, they aim to foster selective and quality-based contracting. Third, they are also designed to deal with the risk selection problem in choice of health funds, as participation in those programmes will be used as additional parameter in the RSA. Furthermore, data gathered through the DMPs will constitute part of the data necessary to develop a morbidity-based RSA by 2007.

121. The reform constitutes a first step towards addressing those problems. The financial incentives linked to DMP participation will lessen the risk selection incentives and have the potential to encourage better care integration for the included conditions. Two challenges remain. First, DMPs are a relatively novel tool in health policy reform and their effect will largely depend on the actual content of the program. It is positive that the law mandates an evaluation of the programmes so that their continuation is made dependent on evidence.[71] Second, care needs to be taken that the prominent role of the DMPs in German health policy reform does not lead to unwanted distortions, as resources and attention might become diverted to the conditions covered.

Summary of recommendations

122. A number of reforms have been implemented to improve the allocative efficiency of public sector spending. Most of the action taken is steps in the right direction. However, more needs to be done to put public sector finances on a sustainable path, improve incentives in inter-governmental financing schemes to contain costs and demand, and improve outcomes in various expenditure programmes. Box 4 provides a synopsis of recommendations for further reform.

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70. Alternatively, the insurance system could be moved to a risk based insurance market system However, the market approach alone would not be compatible with the equity goals inherent in Germany’s solidarity based health care system. Hence, shifting to a full market system would require that redistribution would have to be left to the fiscal tax and transfer system. Moreover, this approach would raise further issues with respect to general access to health care services.

71. It should be cautioned that some design features of the particular programme will make a rigorous evaluation technically difficult: The actual content will differ by fund, region and provider network, pre-intervention data is unavailable and no comparison group to compare this self-selected sample of DMP participants exists.

Box 4. **Recommendations for enhancing public sector spending reform**

Increase the efficiency of public resource management

- Continue introducing more performance-related approaches of personnel management and allow for functional and regional flexibility of public sector pay schemes.
- Subject public sector spending projects to outcome-oriented *ex ante* and *ex post* evaluation methods that assess the costs of a project its benefits over a long-term horizon.

Improve the incentive structure of inter-governmental funding

- Consider widening the scope for regional government to set tax rates, for example as a supplement to the income tax.
- Improve the incentive structure of the inter-state revenue equalisation system by making more use of lump sum transfers from the federal government to the states that are fixed over a multi-annual period. Base transfers on notional rather than actual revenues of the states such that variations in local tax parameters leave transfer positions unaffected.
- Scale down co-funding between different levels of government.
- Internalise spill-overs of local services via co-operation between local governments or public institutions or the merging of local authorities.
- To the extent co-financing is utilised, assess the full costs associated with spending programmes in the selection, planning and evaluation stages.
- Within the Solidarity Pact II (SP II) funding arrangements for the new states require outcome-oriented *ex-ante* and *ex-post* evaluations of infrastructure investment projects to be included in the Progress Reports as a condition for funding.
- Make sure that an adequate share of the SP II funds are passed on from the *Länder* governments to the communities.

Establish a medium-term consolidation rule

- Support fiscal consolidation and the working of the automatic stabilisers by establishing a binding stability pact between the federal government and the states so as to balance the federal and *Länder* budgets over the cycle.
- Enhance the control of the general government budget by securing that consolidated budgets by government level are timely available in terms of the national accounts standard.

Make the social assistance system more incentive compatible

- Combine unemployment assistance and social assistance into one single means-tested social assistance benefit to be paid and administered by one unified public sector authority.
- Remove the potentially indefinite duration of the more generous former unemployment assistance.
- Increase incentives from the funding side to integrate the unemployed into the primary labour market.
- Lower withdrawal rates of social assistance and or introduce wage subsidies such that overall remuneration increases with gross earnings.
- Reform the tax and benefit system so as to support job search of the unemployed and labour force participation. This includes in particular monitoring of job search activities, redirecting active labour market measures in favour of job search, tightening of eligibility criteria for unemployment insurance benefits, cuts in benefits in case of non-compliance with job search rules and abolishment of effective early retirement schemes.

Establish a more outcome-oriented regulatory framework for secondary and tertiary education

- Set nation-wide standards for schooling attainments against which the students' performance is to be evaluated on a regular basis.
- Leave the schools more freedom in determining suitable ways of how to reach the educational targets.
- Widen the flexibility of educational paths in secondary education while introducing more full-time schooling and individual coaching of students.

- Introduce compulsory language tests for students with immigrant background and foster their integration into the school system.
- Establish tertiary studies with a shorter duration as the rule.
- Give universities the right to levy tuition fees. To mitigate the potential adverse distribution impact, Germany's student support system might have to be adjusted.
- Implement a higher degree of competition between universities.
- Link funding of universities out of the general government budget to the universities' performance and re-enforce quality control.

Intensify competitive pressures and the use of price signals in the health care system

- Introduce more efficient pricing mechanisms for health care services, such as diagnosis related fees (DRGs) in the hospital sector.
- Consider dropping the dominant role of the doctors' association in determining the terms of health care provision.
- Strengthen the peer review of the physicians' prescribing practice.
- Consider a more systematic approach to demand side cost sharing to discourage precipitate demand for services.
- Support the development of active purchasers of health care by widening the scope for health funds to compete on the basis of managed care and provision of voluntary health care services.
- Further develop the risk sharing system between insurances so as to avoid adverse selection of risks.

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