Hertie School of Governance

Hertie School of Governance - Working Papers, No. 51, July 2010

Remedies for the Public Debt Problem:
The Impact of Dysfunctional Incentive Structures and Behavioural Aspects on German Municipal Debts

Juliane Sarnes
Hertie School of Governance / London School of Economics and Political Science

working papers

About the Hertie School Working Paper Series

The Working Paper Series of the Hertie School of Governance is intended to provide visibility, internally as well as externally, to the current academic work of core faculty, other teaching staff, and invited visitors to the School. High-quality student papers will also be published in the Series, together with a foreword by the respective instructor or supervisor.

Authors are exclusively responsible for the content of their papers and the views expressed therein. They retain the copyright for their work. Discussion and comments are invited. Working Papers will be made electronically available through the Hertie School of Governance homepage. Contents will be deleted from the homepage when papers are eventually published; once this happens, only name(s) of author(s), title, and place of publication will remain on the list. If the material is being published in a language other than German or English, both the original text and the reference to the publication will be kept on the list.

Foreword

Many cities in Germany and especially North-Rhine-Westphalia have run into serious levels of debt during the last 20 years. The actual public financial crisis has only aggravated this longer term development.
Despite a legal regime of limiting cities level of long term credit for investment, which at first sight seems to be tightly knit, cities were able to continuously raise the level of debt enormously since they could take advantage of two escape routes:

- Cities cannot effectively be limited in taking up short term credit for their running business (Kassenkredite) at very low interest rates;
- The enforcement of oversight of the state government towards fiscally irresponsible cities is limited if (like in North-Rhine-Westphalia) about 20 larger cities are involved. The sheer number of them makes it a difficult political case for the state government to intervene.

Within this framework Juliane Sarnes has analyzed in depth the exogenous and endogenous causes of the municipal debt problem. She concentrates on a group of cities within North-Rhine-Westphalia which under the heading "Memorandum Group" have especially serious debt issues and have tried to mobilize advocacy for their cause.

The real value of her analysis is the focus on incentives and disincentives for the local government actors to deal with the rising debt situation. The chapter on "playing the bail-out game – local coping strategies and rational choice explanations" adds substantially to the existing analyses and knowledge on why this development of increasing debts has developed for so long and has not been counter-acted successfully by the state government oversight.

In her last chapter Juliane Sarnes presents a holistic approach to solving the municipal debt problem. This analysis makes apparent that the longer you have postponed intervention in time the more encompassing and demanding a holistic strategy becomes. Since the local government debt issue had been neglected or only dealt with in a very ineffective way for a long time her bundle of proposals is very demanding. The core element of her proposal is a conditional bail-out process, which has been used internationally for sovereign state debt crises. Its application for the municipal debt situation is largely untested and needs to take into account a number of additional measures. By now the state government of North-Rhine-Westphalia seems to prepare addressing this issue in a more comprehensive way. The proposals of the author have a high relevance as a blueprint for a way out in the future.

The value of her analysis is not limited to the Federal State where municipal debt has exploded, it is also relevant for a couple of other Federal States with similar although less dramatic municipal debt problems.

Jobst Fiedler
Professor of Public Management
Thesis Supervisor

Hertie School of Governance

Bertelsmann Stiftung

THE LONDON SCHOOL OF ECONOMICS AND POLITICAL SCIENCE

Thesis Advisor
Prof. Dr. Jobst Fiedler

Practice Institution
Bertelsmann Stiftung (Dr. Marc Gnädinger)

***

Remedies for the Public Debt Problem

The impact of dysfunctional incentive structures and behavioural aspects on German municipal debts

***

Juliane Sarnes
Student ID: 092078
MPA Public Policy and Management/
MPP Public Policy 2010
Dual Degree

ABSTRACT

The aim of this thesis is to develop guidelines for a sustainable solution to the municipal debt problem. Using insights gained in 17 qualitative expert interviews with local executives and researchers, the different factors which have led to the precarious situation are closely examined. The focus lies on endogenous factors, the decisions and actions taken by local executives and how these contributed to the municipal debt problem. Applying rational choice theory, this thesis investigates especially how certain properties of the political process and Germany's fiscal regulation framework might stimulate misconduct at the local level.

EXECUTIVE SUMMARY

1. Background

Since the early 1990s, countless German communities have accumulated an ever-increasing debt burden, bringing some of them close to bankruptcy today. As a consequence, local infrastructure deteriorates, municipal self-government is eroded and the constitutional guarantee of comparable living conditions throughout the federation endangered. Therefore it is utterly important for the municipal debt problem to be solved.

2. Objective

The aim of this thesis is to develop guidelines for a sustainable solution to the municipal debt problem. Therefore, the different factors, which have led to the precarious situation, are closely examined. The focus lies on *endogenous* factors, the decisions and actions taken by local executives and how these contributed to the municipal debt problem. Applying rational choice theory, this thesis investigates especially how certain properties of the political process and Germany's fiscal regulation framework might stimulate misconduct at the local level.

3. Methods

As direct comparison of communities located in different federal states is problematic, the research is focused on 19 highly-indebted North Rhine-Westphalian communities, the so-called Memorandum Group. To analyse both the nature and causes of the municipal debt problem faced by these cities and towns, 17 qualitative expert interviews were conducted with political and administrative executives as well as external researchers.

4. Findings

There are a number of exogenous factors which contribute to the municipal debt problem. Yet, the current situation is not purely a consequence of exogenous causes, which cannot be influenced by the municipalities. The political and fiscal relations of the different levels of government in combination with the short-term incentives of

the political process of a representative democracy generate a myriad of behavioural dilemmas: collective action problems, problems of externalities, problems of asymmetric information. These turn overspending and risking a debt crisis into a rational course of action. It can be concluded that behavioural aspects and incentives created by the German fiscal regulation framework lead to the inflation of municipal budget deficits and significantly contributed to the accruement of the current debt crisis.

5. Conclusion

In order to solve the municipal debt problem, a holistic approach taking both exogenous and endogenous factors into account is advisable. An appropriate strategy seems to comprise first, a debt reduction fund to reduce existing debts and alleviate the communities' financial problems; second improvement of the communities' structural financial weakness, for example by preventing future violations of the principle of connexity; and third measures targeting the disincentives created by a lack of transparency and monitoring in order to incentivise the communities to operate efficiently in the future (such as an independent supervisory authority, Early Warning System, increased awareness of citizens).

TABLE OF CONTENT

TABLE OF FIGURES AND TABLES

***

APPENDIX

REMEDIES FOR THE PUBLIC DEBT PROBLEM – THE IMPACT OF DYSFUNCTIONAL INCENTIVE STRUCTURES & BEHAVIOURAL ASPECTS ON GERMAN MUNICIPAL DEBTS

I. Introduction

In the aftermath of the worst financial crisis since the Great Depression of the 1930s, public debts are at the centre of attention. Never before in the history of German public debt have indebted communities received so much media coverage. But even though the financial crisis has severely aggravated the financial situation of the cities and towns, it has not triggered a 'municipal debt crisis'. Since the early 1990s, countless German communities have experienced recurring budget deficits and accumulated an ever-increasing debt burden. "If the city of Essen were a private business, we would have gone bust years ago", declared treasurer Bernd Elsemann in a hearing before the North Rhine-Westphalian parliament (Bundesland Nordrhein-Westfalen 2009, 1). Even though Essen may be an extreme case, it is unfortunately not an isolated one.

1.1 The municipal debt problem – a matter of urgency

In many cities and towns, the negative effects of the municipal debt problem are becoming progressively more visible. Local infrastructure deteriorates as public buildings (e.g. schools), roads and parks are not well maintained anymore. Public libraries and swimming pools are closed down, subsidies for local sports clubs and adult education centres are cut back or eliminated, and public administrative staff is let off to save costs – to name just a few examples. All in all the quality of life is in decline. What is more, due to lack of funding for new investments and non-obligatory public services, urban development and city marketing hardly take place anymore. Thus the communities' weak position in the municipal competition is cemented for years to come (Jungfer 2005). Considering that the communities are responsible for the implementation of policies put forward by the superordinate levels of government the functioning of

the state as a whole is at stake, if the municipal debt problem renders local governments incapable of action.

In addition to the negative consequences for the local infrastructure and the quality of life in highly indebted communities, the municipal debt problem also has serious legal implications. For one, it further widens the gap between rich and poor communities. This disparity is effectively a violation of the *constitutional guarantee of comparable living conditions* (in German Gleichwertigkeit der Lebensverhältnisse) all over the German federation[1]. Moreover, if all the non-obligatory public services (the so-called 'freiwilligen Leistungen') were eliminated for cost cutting reasons, local governments would not have any functions of their own anymore. They would simply be performing agents of the federal and state governments. *Municipal self-government* as guaranteed in Art. 28 paragraph 2.1 of the German Constitution (Grundgesetz or 'Basic Law') would cease to exist – which basically amounts to the partial destruction of German decentralisation, an indispensable element of democracy intended to supplement the *separation of powers* (Duve 2010). Therefore, it is utterly important to quickly find and implement a sustainable solution for the municipal debt problem.

1.2 Research question(s) and objective of the thesis

This thesis is meant to contribute to the development of such a remedy. Therefore, the research question is rather straightforward:

What needs to be done to solve the municipal debt problem?

In order to answer it systematically, a number of secondary research questions will be utilised to create a logical line of investigation. Before a solution can be found, an extensive cause analysis needs to take place so as to determine the factors that contribute to the municipal debt problem. According to the local governments, the communities are in debt trouble due to exogenous factors such as structural underfunding and the recent financial crisis. Most of them

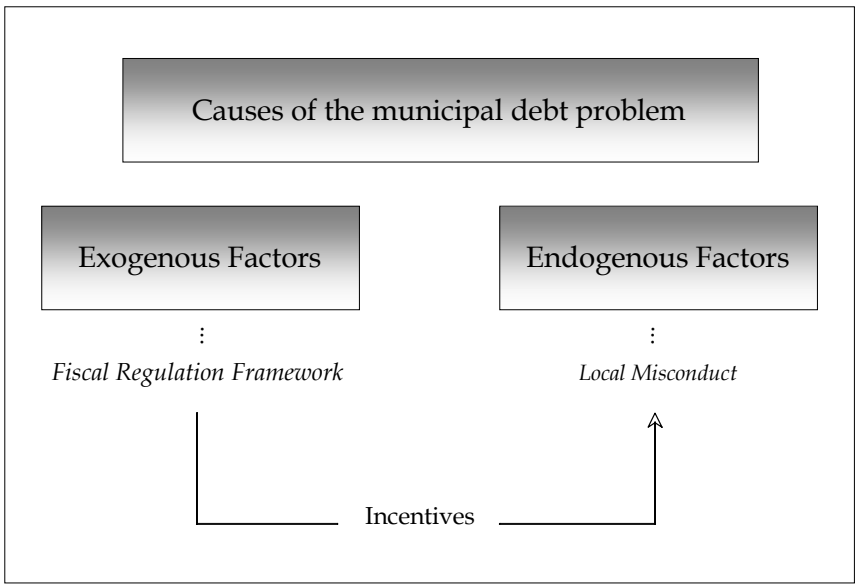
[1] Refer to article 72 paragraph 2 and article 106 paragraph 3 clause 4.2 of the German constitution.

appear to refuse any responsibility for the situation they are facing. Therefore, the first sub-question seeks to establish:

1) *Is the municipal debt problem purely a consequence of exogenous causes that cannot be influenced by the municipalities?*

Even though these exogenous causes are widely considered to be the root of the municipal debt problem, a number of external experts seek at least part of the responsibility within the local governments' scope of action. The question how these *endogenous* factors – decisions and actions taken by local executives – contributed to the municipal debt problem constitutes the core of the research. In this context the focal point is not so much human error grounded in misinformation or misjudgement. Instead it will be investigated how certain properties of the political process and the fiscal regulation framework might stimulate misconduct at the local level. This is clarified in Figure 1.

Figure 1: The focus of the research



SOURCE: MODIFIED AFTER JUNKERNHEINRICH 2007a, 15

This leads to the second and third sub-question:

2) *Which effects do behavioural aspects and incentives created by the German fiscal regulation framework have on municipal debts?*

and:

3) *What can be done to break through these dysfunctional incentive structures and sustainably solve the municipal debt problem?*

Based on the answers to the first two sub-questions, appropriate measures to solve the municipal debt problem shall be deducted, leading to the answer to the primary research question. Even though a sustainable solution must not neglect the exogenous factors, the focus lies especially on measures taking behavioural aspects into account.

While there is a broad scholarly debate on public debts and the contribution of dysfunctional incentive structures, these studies mainly focus on the federal or state level (Hagen et al. 2000, Schwarcz 2002, Blankart and Klaiber 2005, Singh and Plekhanov 2005). The local level has received considerably less attention. In the case of Germany this may be due to the fact that municipal debts make up only about seven percent of the total public debt burden (Duve, 2010). Hence, the lack of scholarly attention may be rooted in a perceived lack of urgency. However, the aggregated numbers are misleading. Municipal fiscal outcomes are very heterogeneous ranking from budget surplus to near-default situations. Therefore, this thesis addresses a significant gap in research.

1.3 Structure of the thesis

The remainder of the thesis is structured as follows: Chapter II provides an overview of the research design and methods employed. Chapter III takes stock of the municipal debt problem as it is experienced by the communities the empirical research is focused on. Also, *exogenous* factors that led to the precarious situation are analysed. The focus of Chapter IV lies on the *endogenous* causes of the municipal debt problem. Empirically observed decisions and actions taken by local actors (political and administrative executives as well as citizens) will be scrutinized in order to reveal the underlying incentive structures created by political processes and the fiscal regulation framework. Rational choice explanations will be provided. In Chapter V pros and cons of potential solutions for the municipal debt problem will be weighed against each other. Taking the

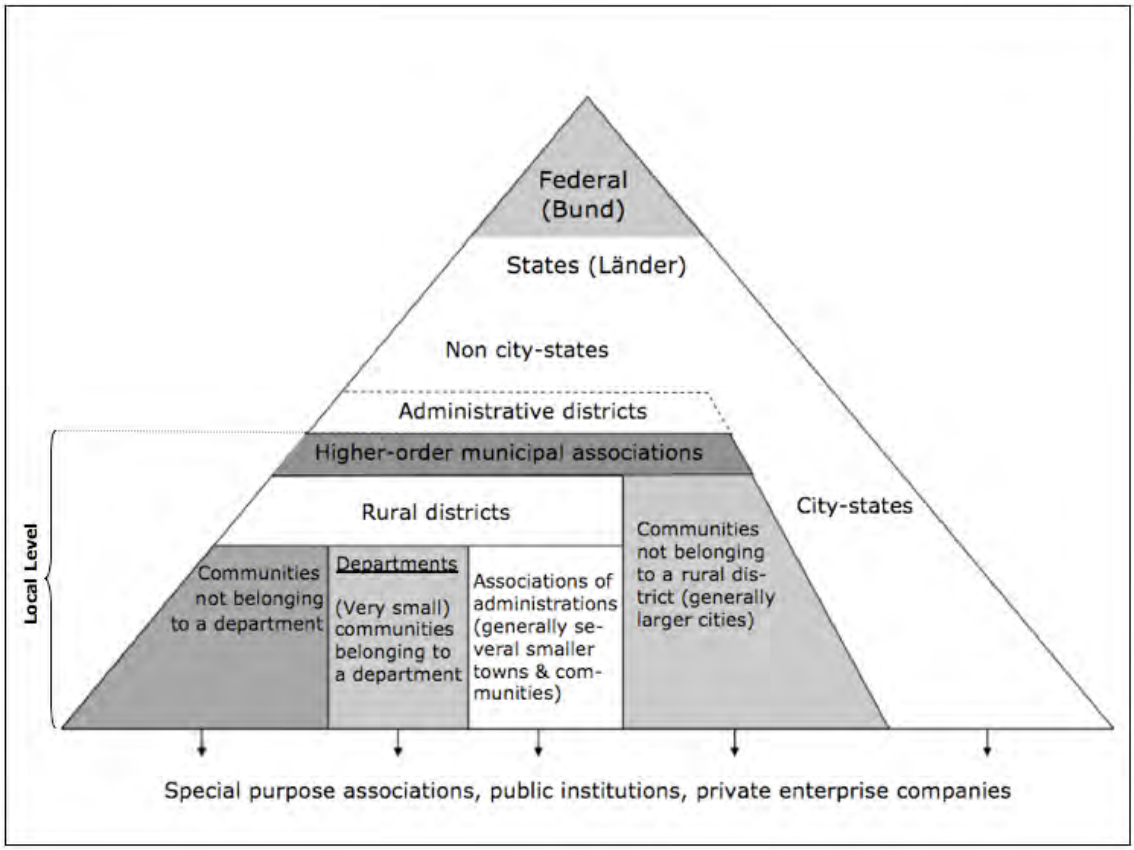
findings of both Chapters III and IV into account the most viable measure(s) shall be determined. Chapter VI concludes.

II. Research Design

1 A brief note on the German administrative structure and potential difficulties of direct comparisons between communities

The German political system has a pronounced federalistic structure featuring three levels of government – federal (Bund), state (Länder)[2] and local[3] – the responsibilities of which are specified in the German constitution. Figure 2 displays the hierarchy of the German administrative structure and the position of the local governments therein.

Figure 2: The administrative structure of the Federal Republic of Germany



SOURCE: MODIFIED AFTER JUNKERNHEINRICH ET AL. 2009, 12.

[2] Prior to the German reunification there were eleven former West German Länder. After 1990 this number increased to sixteen, three of which are in fact large cities – Berlin, Hamburg and Bremen, the so-called 'city states' (Seitz 2000, 188).

[3] Even though the communities are self-governing they are assigned to the states as part of the executive and not a level of government in the proper meaning of the word.

Undoubtedly, an analysis of the causes, consequences, and possible solutions of the municipal debt problem needs to take certain particularities of the rather complex local administrative structure into account. However, this is not a place for a full exposition of the subtleties of German local administration. Suffice it to say, one important factor for the categorisation of the roughly 12,300 communities – e.g. into departments (Ämter), associations of administrations, or communities not belonging to a rural district (kreisfreie Städte) – is (population) size.

Municipalities of different size are comparable only to a very limited extent, as each 'municipal category' involves a different legal framework, a smaller or larger number of municipal tasks and obligations – and, naturally, a very different sized tax base and service capability. Comparing communities located in different states is even more problematical because the tasks assigned to the local level differ in terms of quantity and/or the extent to which the municipalities are involved in the provision of certain services. What is more, the communities also differ in terms of economic power both within and between states. Thus, there are significant disparities regarding financial power and fiscal outcomes making it very difficult to compare even those communities which are similar in terms of size[4] (Micosatt, 2009).

2 Setting a focus: the North Rhine-Westphalian cities and towns of the Memorandum Group

In order to not compare the proverbial apples and oranges, highly indebted cities and towns located in one and the same federal state will be investigated. This ensures a minimum of comparability as all the municipalities analysed are subject to the same legal structure and fiscal regulation framework[5]. Since the debt problem is particularly prominent in the West German federal state of

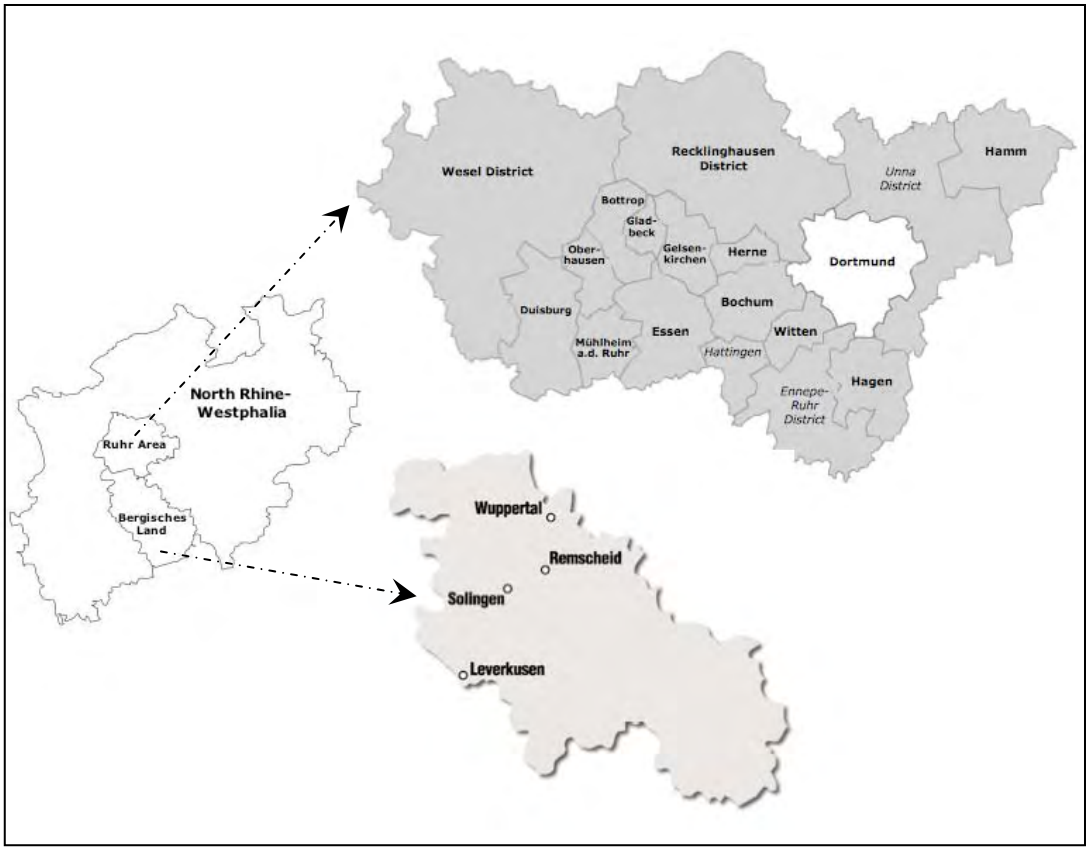
[4] Furthermore, there is no unitary municipal accounting system, i.e. while some states have already implemented accrual accounting, others still employ cameralistics or extended cameralistics making simple numeric comparisons of, for example, deficit sizes somewhat meaningless (Fischer & Gnädinger 2009).

[5] As stipulated in the State Constitution (Landesverfassung) and the Municipal Code (Gemeindeordnung).

North Rhine-Westphalia (NRW), the research is focused on this state, more specifically on the communities which make up the so-called 'Memorandum-Group'.

The Memorandum Group consists of 19 cities and towns of the Ruhr Area – Bochum, Bottrop, Dortmund, Duisburg, Essen, Gelsenkirchen, Gladbeck, Hagen, Hamm, Herne, Mühlheim an der Ruhr, Oberhausen, Recklinghausen, Wesel, Witten – and the Bergisches Land – Leverkusen, Remscheid, Solingen, Wuppertal (see Figure 3).

Figure 3: Map of North Rhine-Westphalia, Ruhr Area and Bergisches Land



SOURCE: ADAPTED FROM SEITZ 2000, 14

Since 2001, these communities have released four written memorandums calling attention to the precarious financial situation they face (hence the name 'Memorandum Group'). Leading a rather normative discourse, they are aiming to move the superordinate state government to support local governments approaching default in solving their debt crisis through special transfers, debt re-

lief and other measures (cf. Die Städte des Ruhrgebietes und des Bergischen Landes 2001, 2002, 2006, 2008, 2009). Even though these communities frequently (and correctly) point out that they are not just some isolated cases, it needs to be mentioned that by far not all local governments in NRW are currently in trouble. While the members of the Memorandum Group have even been ailing in the boom years of 2006-2008, some 150 of the 400 North Rhine-Westphalian communities have been able to write off debts even in the years of crisis 2001-2005 (Junkernheinrich et al. 2010, 4).

Thus, focusing on the Memorandum Group did not only facilitate the research by better targeting the investigation, it also further increased the degree of comparability in the very heterogeneous urban landscape of NRW making it more likely to detect underlying patterns leading to high municipal deficits.

3 Expert interviews

Since it is impossible to fully understand how the financial situation of the communities of the Memorandum Group could turn into a serious debt problem by merely looking at the figures in the budget reports, 17 semi-structured expert interviews were conducted to gain a deeper understanding of the topic. According to Meuser & Nagel an expert is "[…] a person who is responsible for the development, implementation or control of solutions or someone who has privileged access to information about groups of persons or decision processes" (1991, 443). For this reason two groups of experts were targeted:

I. 'Internal experts' who work within the local governments of the Memorandum Group and are very familiar with the municipal debt problem, as well as

II. 'External experts' who also deal with the subject on a daily basis but from a more distanced perspective.

Both of them will be considered in turn.

3.1.1 Internal Experts

Eleven interviews were conducted with mayors, treasurers and financial specialists of eleven communities of the Memorandum Group. These experts possessed invaluable *process knowledge,* i.e. information on routines and specific interactions gained through direct involvement in these processes in addition to *explanatory knowledge* which consists of subjective interpretations of rules, ideas and ideologies (ibid, 445ff.). The codes PIE_{1-3} and AIE_{1-8} were assigned to these interviews. Since the statements of political and administrative executives differed substantially in some points, subcategories were applied[6].

3.1.2 External Experts

The external experts (codes EE_{1-6}) were four researchers (associated with the Bertelsmann Foundation, the Research Association for Regional Fiscal Policy, and the Research Association for Economical Administration)[7], and two members of the German Association of Cities and Towns. While the position of the former can be regarded as rather neutral, the latter represent the interests of the communities. But since they were not directly involved with the Memorandum Group they were classified as external experts, too. In addition to *explanatory knowledge* they provided very specific information such as details on operations, laws etc. *(technical knowledge)*.

4 Caveats of the research design employed

4.1.1 Weaknesses of the focus

By focusing on a particular group of highly indebted municipalities, only one side of the picture is being studied. Hence, it can (at best) be stated what went wrong in these communities. The counterpart, successful communities and what they 'did right', is not examined. Even though a comparative approach –

[6] The issue of missing data was dealt with by, again, contacting the municipalities that had not responded to the request for an interview, directly asking the questions by e-mail. Thusly, the necessary information was obtained.

[7] Bertelsmann Stiftung, Forschungsgesellschaft für Raumfinanzpolitik FORA, Arbeitsge-sellschaft für Wirtschaftliche Verwaltung AWV.

for example deficit municipalities versus surplus municipalities – could offer further insights into the subject matter, it is not feasible in this context for three reasons: firstly, it would go far beyond the scope of this thesis. Secondly, it is very likely that surplus municipalities differ in more aspects than their fiscal outcomes from the deficit municipalities (e.g. economic power). Thus, comparability would be limited. Finally, when attempting to find a solution to a problem it is a viable strategy to first study it intensively and then proceed to make proposals on how to solve it. In a third step, looking at precedents and benchmarks is, undoubtedly, useful. However, if this approach is employed from the outset, proposals for solutions are likely to be confined to what has been done before, potentially impeding innovation and progress.

4.1.2 Weaknesses of qualitative interviews

Objections frequently raised against qualitative interviews are often associated with the way the data is collected. That is through usage of non-standardized purposive sampling making the researcher's pre-existing knowledge and values an integral part of the research process. However, the goal of this research project is not the representative capture of all possible variations, but to get deeper insights into the situation of the Memorandum Group, the individual coping strategies of their local executives and potential solutions to the debt problem.

Furthermore, the reactiveness of this research method is often criticised. Gender-of-interviewer effects and age-of-interviewer effects did, indeed, occur during the interviews. In addition to this, the debt problem is a sensitive issue, hence the social desirability bias was observable. Even though Bogner et al. regard interaction effects as integral part and constituting element of social research (2005, 46ff.) non-reactive research methods were also employed. These included *desk research* of official policy documents, legal documents, statistics, *content analysis* of so-called 'Etatreden', speeches before the municipal council with the aim of finding approval for the new budget, and extensive *literature review* in order to improve the validity of the findings (triangulation).

III. The Municipal Debt Problem and its Causes

This chapter is intended both to take stock of the current situation faced by the communities of the Memorandum Group and to provide an analysis of the exogenous factors which led to its development. This background knowledge is not only essential to understand the complexity and multilayeredness of the municipal debt problem[8], these issues also have significant impacts on the incentive structures influencing the behaviour of local executives.

1 The financial position of the Memorandum Group

1.1 From municipal debt to the municipal debt problem

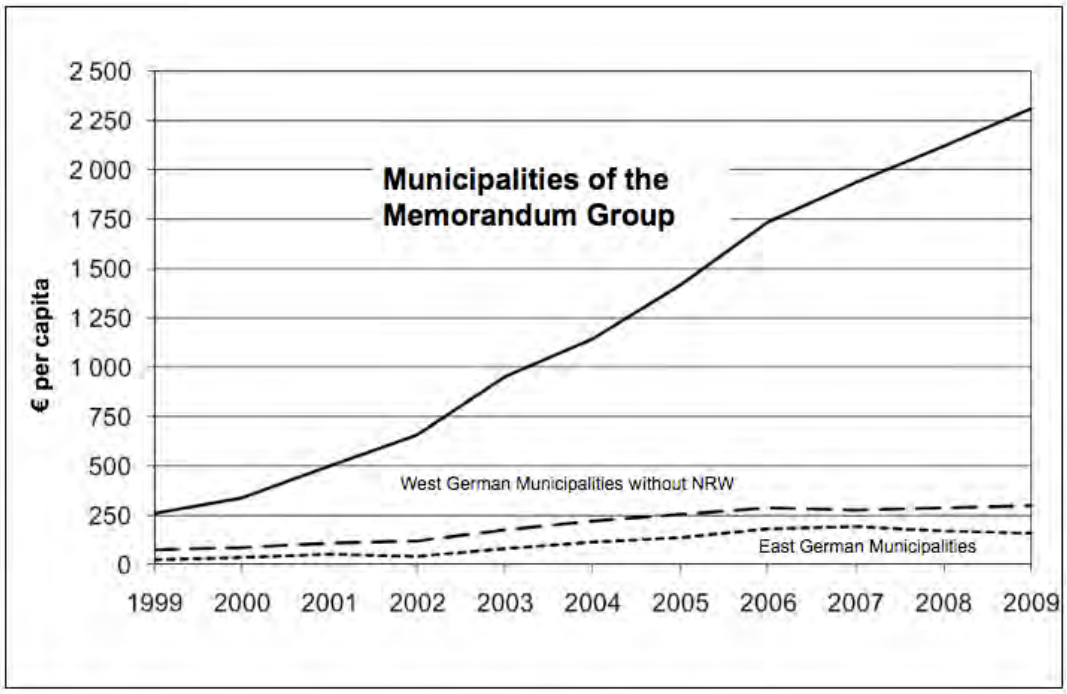
The most frequently utilised indicator of a community's indebtedness is *per capita debt* – the total debt of a city or town divided by its population. However, according to Junkernheinrich et al., per capita debt in itself is not a meaningful measure, because it does not provide any information on the risk involved with a specific debt level (2007 et al., 13). Naturally, economically thriving cities can afford to borrow more extensively than those whose economic power is weak; or as one of the interviewees put it: "Debts *per se* are not the problem" (AIE_8).

Moreover, there are two kinds of municipal debts: those incurred for long-term investments and those accumulated for short-term consumption. While the former are useful to build up infrastructure (*investment loans*), the latter can help a community through periods of low-revenue (*ways and means advances*). All the interviewees agreed that, of the two, investment loans are less problematic because they create value, such as buildings, facilities, etc. Ways and means advances, however, do not create any value; instead, "they are quickly consumed and only leave a higher debt level behind" (AIE_4). However, ways and means advances only become problematic if they are not utilised as a solution for temporary financial difficulties but as a well-established instrument regularly resorted to in order to 'balance' the municipal budget.

[8] All the experts named multiple reasons for the municipal debt problem (see appendix page V).

Figure 4 shows the development of municipal ways and means advances over the past decade. The Memorandum Group does not only have the highest per capita debt of ways and means advances of all the German communities but also the steepest growth rate of these municipal cash credits – they increased more than nine-fold between 2001 and 2009[9] (Die Städte des Ruhrgebietes und des Bergischen Landes, 2008, p.12f).

Figure 4: Municipal ways and means advances (31.12.1999-31.12.2007 & 30.06.2009)



SOURCE: MODIFIED AFTER JUNKERNHEINRICH 2010, 9.

Another point all the experts agreed upon was the existence of "[…] a certain threshold beyond which indebtedness becomes dangerous" (EE2). The communities of the Memorandum Group appear to have passed that threshold. When asked about the current financial position of their respective community, most

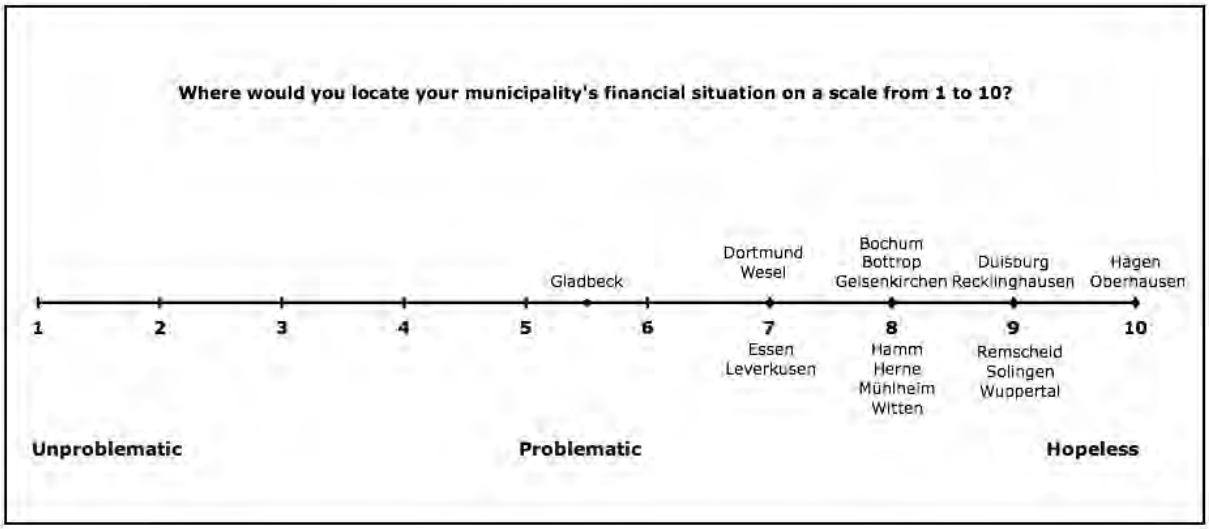
[9] While only 5.7% of the German population inhabit the communities of the Memorandum Group 29.9% of the German municipal ways and means advances are concentrated there (Die Städte des Ruhrgebietes und des Bergischen Landes 2008, 12). This shows that the debt structure of these communities is particularly disadvantageous. In North Rhine-Westphalia the average proportion of ways and means advances of total debt is only 26.8% – communities without any ways and means advances excluded (see appendix page IV).

of the experts painted a rather gloomy picture. According to their specifications, the municipal debt problem becomes manifest in:

1) *Recurring annual deficits*: "Every year since 1993 we have been forced to spend more money than we actually have" (AIE_7),
2) *Accumulating ways and means advances* intended to bridge the budget gap until times get better (which has not happened): "In the past nine years we had to pile up more than one billion Euros of ways and means advances" (AIE_4),
3) Simultaneous *erosion of equity capital*: "If the trends persist, we will have eaten up all our equity capital resources by 2012" (AIE_3), leading to
4) *Imminent overindebtedness* (negative equity capital): "If nothing changes, we will be overindebted in the next four to five years" (AIE_2).

In fact, on a scale from one to ten (one being unproblematic, ten hopeless) all of the interviewees located their municipality's financial position between problematic and hopeless as shown in Figure 5.

Figure 5: The financial position of the Memorandum Group – self-assessment



SOURCE: OWN RESEARCH

While the median value was eight, more than one third of the interviewees considered nine or even ten as the most accurate description of the local finances. The most positive response was "between five and six" (problematic) but the

interviewee hurried to explain: "only because I am a true optimist and my trust in the principle of municipal self-government remains undaunted" (PIE_3) …

1.2 From the municipal debt problem to the 'futility trap'

However, optimism is very rare among the communities of the Memorandum Group. As a matter of fact, all the internal interviewees reported to be either approaching or already experiencing a *futility trap*, a situation in which local efforts aiming to bring the debt problem under control are completely futile. Martin Junkernheinrich who is responsible for the scientific steering of the Memorandum Group coined the term 'futility trap' of which currently no uniform definition exists.

Some experts interpreted the futility trap (analogous with the downward spiral described by the 'debt trap') as "the point at which debts start to become self-reinforcing, that is when new debts are incurred to service the existing ones" (EEI_3). Others took it to be a situation where local efforts will not suffice to solve the debt problem but lead at best to a smaller deficit:

> "Unfortunately, our consolidation measures are no solution but only an improvement of the town's financial situation" (AIE_3).
>
> "Even if we cut all the expenses for non-obligatory public services such as culture, leisure, sports we would still not be able to consolidate the budget" (PIE_3).

A third meaning inferred by the majority of experts is illustrated by the following quote:

> "If a town makes the effort to save 80 million Euros and the federal government assigns a task which costs an extra 100 million, there is an increase in debt even though the local government committed to reduce them" (EEI_3).

In this sense the futility trap is a situation where savings made in earlier periods are annihilated by decisions of either the state or federal government (e.g. the assignment of new duties to the local level without adequate fiscal allocations to fulfil them).

Regardless which definition the interviewees adhered to, it was broadly agreed that "despite all the efforts to economise and reduce expenditures it is

absolutely impossible for the Memorandum communities to get out of the red on their own" (AIE_6). Hence, it is hardly surprising that some of the internal experts, seemed to have already resigned and were rather reluctant to make any further efforts to solve the problem on their own:

> "We can do whatever we want, if the federal government keeps coming up with new ideas about additional responsibilities for local governments […] our situation will not get better in the future but much worse. The wealthier municipalities in NRW or the state government should help us" (PIE_3).

Considering the above quote, the danger of a *self-fulfilling prophecy* becomes palpable. Yet, there was one internal expert who objected to the description of the current situation as a futility trap. He reasoned as follows:

> "I don't particularly like the term. It suggests that you do not have a chance, no matter what you do. Personally, I refuse to fatalistically accept the situation by calling it a futility trap. There may be some communities experiencing such a situation because the debt accumulation process is already too far advanced, but I find it inappropriate that *so many* cities claim that this is the case" (AIE_8).

This expert seems to imply that, only a small number of communities are currently caught in an actual futility trap and hence, local efforts are not in vain. Considering the fact that the Memorandum Group is a strategic alliance arguing that external help from the superordinate governments is necessary to solve the municipal debt problem, the vehemence of this statement appears contra-intuitive. It is most probably due to the vagueness of the concept of the futility trap, which he interpreted as an excuse used by some communities to justify their lack of initiative.

In any case, this example shows that the magnitude and implications of the municipal debt problem are not only a matter of facts and figures, but also of the way local actors perceive it.

1.3 Interim summary

The municipal debt problem is characterised by recurring annual deficits, a large and growing amount of ways and means advances as a proportion of total debts, erosion of municipal equity capital and, hence, imminent overindebtedness. The vast majority of internal experts interviewed were convinced the debt problem experienced by the Memorandum Group was so severe that local efforts would not suffice to consolidate the budgets and were, therefore, futile. This conviction became manifest in resignation and reluctance to take initiative among the interviewees.

2 Exogenous causes of the municipal debt problem

After this exposition of the situation faced by the communities of the Memorandum Group, the question arises how it developed. Table 1 summarises the causes of the municipal debt problem as described by the internal experts in interviews and e-mails with representatives of the Memorandum Group (for further details refer to the appendix page V).

Table 1: Causes of the municipal debt problem ranked by number of mentions*

Rank	Number of mentions	Cause
1	19	Financial crisis, violation of principle of connexity
2	16	Solidarity Pact II, Rising Social Welfare Costs
3	10	Debt Service
4	8	Unreliable revenues
5	6	Socio-economic position of the community
6	5	Local Mismanagement
7	1	New Local Financial Management (NLFM)

*** in expert interviews (AIE1-8; PIE1-3) and e-mails with representatives of the municipalities**

SOURCE: OWN ANALYSIS

Exogenous factors which cannot be influenced by the community such as the financial crisis rank very high on the list, while endogenous factors such as local mismanagement are at the very bottom of the ranking. This, however, does not necessarily reflect the actual impact of these causes, since firstly, the Memorandum Group is calling upon the superordinate governments for aid, which

would be far less likely to happen if the debt problem were self-inflicted. Secondly issues of social desirability may have arisen during the interview process. While a discussion of the endogenous factors will take place in Chapter IV, the subsequent paragraphs will throw light on the exogenous ones.

2.1 *Macroeconomic causes: The financial crisis*

All the internal interviewees named the global financial crisis as one of the most prominent causes of the municipal debt problem. This is because it involved a significant decrease in tax revenues (mainly income and local business tax) and simultaneously escalating social welfare costs due to a sharp increase in unemployment. In many communities these developments entailed a considerable budget deficit.

Yet, the financial crisis is not actually a cause of the municipal debt problem, but merely a factor adding to its magnitude. Not all the cities and towns are equally affected by the crisis. The communities of the Memorandum Group "which have only been able to keep afloat with the help of ways and means advances for the past ten years" (EE_6) are hit especially hard by slumps in tax revenues because often there is no more scope for new debts or further expenditure cutbacks. As one of the interviewees put it: "If the lake dries up, the boats in shallow waters keel over first" (EE_6).

2.2 *Violations of the principle of connexity*

Both internal and external experts named violations of the principle of connexity by either the federal or the state government as the most important cause of the municipal debt problem. The principle of connexity has been incorporated in the German state constitutions during the last municipal debt crisis of 2001-2003. It demands that revenues be matched to the municipal functions and expenditures (Edling 1995, 15). It is violated, "[…] if the federal or state government assigns a task to the local level without simultaneously allocating the necessary financial means to fulfil that task" (EEI_3). This seems to occur quite frequently – all the internal experts were able to describe at least one such incident:

> "It just recently happened when the federal government enacted the law concerning childcare for children under the age of three. A decision which considerably affected the budgets of local governments, and, once more, jeopardized our scope of action" (PIE_2).

Reasons for such violations of the principle of connexity are: a) the effective cost of a certain public good or service cannot always be precisely determined in advance; b) the level of financial support provided by the superordinate government is usually not renegotiated when circumstances change, i.e. when the demand for a public service increases (for example due to macroeconomic reasons) or when it becomes more costly to provide; and even if renegotiations take place, they usually have no retroactive effect. Thus, the already accumulated debts remain with the local governments. Furthermore, it cannot be denied that c) "federal and state governments are deliberately trying to shift costs to the local level in order to disburden their own budgets since their debt load is even greater" (EEI_3). This is especially problematic since communities have very limited means to defend themselves against such abuses[10].

2.3 *Unreliable revenues due to changes in federal law*

Violations of the principle of connexity are not the only way decisions made by the federal government affect local budgets. Many experts stated that in the past municipal revenues were diminished by tax decisions of the federal state on numerous occasions. The following quote illustrates such a case:

> "The federal government enacted the corporate tax reform which came into force in 2001. This decreased our revenues by about €100 million per annum. We never really recovered from this blow" (AIE_7).

[10] "They can only take legal action against the state government but not against the federal government" (EEI_3).

Another example is the recent *Growth Acceleration Act* (Wachstumsbeschleunigungsgesetz) which both directly and indirectly affects municipal revenues[11]. Appropriate compensations for such cutbacks are usually not given. This is partly due to the fact that the communities do not have a direct means to influence the federal government – or as one interviewee put it:

> "While the Länder have the possibility to influence such decisions in the Federal Council of Germany [Bundesrat], we cannot do anything against this" (AIE_7).

2.4 *Solidarity Pact II*

Among the communities of the Memorandum Group one very contentious issue were the payments into the German Unity Fund as specified in the Solidarity Pact II[12]. This is the key investment instrument of the federal government for improving economic and social conditions in Eastern Germany aiming to overcome the division-related inequalities by 2019 (when the Solidarity Pact II phases out). Naturally, North Rhine-Westphalia is not excluded from this special equalisation scheme. But as they are currently struggling themselves, the communities of the Memorandum Group consider these payments as an unreasonable burden. This is illustrated by the following quote:

> "We are not allowed to take a loan for investments in our own infrastructure, but every year we must take a loan of €2 million to pay for the transfer to East German communities. That is absurd" (PIE_3).

Hence, many interviewees raised the question: "Why is there financial support according to the point of the compass and not according to need?" (AIE_8) and

[11] This is mainly because the Growth Acceleration Act comprises an increase of child benefits and tax exemption for dependent children as well as a VAT reduction for overnight stays at hotels. Child benefits are regulated through the income tax. If the total income tax yield is decreased, the 15 percent share of the income tax, which then is distributed to the local governments, is, of course, smaller as well. Similarly, if VAT is reduced – local governments receive a share of 2.25 percent of the overall VAT revenues – the budget is directly affected.

[12] Solidarity Pact II was enacted in 2005 following up the Solidarity Pact I agreed in 1993.

demanded the Solidarity Pact II be changed to also take the state of need of West German communities into account[13].

2.5 *Socio-economic position*

Most of the cities and towns of the Memorandum Group are former mining towns and – owed to the coal and steel industry – have once been economically strong. But ever since the *economic structural change* they have experienced the disadvantages of mono-economics. They struggle with high unemployment rates accompanied by strongly diminished financial power due to slumps in tax revenues. In fact, the costs for social welfare shouldered by the communities of the Ruhr Area have been 35% higher than the pan-German average for over a decade (Die Städte des Ruhrgebietes und des Bergischen Landes 2001, 6).

Although one could argue that this situation is partially homemade – after all the economic structural change did not happen overnight (and could have been mitigated) – social welfare costs in general have risen dramatically:

> "Today, the expenses for social welfare account for a third of the total budget. Twenty years ago it was only 20 percent[14]" (EEI_3).

In combination with cost-shifting strategies of the federal and state governments, this represents a significant burden.

> "For example, the housing costs of the long-term unemployed have been shifted to the local level, i.e. the municipalities have to finance more then three quarters

[13] According to the response given to the minor interpellation by a member of the North Rhine-Westphalian state parliament, none of the communities currently employing budget consolidation plans (Haushaltssicherungskonzepte) would be in a different situation, if the German Unity Fund did not exist (Landtag Nordrhein-Westfalen 2006). In other words, these payments are further aggravating the financial situation of the communities in need, but they did not cause the debt problem.

[14] This is due to the fact that the unemployment rate (especially structural unemployment) has been on a constant rise since the 1970s. In the early 1960s, when welfare aid (Sozialhilfe) was introduced, it was intended to offer temporary support. Due to increasing structural unemployment, today many people live on welfare for many years, which puts a lot of pressure on the social security system.

> of these costs. For cities with a problematic social structure, aging population and high unemployment rates this represents a tremendous problem" (AIE_8).

As the above-quoted interviewee mentioned, some communities of the Memorandum Group are already experiencing sizeable population losses due to *demographic change*, which further aggravates the problem of decreasing revenues. Often administrative costs cannot easily be adapted to the changed situation, further widening the gap between municipal revenues and expenditures.

2.6 *Additional financial pressure arising from debt service*

One of the most aggravating side effects of the municipal debt problem is that the debt service has become a serious financial problem in itself. Within the Memorandum Group, one of the worst cases is Oberhausen where the interest payments alone made up almost 16% of total revenues in 2009 (Schmidt 2010, 13). The North Rhine-Westphalian median value was merely 8%. Naturally, this dramatically limits the budgetary scope of action.

> "There are cities where the debt service impedes necessary investments – often for many years to come. Some cities are not even able to fulfil their legal obligations anymore because the debt service eats up such a large proportion of the budget" (EE_2).

Interestingly, most of the internal experts did not regard the debt service even as a partially self-inflicted burden. However, it cannot be denied that a part of the accumulated debts – those incurred for investments – originated in conscious decisions by the local government (see Figure 7).

2.7 *Interim summary*

The municipal debt problem cannot be attributed to one specific cause; it is rather the result of the interaction of a variety of different factors. Some of these are purely exogenous, such as the macroeconomic situation, decisions made by

the federal or state governments influencing the financing base and scope of action of the communities, and the overall fiscal structure of Germany.

Other factors like the socio-economic position and the increasing debt service burden could have been at least partially influenced by the communities of the Memorandum Group had they acted more forward-looking and in due time.

This partially answers the first sub-question. While this chapter could only raise the suspicion that the municipal debt problem is *not* purely a consequence of exogenous causes, which cannot be influenced by the municipalities, the following chapter will deliver a detailed justification for this notion.

IV. Playing the Bailout Game – Local Coping Strategies and Rational Choice Explanations

In order to justify why the municipal debt problem is *not* purely a consequence of exogenous causes, which cannot be influenced by the municipalities the focus of this chapter rests on the *endogenous* factors contributing to the municipal debt problem. Furthermore, an answer to the second sub-question – 'Which effects do behavioural aspects and incentives created by the German fiscal regulation framework have on municipal debts?' will be provided.

For this purpose, light will primarily be shed on the decisions and actions taken by local actors (political and administrative executives as well as citizens) revealing the underlying incentive structures, which stimulate certain debt-increasing behaviours. This will be done by linking the empirically observed facts with rational choice explanations.

1 Local self-responsibility for the municipal debt problem

1.1 Refusal to take any responsibility

As shown in Table 1 in the previous chapter, only five of the 19 communities stated that endogenous factors such as local mismanagement had contributed to the municipal debt problem. While most of the interviewees simply omitted this subject by stressing the importance of exogenous factors, one expert categorically refused even the possibility of the current situation being (partially) self-inflicted:

> "This assumption is based on a fundamental misconception of municipal scope of action. In the past, municipal self-government has very often been violated leaving the communities with hardly any freedom of manoeuvre" (EE_4).

In other words, due to unconstitutional interventions by superordinate governments local governments have limited scope of action and, therefore, should not be able to do anything 'wrong'[15].

1.2 *Avowal of partial self-inflictedness of the municipal debt problem*

Other experts, however, were more self-critical. As if in direct response to the expert quoted above, one of them stated:

> "If in the past ten years both the federal and the state governments had never violated the principle of connexity, we would probably still have a problem today. Only it would not be as big. Perhaps" (AIE_3).

In saying so the interviewee mostly had unsustainable investment decisions in mind. Indeed, several experts admitted: "[.] we made certain investment decisions in the past which were beyond our financial scope" (AIE_8). Consider the following example:

> "In the 1970s, veritable public swimming-pool and water park spend-fests took place. Many such facilities were built without ever thinking about the maintenance costs that were bound to follow up – energy, staff, etc…" (EE_4).

While the case described above can easily be attributed to human error, the following cannot:

> "Some communities have virtually failed to plan ahead and spent beyond their means *for decades*. Some local governments are *just now* slowly starting to adjust to the changed environment – now that they have barely any scope for adjustment left" (EE_3).

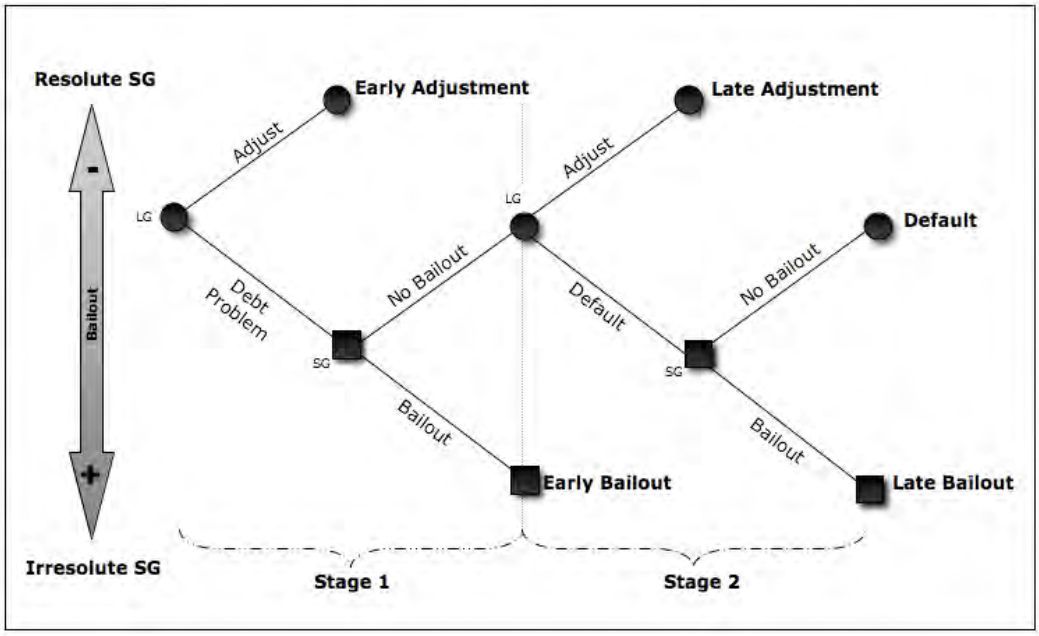
Even though only few interviewees actually gave statements of that nature, there is good reason to believe that this has happened in many communities of the Memorandum Group.

[15] This neglects the fact that not doing anything, such as not adapting expenditure to decreased revenues, can also be wrong (and does indeed lie within municipal scope of action).

2 The bailout game

But why would local governments prefer not to adapt to fiscal shocks and consciously risk a debt crisis? Jonathan Rodden (e.g. 2000, 2002, 2004, 2009) describes the rationale of subordinate governments as a 'dynamic game with incomplete information' which is displayed in extensive form in Figure 6.

Figure 6: The Bailout Game



SOURCE: MODIFIED AFTER RODDEN 2000, 15

The local government (LG) [16] is faced with an adverse fiscal shock with lasting effects requiring adjustment. After the shock it basically has two choices: it can choose to end the game quickly and adjust early on to the decreased revenues (EA); or it can choose to fill the budget gap by pursuing borrowing "[…] that may ultimately be unsustainable, hoping for an eventual bailout" (Rodden 2009, 4f.). Afterward it is the state government's (SG) turn to make a move. It must decide whether to solve the growing debt problem of the community by pro-

[16] Even though Rodden applied this framework to state governments, I argue that the same incentive structures are at work in any kind of subordinate government, be it a community or a member state of the European Union.

viding financial support. Should it decide to do so, the game ends with an early bailout (EB) after the first stage.

If this is not the case, a second stage ensues. Again, the local government has to decide for either (late) adjustment (LA) or attempting to externalize the costs of adjustment and accumulating even more debts. But this time the stakes are higher, as the default of the municipality is imminent and a bailout is far more costly. Again, the state government has to decide whether to provide a late bailout (LB) or not (D).

The expected utility of the local government is rather clear: it would prefer an early bailout, but if this were not in the cards, it would certainly prefer to get one later in the game. If the state government does not provide any bailout at all, the local government has to bear the full costs of adjustment. Naturally, it prefers the less costly early adjustment to a rather painful late adjustment. The worst-case scenario is a default. Thus, according to Rodden, the local government's payoffs are:

$$U_{LG}(EB) = 1 > U_{LG}(LB) > U_{LG}(EA) > U_{LG}(LA) > U_{LG}(D) = 0$$

For the state government, expected utility is less clear. Rodden assumes that the local government operates under uncertainty, because it does not know whether the superordinate government is of the resolute or irresolute type. While the irresolute type always prefers to provide a bailout at the final stage of the game, the resolute type prefers to allow for a default of the local government to take place[17] (ibid, 6).

In the following sections this framework will be applied to the strategies employed by the communities of the Memorandum Group in order to show why the bailout game of these German communities will most probably end in a late bailout.

[17] Hence, the payoffs for a resolute state government are:
$U_{SGr}(EA) = 1 > U_{SGR}(LA) > U_{SGR}(D) > U_{SGR}(EB) > U_{SGR}(LB) = 0$. And respectively:
$U_{SGi}(EA) = 1 > U_{SGi}(LA) > U_{SGi}(EB) > U_{SGi}(LB) > U_{SGi}(D) = 0$ for an irresolute one.

2.1 *The Bailout Game Stage 1*

2.1.1 Local strategy I: Early adaptation – The path not taken

As explained above, in the first stage of the bailout game a local government is facing a negative fiscal shock with lasting effects. This could for instance be a macroeconomic phenomenon, such as the economic structural change, resulting in sharply decreased local tax revenues and burgeoning welfare costs. In this situation the local government could decide to undertake the necessary adjustment measures by increasing revenues through higher taxes and fees and/or cutting expenditures by reducing or eliminating services. But from the utility function explained in section 2 it is clear, that this is by far not the most favoured (nor most likely) strategy.

The Memorandum Group did most probably not opt for this policy to deal with the fiscal shock. This is not to say that no measures have been taken at all. Indeed, most of the internal experts pointed out that their communities had adopted budget consolidation plans very early on (in the 1990s). But there is evidence that these attempts to cut spending were rather half-hearted and, hence, not very fruitful. While this is not deducible from the recurring budget deficits and ever-rising debt levels alone – because these may, indeed, originate in the exogenous factors discussed in the previous chapter – the fourth memorandum openly states that the communities of the Memorandum Group were lacking certain imperatives necessary for this kind of foresighted budget keeping.

These include both *favourable financial conditions* – abundant revenue streams or certain attractors for economic growth (e.g. airport)[18] – and *favourable political conditions*, such as the presence of local executives with the 'unwavering determination' (and necessary skills) to consolidate as well as cooperation of all political actors. It is argued that these conditions were given in North Rhine-Westphalian communities that managed to keep their budgets in balance (Die Städte des Ruhrgebietes und des Bergischen Landes 2008, 14).

[18] However, scarce revenues do not necessarily lead to budget deficits. According to Müller (1998, 3) communities with continuously low financial power often fare even better than their more affluent counterparts with higher but more volatile revenues. Since they invariably have to come to terms with their narrow means, the former tend to be more fiscally prudent. The latter tend to over-borrow in bad times in anticipation of rising revenues in the future.

Without meaning to generalise or negate the efforts of the fiscally more prudent members of the Memorandum Group, there is reason to believe that many local governments of the region only paid lip service and not the necessary adjustment costs.

> "Once agreed, saving measures included in the budget consolidation plan should not be watered down or even abandoned in everyday politics. […] If we want to consolidate, we must stick to the decisions we make. […] Business as usual won't do" (Buchhorn 2009, 3).

This quote taken from a treasurer's speech before the municipal council seems to confirm that the change in spending habits was little more than a change in spending rhetoric. Even if all the local actors recognised the existence of a problem and agreed that it should be solved by implementing a budget consolidation plan, they preferred to do "business as usual" (Buchhorn 2009, 4). The reasons underlying this behaviour will be explored in the following paragraphs.

2.1.2 Local strategy II – 'Business as usual'

'Business as usual' seems to be a good description of the strategy employed by many members of the Memorandum Group. According to Rodden, not adjusting expenditure levels to the decreasing revenues after the fiscal shock, piling up debts and hoping for a bailout is the preferred strategy of local governments playing the bailout game (see section 2). Indeed, most interviewees blamed other communities to have used this tactic:

> "*We* are not just twiddling our thumbs, waiting for God or the state government to solve the problem. We are actively fighting against it with consolidation measures. There are cities, however, that have chosen to take the other path, to wait and see, but not us" (AIE_7).

One of the internal experts even spoke very bluntly about their own community:

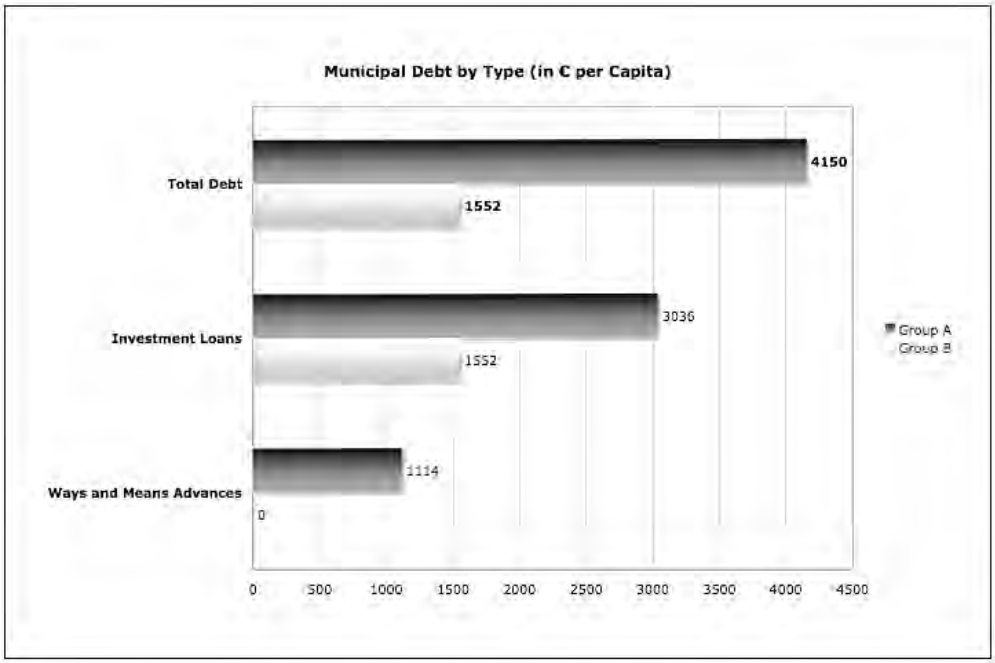
> "Twenty-five years ago we still had 600,000 inhabitants, today only 493,000. But the local government never saw the necessity to reduce expenditure by closing

> any of the public libraries or swimming pools in response to the shrinking population and the decreasing tax revenues. […] Until the early 2000s expenditure levels have never been adjusted at all. The gap was simply filled by incurring debts. Serious saving measures have never been taken" (PIE1).

This proves that at least one community of the Memorandum Group chose not to adapt and deliberately incurred potentially unsustainable debts. However, it could be argued that this was only an isolated case. But the records reflect a rather systematic use of this strategy.

Figure 7 shows that those North Rhine-Westphalian communities which are today forced to bridge budget gaps with the help of ways and means advances, Group A, also have incurred much higher debts for investment loans than the communities belonging to Group B which are not experiencing any debt trouble today.

Figure 7: Municipal debts by type



SOURCE: MODIFIED AFTER BOETTCHER ET AL. 2010, 105

This supports the argument that highly indebted communities have not adapted their spending habits to the loss of revenues experienced, over-borrowed and lived beyond their financial means, while communities without debt problems have spent more cautiously.

2.1.3 Interim summary and implications

To sum up: the first move in the bailout game taken by the communities of the Memorandum Group was most probably not early adjustment, but a 'business as usual' strategy involving practically unchanged expenditure levels. It is very likely that conscious and systematic overspending of local governments has significantly contributed to the accruement of the current debt crisis[19].

In the following political reasons why it is rational for local governments to accumulate debts (section 2.2) will be analysed and various accountability issues facilitating this strategy will be explored (section 2.3).

2.2 *Why 'business as usual' is a rational strategy – incentives created by the political process*

2.2.1 'Not in my backyard – or else I leave!' The interaction of citizens and local political executives in consolidation processes

2.2.1.1 The Nimby syndrome

It goes without saying that tax hikes and expenditure cuts are never popular among voters, let alone in times of crisis. Therefore, making such decisions is potentially costly for politicians hoping to be re-elected. All the political internal experts agreed: "citizens often lack understanding for necessary expenditure cuts" (PIE_3).

> "Whenever we want to make cuts, citizens react very negatively. For instance we just introduced a small charge for the use of the public gymnasiums, which has been free until this year. Now every adult who wants to use the facilities has to pay one Euro per month. For children it remains free of charge. This may sound like a very moderate fee to ask for, but there were people's revolts in the streets because of this. It got really ugly" (PIE_2).

Many interviewees had also experienced the following:

[19] However, this does not mean that the local executives involved were malevolent. According to Qiang and Weingast "political officials may be sufficiently honest and possess good intentions. Nonetheless, they often produce bad [.] policies" (1997, 84).

> "Whenever citizens are personally affected, they won't listen to reason. For instance, if there are ten public swimming pools in town, I daresay it would not be a problem to shut two of them down. And in theory the citizens do agree with that. But when the swimming pool in their neighbourhood is targeted they protest" (AIE_4)

What these interviewees describe is the so-called *Nimby syndrome.* In theory the citizens agree with the local government's intention to consolidate the budget, "[…] but when you ask 'where should we make the necessary cuts or raise fees?' the answer is: not in my backyard" (AIE_8). As a consequence, society as a whole does not receive the benefits of the collective good (balanced budget) because no one is willing to bear the localised costs[20] (McAvoy 1999). Considering this, it becomes conceivable that politicians pressing for expenditure cuts risk not to be re-elected. Hence, it is only understandable that "[.] politicians will do what they can to avoid paying these costs" (Rodden 2000, 1).

2.2.1.2 The problem of the fiscal common-pool

If local leaders were able to distinguish between temporary downturns and permanent ones, they would clearly have an incentive to "smooth expenditures and revenues" by incurring debts during bad times and paying them off during good times (Rodden 2000, 1). However, local governments seem to have dealt with permanent downturns in much the same way. One interviewee openly spoke about this problem:

> "I cannot deny […] the propensity of local politics to be overeager to please the voters. In my opinion this resulted in far too many costly investments and benefits, which in the end exceeded our financial limits" (PIE_2).

This is largely in agreement with Rodden's assumption that subordinate governments "[…] might simply refuse to adjust, over-borrowing and externalizing

[20] According to McAvoy the Nimby syndrome characterises citizens as "a) overly emotional, uninformed, and unscientific […]; b) motivated by narrow, selfish interests; and c) obstructing policies that would provide for the collective good"(1999, 3). However, recent studies contest the first two of these characteristics.

the political costs of adjustment to future administrations" (2000, 1) and future residents. If time horizons (i.e. political term limits) are sufficiently short, a variation of the *common pool problem* arises: political actors value the welfare of present-day voters higher than that of future voters, because the latter do not have a voice in current elections. This leads to an overuse of resources in the current period, dangerously limiting the financial scope in the future (problem of intergenerational equity). In other words: because present-day voters do not have to bear the full costs of debts the resulting debt level is much higher than the welfare maximising optimum.

Otherwise, the local government is likely to try and externalize the political costs of adjustment by provoking a bailout from the state government. This effectively means that the citizens of other jurisdictions (partially) pay for the adjustment. In short: "[…] individual jurisdictions do not internalize the full costs of debts and, hence, run larger budgets than would a single general-purpose government that considered the effects of its policies on all groups" (Berry 2010, 802). Thus, the classical common pool problem often observed in multi-layered governments arises (Weingast, Shepsle, and Johnsen 1981) and becomes manifest in systemic over-borrowing.

The same dysfunctional incentive structure also leads to exorbitant demands on the part of the citizens, as they do not have to bear the full costs of the public services they claim. However, due to transparency issues citizens often do not even know the true cost of a public good (see section 2.3).

2.2.1.3 Municipal Competition

Another motive for the Memorandum Group not to adapt to the fiscal shock is closely related to the one described above. Local executives fear that "expenditure cuts and tax hikes might have a negative impact on the community's position in the *municipal competition*" (AIE_2). Tiebout (1956) argues that competition for mobile residents and local businesses among jurisdictions is one major

source of benefits from decentralisation[21]. Analogous to the struggle among firms in a private market, it compels local governments to adopt efficient policies in the public good provision (Berry 2010). Furthermore, "[…] it allows citizens to sort themselves and match their preferences with a particular menu of local public goods" (Qian and Weingast 1997, 83). However, in the communities of the Memorandum Group this mechanism seems to have led to overspending and too little saving efforts, which can hardly be classified as 'efficient public good provision'[22]. One interviewee confided:

> "As a consequence of the expenditure cuts we are facing a dangerous downward-spiral of outmigration and an ever-further reduction of our tax base. Even today our social structure is such that we have an above average proportion of unemployed people and people living on welfare" (AIE_7).

In other words, communities raising taxes and cutting back on public services run a risk of losing citizens to other jurisdictions. This, on the other hand, triggers a vicious circle. Since the more affluent taxpayers are most likely to leave and the transfer receiving citizens are most likely to stay, the socio-economic position – and, hence, the financial situation of the community – becomes ever worse, making more cutbacks necessary[23].

For similar reasons, local executives are concerned about the effect of expenditure cuts and tax hikes on *local businesses*. Several interviewees stated:

> "If we cannot offer certain public services or infrastructure anymore, firms will leave the city. And of course the local business tax is an issue" (PIE_3).

When people or businesses leave the community because they perceive the situation to be more beneficial elsewhere, they 'vote with their feet'. Hence, the consequences are effectively the same as described in section 2.2.1.2: local ex-

---

[21] Hayek (1945) underlined the efficiency benefits arising from informational advantages of governments functioning at lower levels.

[22] This could be due to the fact that the market mechanism of municipal competition is employed in a non-market environment. Since communities are not financially independent (see section 2.5.2), they have an incentive to overspend and externalise the costs. Therefore, their investment decisions will not be reflective of their financial position in the municipal competition.

[23] Sarcinelli even declares: "There is nothing more expensive than losing citizens" (2006, 8).

ecutives are overeager to please (seeking to use their policies as a means to prevent outmigration), over-borrow and try to externalise the costs to future administrations or other jurisdictions. The local cost of adaptation – outmigration of citizens and local businesses is perceived to be greater than that of (collectively financed) unsustainable debts.

While the risk not to be re-elected is conceivable, the risk of people voting with their feet is not nearly as high[24], as it involves much greater costs. In fact, most of the experts stated "[.] at the moment out-migration is not a big problem because in the region the situation is the same in every town" (AIE_3). Apparently the *possibility* of voting by the feet alone is enough to prevent necessary expenditure cuts and induce overspending.

2.2.2 The interaction of local politicians adhering to different parties – political power struggles in consolidation processes

Because citizens and local businesses act as described above, politicians belonging to opposition parties try to use this as a lever to gain the upper hand in the political struggle for votes. The following anecdote shows that this is happening within the Memorandum Group:

> "We are trying to introduce consolidation measures but the Social Democrats always veto our suggestions. Only last Monday we had a heated debate in the cultural affairs committee about where to make expenditure cuts but all our ideas fell on deaf ears. And the next day I hear on the radio 'The SPD – Saviour of Cultural Life in Duisburg'" (PIE_1).

In order to win votes (and potentially the next elections) politicians of the opposition party have a tendency to stymie consolidation efforts of the party in power. The governing party, on the other hand, expects this and refrains from making ambitious expenditure cuts in the first place. As a result, many budget consolidation measures are either not implemented or not even considered. The expert quoted above further observed:

[24] It must be admitted that businesses are, indeed, more mobile than citizens, even if the tax level alone is not the only attractor of a business location.

"None of them would act so irrationally and irresponsibly if this were about their own private debts" (PIE_1).

However, this kind of 'irrational and irresponsible' behaviour is not irrational from the perspective of local politicians. After all, these are not their private debts and they will not personally be held accountable for them. The worst thing that could possibly happen to local politicians is not to get re-elected. Hence, doing what it takes to get re-elected is actually the most rational choice they could make. Whether this kind of behaviour is also responsible, however, is a whole different question. But it explains why *favourable political conditions* such as cooperation of all political actors mentioned in section 2.1.1 are so utterly important in the consolidation process.

The situation being as it is, local executives willing to make consolidation efforts are faced with a *prisoner's dilemma* – a situation in which the individually worst choice (consolidating debts and risking not to be re-elected or to lose citizens and businesses to other communities) would be necessary to achieve the welfare maximising collective optimum (Aggarwal 1996, 48). Figure 8 shows that it would be best for everyone, if both actors opted for consolidation (collective payoff = 10). However, the cost of opting for consolidation while the opponent decides to shirk is extremely high (payoff -10). Moreover, shirking is rewarded by the citizens in the shape of votes (payoff 10), which makes it very likely for the opponent to opt for this tactic. Therefore, both actors will most probably decide not to consolidate and issue more debts.

Figure 8: To consolidate or not to consolidate? The dilemma faced by politicians

		Opponent	
		NO	YES
Politician	YES	10 - 10	5 5
	NO	0 0	- 10 10

2.2.3 Interim summary

Certain dynamics of the local political process, such as the competition for votes and taxpayers, appear to have incentivised the Memorandum Group not to adjust to the fiscal shock. Instead local executives favoured bridging the emerging budget gap with debts and trying to externalize the political costs of adjustment by provoking a bailout from the state government. As Niederste-Frielinghaus stated: the high deficits are due to a flaw in the system, "[...] the contradiction of short-term incentives of a representative democracy and the long-term necessities of public finance" (2007, 25).

Furthermore, the multilayeredness of Germany's fiscal regulation framework (in combination with some of its other properties which will be discussed in section 2.5.2) encourages local actors to regard the federal tax base as a fiscal common-pool they can tap into for additional financial resources. This most probably resulted in aggregate overspending and exacerbation of the German municipal debt problem.

2.3 Why it is so easy to do 'business as usual' or How the lack of accountability disincentivises local consolidation efforts

Having thrown light on the political issues turning debt accumulation into a rational strategy, some other factors promoting the 'business as usual strategy' pursued by the Memorandum Group will be discussed in the following. These originate mostly in the fact that it is very difficult to ensure accountability for fiscal outcomes. The main reasons are *intransparency due to complexity*:

- of municipal budgets in general (2.3.1) and
- of the municipal debt problem in particular (2.3.2);

as well as *intransparency due to entanglement*:

- of political and financial responsibilities (2.3.3) and
- of supervisor and supervisee (2.3.4).

2.3.1 The opaqueness of municipal budgets

Public budgeting is not only a science; it is a world of its own. Volumes could be filled about the accounting methods used in German municipalities (and as a matter of fact, this is being done), but only a few aspects of local budgeting that may have contributed to the municipal debt problem will be discussed in the following.

Until very recently, the communities of the Memorandum Group used the *cameralistic or cash based accounting system*. In cameralistics, only monetary values are displayed, neither depreciation of municipal assets nor erosion of equity capital is included. Thus, the consumption of resources is only partially depicted[25] (Ridder et al. 2005). Furthermore, cameralistic accounting merely keeps track of the core budget and disregards public funds, institutions and enterprises. Their financial activities are recorded separately in ancillary accounts. Debts issued by these entities are therefore not included in the general municipal debt statistics, which causes significant distortions of the figures (e.g. the actual average debt level would be much higher). This leads to an inefficient use of resources because, firstly, it is impossible to tell the actual size of the deficit, which makes strategic action to consolidate the budget rather difficult; and secondly, it offers unsustainable temporary solutions to the debt problem, as it is possible to simply sell the proverbial family silver on municipal assets to balance the budget.

Besides the negative implications of a permanent loss of municipal assets, the fragmentation of the budget creates an incentive to simply shift debts to other entities in order to make them disappear from the core budget. Thus, it becomes very difficult for the supervisory authorities to recognise an emerging debt problem (Junkernheinrich 2007b, Fischer and Gnädinger 2009). In addition to that, the high complexity of cameralistic accounting (combined with the fact that much of the data is only accessible to experts) makes democratic control by

[25] Incidentally, this is another factor making direct comparison of different municipalities very difficult (see Chapter II.2.1).

the press and the public almost impossible, significantly reducing public pressure on local executives to economise[26].

2.3.2 The multilayeredness of the municipal debt problem

While it should be sufficiently clear from the account so far that neither exogenous nor endogenous factors alone could be blamed for the emergence of the municipal debt problem, the multitude of its causes enables local executives to conceal their failure to adapt to fiscal shocks by drawing all the attention to the exogenous factors.

> "We have to live with the federal state assigning new tasks to us without allocating adequate financial means, state interventions reducing our tax revenues such as the corporate tax reform in 2001 and economic shocks such as the financial crisis – which is not our fault either" (AIE_7).

However, macroeconomic phenomena and cost shifting strategies of the federal and state governments are not the sole causes behind the municipal debt problem. Yet the existence of these exogenous factors allows the communities of the Memorandum Group to appear as 'victims of the system' or as 'community of fate' (Schicksalsgemeinschaft) as they refer to themselves.

The fact that the Memorandum Group now consists of 19 communities further adds to their credibility, as it places special emphasis on the systemic nature of the municipal debt problem (as opposed to individual debt trouble, which could much more easily be attributed to local actions). This is why all of the internal actors stressed:

> "We are in a lot of trouble, but we are not the only ones facing this situation. In the region, most local governments have the same problem" (PIE_3).

[26] In order to create more transparency and induce greater efficiency, several German states have recently implemented the New Local Financial Management (NLFM), which basically represents a move towards accrual or double entry accounting used in the private sector. In North Rhine-Westphalia NLFM became compulsory for communities in 2010.

Also, there are indeed a small number of communities within the Memorandum Group that have tried to adjust early on and foundered on the sheer size of the adjustment necessary. These unconsciously function as an alibi for the whole group seemingly proving that they cannot be held accountable for their debts:

> "We acted, we tried to solve the problem, but it is just too big for us to handle on our own" (AIE_5).

2.3.3 The entanglement of political and financial responsibilities

Another factor adding to this accountability problem is the fact that "there is no clarity which duty should be fulfilled by the federal government, the states or the municipalities"(EEI_3). Due to overlapping political and financial responsibilities of the different levels of government (and the consequential hybrid financing of public goods) none of the actors involved have an incentive to handle resources efficiently because none of them can be directly held accountable for the results of a policy (Junkernheinrich and Boettcher 2008, 10).

Moreover, hybrid financing means that, when it comes to local public good provision, there is no clear correspondence between decision makers, consumers and payers (Junkernheinrich et. Al. 2010, 28), i.e. the costs and benefits of a local public good or service are not fully tangible for any of the actors involved. Hence, payers who cannot enjoy the benefits are inclined to underprovide financial means, while consumers exhibit an excessive demand for the seemingly 'cheap' goods. Unsurprisingly, this has a negative effect on the municipal debt level as local executives have an incentive to satisfy their constituents' demands by issuing debts (as discussed in section 2.2).

2.3.4 The lack of an independent Local Supervisory Authority

All the transparency and accountability issues described above are further exacerbated by the fact that there is no clear division between supervisor and supervisee. In fact, the lower levels of the supervisory authorities (Kreisverwal-

tung) are closely linked with the local politicians. As one of the external experts explained:

> "These people know each other from the county council [Kreistag] where they work together. Thus, there is no real neutrality and this has in the past led to the approval of loans, which should have better not been approved" (EE_5).

Hence, the Local Supervisory Authority not only lacks the capability to assess the true financial situation of a community, it also lacks the independence necessary to actually do so. This means the pressure to economise and operate efficiently imposed on the communities of the Memorandum Group is much lower than would be desirable.

2.3.5 Interim summary and implications

Municipal finances are opaque. This lack of transparency is due to several factors, such as the (former) cameralistic accounting system, the complexity of the municipal debt problem, the entanglement of the different governmental levels as well as the lack of an effective supervision due to the entanglement of supervisor and supervisee. It is very likely that all of the above contributed substantially to the municipal debt problem by disincentivising local consolidation efforts.

The intransparency of municipal budgets and the lack of a functioning monitoring system give rise to a *principal-agent problem* (Hindmoor 2006, 133ff.). The relationship of state and local government is characterised by *information asymmetry*. Because the two actors have different interests, inefficiencies are unavoidable. Local executives could for example overstate the costs for the provision of a certain public good while understating their own financial scope of action, incur debts and hope to obtain additional funding from the state. Hence, the pressure for greater economy and efficiency in local public good provision is rather low as it is easier to issue debts and blame structural reasons without running a great risk for this tactic to be uncovered.

2.4 *The strategy of the state government*

Once the local government has made its decision not to adapt and accumulate debts, it is the state government's turn to decide whether to provide an early bailout and end the game. While a resolute government would never decide to do so, an irresolute one is, for two reasons, not very likely to do so either. Firstly, it may hope that the local government mistakes its 'no early bailout'-strategy for a true commitment not to provide a bailout at any stage of the game, thus, inducing late adaptation on the part of the local government; and secondly, it is well aware that an early bailout would not only incentivise other local governments to follow suit, it would also make a credible 'no bailout' commitment very difficult in the future.

Therefore, the most likely move of the state government is 'no bailout'. For the North Rhine-Westphalian government this has, indeed, been the case so far.

2.5 *The Bailout Game Stage 2 – To risk default or not to risk default?*

Given the state government's decision not to provide an early bailout, the local governments of the Memorandum Group, again, has to make a choice whether to adapt or to issue more debts. In this second stage the stakes are significantly higher. The debt trouble is much more tangible, bankruptcy is imminent. If the state government were of the resolute type, it would be wise for the local government to opt for late adaptation. Even though this would involve much higher costs than the early adaptation refused in the past, it would be less costly than a default. The question is: should the local government risk a default? If it can harbour rational bailout expectations, the answer to this question is much more likely to be yes. Otherwise it will be more inclined to bear the costs of a late adjustment to the fiscal shock.

2.5.1 Local strategy III: Late adaptation – Too little too late

So how did the communities of the Memorandum Group decide? At first glance it seems as if all the communities are much more inclined to take certain consolidation measures now that the debt problem has gained some momentum. As mentioned before, budget consolidation measures can include modifications of the revenue and the expenditure sides of the budget. Since tax hikes are very unpopular among the voters, the focus is usually on cutting expenditure as the following quote shows:

> "We are trying to find potential for economies – where can we make cuts, where can we be more efficient? And we are also thinking about increasing our revenues by raising fees and charges. But this is even more difficult than eliminating certain services that we have grown attached to" (AIE_4).

Müller (1998, 1-8) offers guidelines for communities how to effectively make savings and consolidate the budget by following four consecutive steps. Firstly, he argues that in most communities there is abundant potential for savings within the public administration itself by increasing efficiency of the service provision (e.g. downsizing, restructuring work processes to make use of synergy effects, increased use of IT, etc.). Several experts reported that this was being done in their community:

> "We implemented a lot of expenditure cutbacks, such as an administrative reform. We lumped together some of the bureaus and axed about 300 jobs" (PIE_3).

Müller recommends that, in a second and third step, the services provided should be scrutinized for 'phantom standards' and 'luxury standards' – that is for services that are not mandatory anymore (e.g. due to a change in the law) and for those that have never been mandatory (non-obligatory public services). The following quote shows that this is, indeed, being done in practice:

> "At the moment we are screening the budget for services we do not have to offer or which we could offer at lower costs. Sometimes the standards we set for ourselves are too high" (PIE_2).

In a fourth step (only to be taken when the first three did not suffice) certain public services should be reduced (e.g. shorter opening hours for public librar-

ies) or even eliminated (e.g. closing down the least frequented public swimming pool). That, too, is being done:

> "We have cut back on the non-obligatory public services, have shortened the opening hours of libraries, and completely abandoned the bookmobile" (AIE_5).

However, the best-suited description for the consolidation efforts made by the Memorandum Group seems to be 'too little too late'. Even though drastic measures would be necessary to produce an effect at this advanced stage of the municipal debt problem, radical changes are (at best) rarely to be seen. But since those are not more popular among constituents and local businesses than they were at the first stage of the bailout game, most of the internal experts were making excuses, why more consolidation efforts were not feasible.
Even though this may be accurate for some communities of the Memorandum Group, the following quote taken from a treasurer's speech before the municipal council seems to underline that a true change of thinking (or of strategy) has not taken place:

> "To some of you the information that our town will be overindebted by 2012 may be as important today as it has always been: namely, not important at all. How else should I interpret the fact that there is still a competition for new expenditures instead for consolidation measures? […] Frankly, I was shocked about the unscrupulousness of this year's applications for budget funds" (Haug and Weeke 2008, 1).

Without denying that there are exceptions to the rule, many communities seemed to regard consolidation efforts merely as a means to an end, namely to be bailed out by the state government. Hence, they implemented just enough measures to be able to tell they had tried and failed, hoping this would bring the Local Supervisory Authority on their side:

> "I am convinced our willingness to make use of the local potential for consolidation is the precondition and basis for negotiation with the Local Supervisory Authority" (Tischler 2009, 11).

Also, they were confident that the implementation of certain measures would greatly improve their chances to receive a bailout from the state government, as "[…] nobody would invest a single cent in a money sink. If we ask for aid, we will be asked to make certain efforts in return. State transfers and inter-municipal solidarity are not to be had for nothing" (Langner 2010, 5).

In summary: even though the communities of the Memorandum Group are currently implementing a series of budget consolidation plans, saving efforts seem rather constrained, whilst radical change would be necessary. Hence, it is very unlikely that the local governments have opted for late adaptation. The following section will attempt to elucidate why this is a rational choice.

2.5.2 Dysfunctional incentives created by Germany's fiscal regulation framework

Feld and Baskaran (2009) name several properties of the German fiscal constitution which make the strategy of late adaptation irrational, inducing local governments not to shoulder the costs of adjustment, issue more debts and bring the community close to a default. These are:

1) The relatively *low level of municipal tax autonomy* or the fact that communities can only influence a marginal proportion of their revenues. Hence, if a local government wishes to increase expenditures (or not to reduce them in response to a fiscal shock), debts represent the easiest way to finance them.
2) The *strong dependence on federal and state grants and revenue-sharing* (ct Innenministerium des Landes Nordrhein-Westfalen 2009, 70), which basically means that non-residents fund a large share of local expenditures[27]. This gives rise to common pool externalities, as local governments have an incentive to overinvest and overborrow while their incentive to make individual saving efforts is inefficiently low. In fact, "when faced with a long-term decline in revenues requiring politically painful expenditure

[27] According to Blankart and Klaiber tax revenues cover less than one third of the entire revenues of municipalities; "grants predominate" (2005, 7).

cuts, the temptation to avoid adjustment might be strong in the most transfer-dependent states" (Rodden 2001, 10).

But most importantly, when the superordinate government is this heavily involved in the financing of a jurisdiction, it cannot credibly commit to deny a bailout when a community has over-borrowed (soft budget constraints). As a consequence of both 1) and 2), creditors and possibly even voters do not always regard local executives as sovereign over their own finances, but as part of a complex intertwined system. According to Rodden "this may create a unique set of incentives for [local] level fiscal decision-makers, some of which differ from commonly-held baseline assumptions about public finance, and some of which are undeniably perverse" (2001, 9).

3) The *constitutional guarantee of comparable living conditions* throughout the federation, which stipulates "that all sub-national jurisdictions [have] to exhibit identical or at least very similar policies in the most important policy areas", such as social policy (Feld and Baskaran 2009, 9). To fulfil that end, financial equalisation between poor and affluent states as well as between municipalities is taking place.

Feld and Baskaran assert: "while each of these characteristics on its own does not necessarily lead to public overborrowing, their interaction is bound to diminish incentives for sound fiscal policies" (ibid). Indeed, why should a local government bear the costs for a late adjustment all by itself, when it can rationally expect to be bailed out by the state government in the future?

What is more, in the author's opinion a fourth factor should be added to the list, which turns the rational bailout expectation of local governments into legal certainty: according to §131 paragraph 2 GO (Municipal Code of North Rhine-Westphalia) "no insolvency proceedings will take place for municipalities" (Borchert 2004, 3). In other words: communities cannot fail[28].

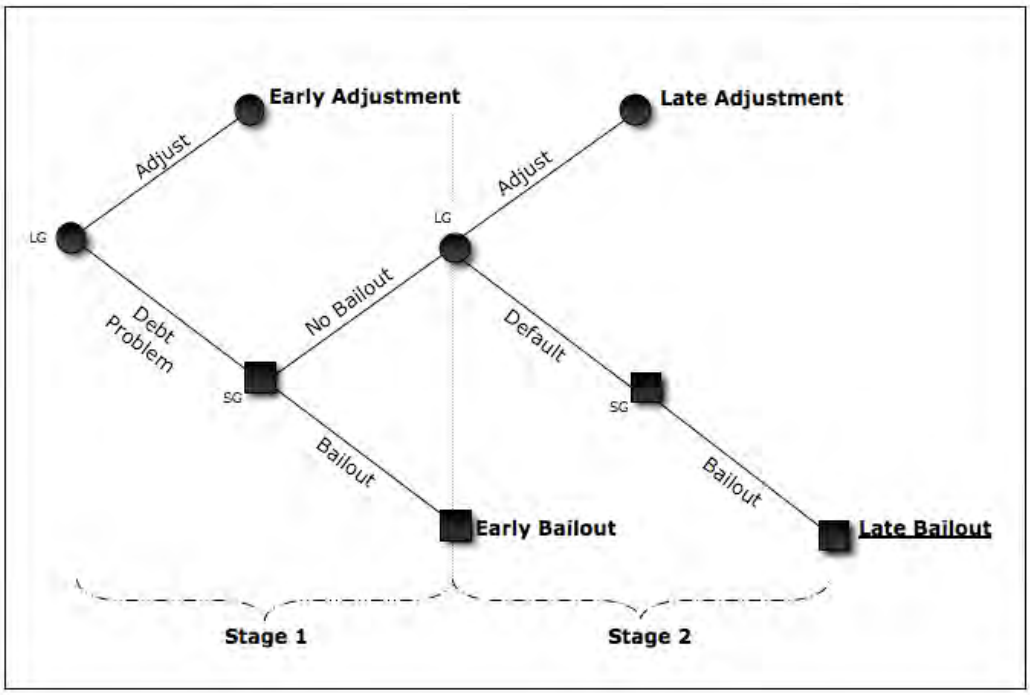
2.5.3 Local strategy IV: Issuing more debts and risking a default

[28] Additionally, paragraph 12 of German insolvency law stipulates that municipalities are not allowed to go bankrupt, unless one of the states explicitly allows a bankruptcy, which has not happened yet (Blankart and Klaiber 2005, 7).

What implications do the above-mentioned characteristics of the German fiscal constitution have for the local government playing the bailout game? Figure 9 integrates these aspects into Rodden's theoretical framework showing that the state government (SG) cannot allow for the local government (LG) to default. Therefore it will eventually provide a late bailout. By using backward induction, the local government expects this and hence, will not opt for late adjustment, but pile up more debts.

The same will happen at the first stage of the game: knowing that the state government will eventually have to provide a bailout the German local government can be certain to be dealing with an 'irresolute state government'. The strategy not to provide an early bailout in order to induce local adjustment efforts will be unmasked. Therefore, early adjustment becomes very unlikely, too; over-borrowing is bound to take place.

Figure 9: The modified bailout game



SOURCE: MODIFIED AFTER RODDEN 2000, 15

2.5.4 Moral hazard

The expectation of a bailout gives rise to a *moral hazard problem* both on the side of the borrower as well as the side of the lender (ct Blankart and Klaiber 2005,

Heppke-Falk and Wolf 2007, Rodden 2001, Seitz 1999). Without the possibility of a bankruptcy debtors and creditors can feel safe. While the former has fewer incentives to run a sustainable fiscal policy, the latter is encouraged to neglect the borrower's performance and underprice risks. Interest rate spreads remain constant even with increasing indebtedness. Effectively the credit rating of the German federal government is assigned to all subordinate jurisdictions. In short: the capital market loses its controlling function, overborrowing occurs.

There is evidence that both debtor and creditor moral hazard arose in the case of the Memorandum Group. One of the external experts acknowledged:

> "The cities and towns certainly do not have any problems to get cheap loans[29]. They are practically overwhelmed with easy money. And I don't see why this should change in the future because of the mere existence of the state's legal obligation to assume liabilities in case of a debt crisis" (EE4).

2.5.5 The 'too big to fail' doctrine

Even if the German state were not legally bound to provide a bailout for communities in debt trouble, it would still be unlikely for a municipal bankruptcy to actually take place. For one, the default of a local government can impose a negative externality upon other communities or even the state or federal government by increasing the cost of borrowing for all fiscal entities (Seitz 1999, 1). Therefore, Wildasin (1999) argues that moral hazard is most prominent among larger jurisdictions, whose leaders know they are 'too big to fail'.

The *too big to fail* doctrine is usually associated with large banks and the moral hazard problems occurring when these assume the government – fearing harmful spillover effects on other banks, citizens or the entire economy – would not let them bear all their losses from a bankruptcy. However, it also applies to other organisations such as communities when a superordinate government

[29] One of the internal experts even quantified this: "For a loan of 100 Million Euros we are paying a very, very low rate of interest – about 0.7 percent or €700,000" (AIE3).

cannot let a subordinate jurisdiction fail because the economic, social or political costs would be too high (Gup 2004).[30]

According to Seitz state governments seem to be more likely to grant bailouts, if the orderly provision of public services regarded to be "especially sensitive" are at risk (1999, 32). He argues that this creates incentives for local governments to threaten to cease providing such services if they do not receive additional financial assistance. Considering the following quote, this seems to apply to the Memorandum Group:

> "We need help from the state. We have reached a point where we cannot make much more cuts, because then we would not fulfil our duties anymore. I don't think this would be beneficial" (PIE_3).

Other factors making a bailout more likely are political favouritism and the importance of the community in the public opinion. Especially the latter currently plays a role for the Memorandum Group. Even though no bailout has been announced so far, the internal experts commented: "[…] with the North Rhine-Westphalian state elections coming up, we have high hopes to be heard" (PIE_2).

2.5.6 Interim summary

Some properties of Germany's multilayered fiscal regulation framework create dysfunctional incentives for local executives encouraging them to issue more debts and bring their communities close to bankruptcy. These are the relatively low level of municipal tax autonomy, the strong horizontal and vertical dependence on intergovernmental grants the constitutional guarantee of comparable living conditions and last but not least the fact that communities cannot fail. Due to rational bailout expectations, a problem of creditor and debtor moral hazard arises leading to overborrowing.

[30] On the basis of the 'too big to fail' argument, the alliance of the communities allowed the Memorandum Group to build a much larger 'jurisdiction' representing about five million citizens.

3 The municipal debt problem – a joint responsibility

After this extensive analysis of the effects of behavioural aspects and incentives created by the German fiscal regulation framework, the second sub-question[31] can be answered as follows: the political and fiscal relations of the different levels of government in combination with the short-term incentives of the political process of a representative democracy generate a myriad of behavioural dilemmas: collective action problems, problems of externalities, problems of asymmetric information. These turn overspending and risking a debt crisis into a rational course of action. In short, *behavioural aspects and incentives created by the German fiscal regulation framework have inflated municipal budget deficits and significantly contributed to the accruement of the current debt crisis.*

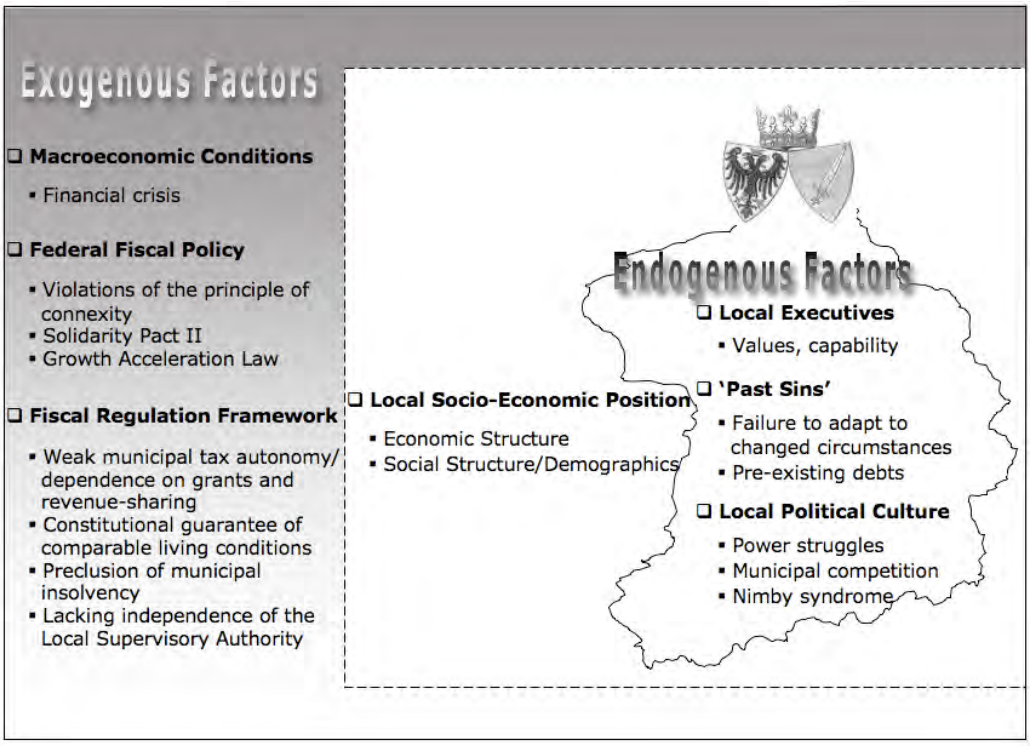
However, the exogenous causes discussed in the previous chapter should neither be belittled nor ignored. As one of the external experts put it:

> "Considering that part of the loans have been taken out to cover expenses for obligatory tasks that the state government assigned to the local level, it is appropriate to speak of co-responsibility" (EE_5).

Moreover, following the principle of vertical public administration, local governments are subject to the state's supervision; and these supervisory authorities have approved the loans, which eventually drove the towns into debt trouble. While the communities do have some scope of action when it comes to certain endogenous factors (e.g. capability and values of local executives, cooperation of political actors adhering to different parties, early adaptation to changed circumstances etc.) there are factors on which communities have only limited (e.g. socio-economic position) or hardly any influence at all (e.g. federal fiscal policy, lacking tax autonomy, etc.). Therefore "it would be untrue to say that the actions of local politicians and bureaucrats alone led to the debt problem, but only blaming it on the state government would be just as wrong" (EE_5). When attempting to solve the municipal debt problem, this should be taken into account. For that reason, Figure 10 summarises the main factors causing the municipal debt problem discussed in Chapters III and IV.

[31] 'Which effect do behavioural aspects and incentives created by the German fiscal regulation framework have on municipal debts?'

Figure 10: Overview of factors contributing to the municipal debt problem



SOURCE: OWN ANALYSIS

V. Solving the municipal debt problem – A holistic approach

The aim of this chapter is to advise the state government on its next move in the bailout game and to answer the last secondary research question: *What can be done to break through the dysfunctional incentive structures discussed in the previous chapter and sustainably solve the municipal debt problem?* Pros and cons of different options will be weighed against each other, taking the findings of both Chapters III and IV into account in order to determine the most viable measure(s).

1 Is 'business as usual' an option?

Even though most of the experts were of the opinion that the municipal debt problem is a pressing issue that needs to be solved as fast as possible – after all, some of the communities of the Memorandum Group are already dangerously close to a default – one of them pointed out that the state government did not necessarily have to provide a bailout. In accordance with Chapter IV.2.5.5 he argued that cheap loans would be available and no bailout necessary as long as the state guaranteed on paper for the debts incurred by the communities:

> "The cities and towns certainly do not have any problems to get cheap loans. They are practically overwhelmed with easy money. And I don't see why this should change in the future because of the mere existence of the state's legal obligation to assume liabilities in case of a debt crisis" (EE_4).

In other words, even though the North Rhine-Westphalian state government does not have the option to let the communities of the Memorandum Group fail, considering creditor moral hazard, it could decide to let the communities continue on the unsustainable debt path, as a default would not take place.

However, this would merely be a postponement of the action that eventually needs to be taken. Business as usual would only aggravate the already existing symptoms of the debt problem, such as declining local infrastructure and quality of life, and entail a further loss of municipal self-government. Fur-

thermore, the municipal debt problem could eventually have negative spillover effects on the federation as a whole and destabilise the economy. In addition to that, both the costs for adjustment as well as a bailout will continue to rise the further the debt problem advances. Considering the recently enacted 'debt brake'[32] (Schuldenbremse) for the German federal and state governments, this would not be a forward-looking move. Given the post-crisis financial position of the North Rhine-Westphalian state government, a bailout could become very difficult in the future, as the state cannot issue debts to provide it anymore.

For all these reasons it is not recommended for the state government to simply leave the communities to their debt problems.

2 Solutions for the municipal debt problem

2.1 Propositions from the Memorandum Group

After having once more established that the municipal debt problem needs to be solved, the question arises what would be the best way to do so. Table 2 summarises the measures preferred by the communities of the Memorandum Group.

Table 2: Solutions for the municipal debt problem ranked by number of mentions*

Rank	Number of mentions	Solution
1	19	No more violations of the principle of connexity
2	16	End of Solidarity Pact II (current version)
3	15	Debt reduction fund, reliable revenues
4	11	Increase of individual saving efforts
5	8	Reform of the municipal equalisation scheme
6	6	Creating awareness among citizens
7	3	Economic revival
8	1	Individual debt relief, complete bailout

*** in expert interviews (AIE_{1-8}; PIE_{1-3}) and e-mails with representatives of the municipalities**

SOURCE: OWN ANALYSIS

[32] Art. 110 GG (Basic Law) and Art. 115 GG stipulate a zero limit on net borrowing for the state governments and a limit of 0.35 percent of GDP for the federal government budget deficit in the future. The debt brake will become effective in 2016 for the federal and 2020 for the state governments. Only recessions and natural disasters permit higher borrowing (Fischer and Gnädinger 2009, Feld and Baskaran 2009).

The internal experts named on average at least four different measures necessary to solve the debt problem (for more detail refer to the appendix, page VI). As the ranking shows, economic revival is not hardly expected to solve the problem; instead structural changes prevail (e.g. protection from future violations of the principle of connexity and security of revenues). Moreover, 17 of the 19 communities favour a bailout of some kind by the state government, while 13 of them mentioned measures on the part of the municipalities, such as increasing individual saving efforts and creating awareness for the debt problem among the citizens as possible solutions.

2.2 *A brief taxonomy of possible solutions*

One of the external experts summarised:

> "There are solutions of two kinds: preventative measures that should be employed to avoid future debts and measures aiming at fiscal consolidation" (EE_5)

However, as Chapter III and IV showed, there is yet another dimension which needs to be taken into account: it is important that solutions provide *incentives* for local governments to increase their own consolidation efforts and future fiscal prudence while simultaneously improving the financial situation of the municipalities. Figure 11 categorises potential solutions for the municipal debt problem along these dimensions.

Figure 11: Categorisation of possible solutions for the municipal debt problem

	Preventing future debts	Debt consolidation
Improvement of the financial basis	▪ Respecting the principle of connexity ▪ End or reform Solidarity Pact II ▪ Fiscal reforms e.g. *Municipal equalisation scheme*	▪ (Partial) Bailout e.g. *Debt service aid,* ▪ Savings Commissioner ▪ Increase of saving efforts
Improvement of the incentive structure	▪ Early warning system ▪ Municipal insolvency law ▪ Independent supervisory authority	▪ Conditional bailout, e.g. *Debt reduction fund* ▪ Creating awareness among citizens

Recognizing the municipal debt problem as a joint responsibility of federal, state, and local governments

SOURCE: OWN ANALYSIS

This list is by no means exhaustive, but it still serves its purpose: to provide an orientation guide for the rest of this chapter giving a broad overview of possible solutions for the municipal debt problem as well as their respective main objective. In the following, a few selected examples of the measures displayed in Figure 11 will be considered.

2.3 *Preventative measures*

2.3.1 Preventing future debts by improving the financial basis of municipalities

2.3.1.1 Abiding by the principle of connexity

As explained in Chapter III.2.2 one of the main factors causing the municipal debt problem is the discrepancy between increasing responsibilities on the one hand and financial (in)capability on the other. Hence, unsurprisingly, all of the interviewees agreed:

> "There should not be any more violations of the principle of connexity"(EEI3).

For this purpose it would be necessary to make the true cost structure of the assigned tasks more transparent. For every public service the municipalities have to deliver general standards should be agreed upon. Thus, conflicts about the adequate level of financial support given by the superordinate government

for the provision of a certain public good or service could be settled before they occur.

> "If, however, a community decides to provide a higher standard it should pay for the additional costs by itself" (AIE_5).

In addition to that the state government should resist the temptation to disburden its own budget by shifting costs to the local level.

2.3.1.2 Fiscal reforms leading to more stable revenues

A detailed discussion of the fiscal reforms necessary to stabilise municipal finances would go far beyond the scope of this thesis. However, since all the experts agreed:

> "Without a reasonable fiscal reform restructuring the financial relations from the federal to the state and local level our situation is hopeless" (AIE_3),

the two main points raised during the interviews shall be presented: firstly, "[...] it is absolutely vital that federal and state governments keep in mind the consequences for the local governments whenever they change laws" (PIE_2). In other words, if decisions made by a superordinate government have a negative effect on the finances of the local level, adequate compensations should be made.

Secondly, the experts were concerned about the growing inequalities between municipalities.

> "Since we cannot force businesses to move to Dortmund or Essen if they prefer to be in Munich, we have to find some other way to make up for the growing structural differences between communities" (AIE_3).

For this purpose, the experts supported the idea of a horizontal municipal equalisation scheme:

> "The equalization scheme should be expanded to the local level. Cities like Düsseldorf should help structurally weak cities" (AIE_7).

Or alternatively, an adjustment of the existing equalisation scheme taking the problematic socio-economic position of certain communities better into account:

> "Grants should be raised for cities like Dortmund that have been heavily hit by the undesirable developments of the labour market and hence have much higher expenditures for social welfare" (AIE_4).

Since, the communities are, indeed, "at the bottom of the fiscal food chain" (AIE_2) as one expert put it, both the federal and state governments should reassess the fiscal regulation framework in order to determine, whether it is still suited to the ever-increasing responsibilities of the local level.

2.3.2 Preventing future debts by improving the incentive structure

2.3.2.1 Introducing a municipal insolvency law – pros, cons, feasibility

If the communities of the Memorandum Group were private businesses they would have to declare bankruptcy in case of overindebtedness. As explained in Chapter IV.2.5.3, this is not possible for municipalities. As a consequence creditor and debtor moral hazard occur, leading to overborrowing. Therefore, the question arises, whether an insolvency law for municipalities should be introduced. Even though the fact that "[...] public institutions cannot go bankrupt is a sanctum, a holy cow that is absolutely untouchable" (Borchert 2004, 3), the implications of a municipal insolvency shall be briefly discussed.

On the one hand, it would create an incentive for local governments not to accumulate debts because this would negatively affect their ratings on the credit market. In order to get low-priced loans for investments spending would have to be curbed, but local fiscal discipline would be rewarded. What is more, the state governments cannot count on the municipality's piling up debts anymore when attempting to relieve their own budgets by shifting costs to the lower level. Thus the possibility of municipal insolvency would most probably also discipline the superordinate government.

On the other hand, interest rates would explode. Not only would it generally become more expensive to get loans for necessary investments – which could lead to underprovision of public goods as opposed to the current over-

provision[33] –, it would also extremely aggravate the financial situation of the financially stricken local governments. With the debt service becoming ever more expensive, it would probably precipitate (if not provoke) municipal bankruptcies in theses cases. As one of the experts put it:

> "Even more cities would be endangered of falling into the futility trap than under current conditions" (EE_2).

Moreover, local governments have limited influence their own revenues. Even if the tax autonomy were to be increased, the following problem would remain:

> "Many public services cannot be provided in a cost-covering way because the citizens cannot be asked to pay the full price. At cost-covering price a passport would become a luxury item" (EEI_3).

This means, cities and towns with lower tax revenues – due to a problematic social or economic structure for instance – are even further disadvantaged because the credit rating would not reflect their efforts or degree of responsibility in financial matters.

In addition to that, it is argued that municipalities and businesses cannot be compared at all. For one, many assets of a town – roads, schools, etc. cannot simply be sold to satisfy the creditors. Moreover, businesses can react much more quickly to changes in their environment. For example, they can lay off staff very quickly. Municipalities cannot. Nor can they simply move their business to a more favourable location or quickly rid themselves of costly and unsustainable infrastructure. Many consolidation measures take a few years to take effect. In short: "A town is not a business and, therefore, cannot be treated by the law as such" (EE_5).

Hence, even though the idea of a municipal insolvency sounds good on paper, in practice this mechanism would probably not work. It cannot be considered a viable solution for the municipal debt problem.

[33] For more detail refer to Besfamille and Lockwood 2008. They argue that insensibly hard budget constraints could be just as inefficient as soft budget constraints.

2.3.2.2 Implementing an Early Warning System (EWS)

Some external experts suggested implementation of an Early Warning System, a set of different benchmarks and indicators to assess the financial situation of a community. At the moment, this instrument is successfully utilised in the states of Saxony and Mecklenburg-Western Pomerania. The following comment by one of the internal experts was meant to prove that the Solidarity Pact II is becoming obsolete, if not absurd:

> "The East German city of Leipzig which can be compared to Dortmund in terms of population, etc. has pretty stable finances" (AIE_4)

However, one of the external experts explained this phenomenon as follows:

> "If we compare the financial situation of Saxony and North Rhine-Westphalia it becomes clear that Saxony (where investment activities and debt levels are closely monitored with the help of an early warning system) has managed to reduce its debts while NRW's debts have significantly risen" (EE_2).

In Saxony problematic situations are being detected much earlier, communicated more openly and, hence, can be solved more quickly. Thus, the worst debt trouble can be averted and municipal scope of action preserved. In other words, the EWS creates transparency, which in return creates a sense of urgency to act upon the problem (Duve 2010). Hence, it would be recommended for the state of North Rhine-Westphalia to implement such an instrument in order to prevent future debts.

2.3.2.3 Creating an independent supervisory authority

Since the great entanglement of the lower levels of the Local Supervisory Authority with the local politicians has significantly contributed to the municipal debt problem, a truly independent supervising authority should be created. It could also be part of the EWS described above, its role consisting in monitoring investment activities and to put a cap on investment loans; thusly pressuring the communities to spend prudently and operate efficiently.

The adoption of the New Municipal Financial Management by all the North Rhine-Westphalian communities by January 2010 is one important step into the right direction. Since this accounting system allows for more transparency and comparability, the supervisory authority would now be much better able to obtain the information necessary for it to function effectively.

2.4 *Debt consolidation measures*

While preventative measures are intended to prohibit the accumulation of debts in the future, consolidation measures are aimed at the reduction of already existing debts. Again, there are measures targeting the structural financial weaknesses of the communities, and measures seeking to improve the incentive structures leading to systemic overborrowing.

2.4.1 Consolidating debts by improving the municipalities' financial situation

2.4.1.1 Employing a Savings Commissioner

According to §124 of the North Rhine-Westphalian Municipal Code, the state government has the option to delegate an external expert to overindebted communities. The so-called '*State Commissioners*' (Staatskommissare) effectively substitute the mayor and/or the municipal council. They are authorised to make all the necessary financial decisions for the community (even against the will of the local executives) in order to consolidate the budget. However, this is an instrument of last resort and has never been utilised, yet. Instead, '*Savings Commissioners*' (Sparkommissare) are sometimes employed – for example in the town of Hagen. They merely have a consultative function and the communities cooperate on a voluntary basis (Holtkamp 2009).

The advantage is that local executives willing to make cuts can use the recommendations of an external consultant as a lever to convince other local executives and citizens of the necessity of certain consolidation measures. But since the Savings Commissioners do not have any authority to sanction deviations from their recommendations, success depends on the individual case. This is illustrated by the following quote:

> "Often there is no acceptance and no support on the part of the municipality for this kind of intervention. Information is held back or only hesitantly given which severely compromises pace and effectiveness of the Savings Commissioner's work" (EE_2).

Considering this statement, it is not surprising that several interviewees remarked:

> "I haven't heard of a single case where they [the Savings Commissioners] could actually make ends meet" (AIE_3).

The problem is that in highly indebted communities making additional expenditure cutbacks is rarely more than a good start to solve the debt problem. Consider the following case:

> "The Savings Commissioner stayed for 3.5 years and he really had been given free reign to do what he thought fit. Yet, in the end all these measures were – well, not in vain because the situation did improve a bit – but they did not solve the town's debt problem" (EE_5).

Therefore, the delegation of a Savings Commissioner alone is but a blunt instrument and no convincing solution for the municipal debt problem – which is probably also the reason why it is rarely ever employed.

2.4.1.2 Providing a (partial) bailout

Many internal experts were of the opinion that "the state government has to take responsibility for the violations of the principle of connexity in the past by relieving us now of our debts or granting us some other kind of compensation" (AIE_4). Even though the state government is partially responsible for the municipal debt problem, there are several factors which make a bailout (even a partial one) problematic and not commendable as the state government's final move in the bailout game. As the following quote shows, the internal experts are well aware of this:

> "A complete bailout in the shape of special transfers or the full assumption of debts by the state government would be the best solution for us, but it would

> probably entail a lot of trouble. Because then all the cities without debts would be upset that they don't get any money" (AIE_4).

This expert is speaking of the fact that municipalities which have operated economically and made all the painful cutbacks would in some way be punished for solving the difficulties on their own, if the cities and towns which (potentially) shirked expenditure reductions get bailed out by the state or federal government. What is more, this proceeding may have extremely negative effects on the incentives for individual savings efforts and timely adaptation to fiscal shocks in the future – and not only for the communities that are currently in debt trouble. Other communities might be incentivised to follow their lead.

Apart from this, one of the external experts remarked that the financial situation of the superordinate governments is not substantially better. While the state of North Rhine-Westphalia incurred new debts worth €1.1 billion in 2008, this figure skyrocketed to €6.6 billion in 2010 (Linssen 2010). What is more, as explained in section 1 the state's borrowing capacity will be restricted in the near future:

> "Technically the federal and state governments still have the right to incur more debts, but only until 2016 and respectively 2020, when the debt brake comes into force; and, of course, if everyone has too little, motivation to share is low" (EE_6).

And motivation is even further reduced, if the lasting effect of a bailout is doubtful. As one of the experts pointed out:

> "You want to make sure that debt levels don't start to rise again immediately after a bailout. It is not enough to just pour money into the ailing cities and towns"(EE_5).

How can this be achieved?

2.4.2 Consolidating debts by improving the incentive structure

2.4.2.1 Providing a conditional bailout – the debt reduction fund

A conditional bailout combines the improvement of local finances through aid from the superordinate government with strong incentives for individual con-

solidation efforts on the part of the communities. The majority of the experts favoured one such measure, namely a *debt reduction fund* (Entschuldungsfonds).

Again, there is a danger to disincentivise future fiscal discipline both on the part of participating and non-participating communities. However, this can be avoided if the debt reduction fund is well-designed. Not only should the aid be conditional on verifiable efforts on the part of the community, the existence of sanction measures and a credible commitment to make use of them is indispensable. In addition to this, the aid should be restricted to a limited period of time only (Schmidt 2010, 22).

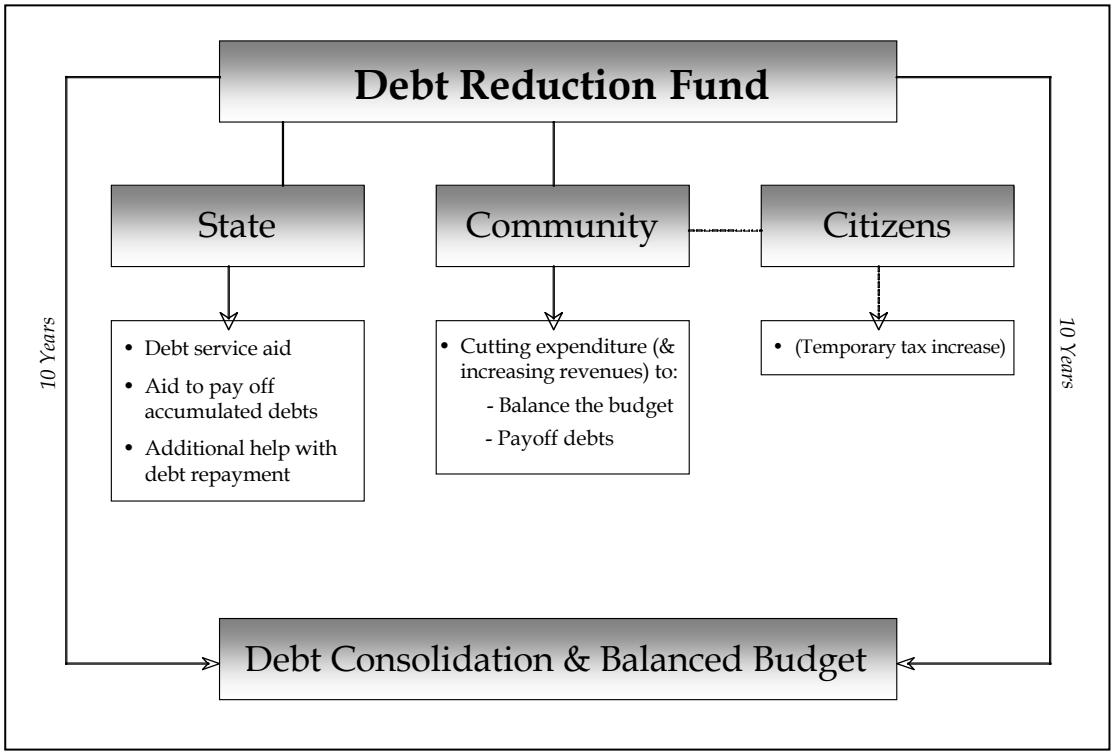
The idea of the debt reduction fund advocated by the Memorandum Group is for the state government to establish a fund into which the participating communities transfer for ten years all the ways and means advances accumulated in the past. In a first step, the state relieves the communities of the interest payments, so as to give them back a certain scope of action. As from the second year, the resources thusly released must be utilised strictly for budget consolidation. Secondly, the state government provides aid to pay off the ways and means advances by assuming liability for four percent of total borrowing[34] (about €800 million) per annum. Thus, when the debt reduction fund phases out after ten years, 40 percent of these loans will be amortised. Thirdly, additional aid with the repayment of existing debts will be granted to the communities: for every Euro they pay off, the state government adds another one. This is to incentivise individual efforts for a swift reduction of ways and means advances.

All the measures described are conditional on significant budget consolidation measures on the part of the communities – expenditure cuts and/or a temporary property tax hike[35]. Figure 12 summarises these different pillars of the debt reduction fund.

Figure 12: The concept of the Debt Reduction Fund

[34] In the year of reference, e.g. 2011.

[35] While the former will be required in any case, the latter is an instrument of last resort. Only communities that are unable to achieve a balanced budget with the help of cutbacks will need to raise taxes.



SOURCE: MODIFIED AFTER DIE STÄDTE DES RUHRGEBIETES UND DES BERGISCHEN LANDES 2009, 4 & 6.

Should a community attempt to avoid these adaptation measures, the aid provided by the state government will be reduced immediately. In case of repeated misconduct, it will be completely cancelled. Should a community not be able to balance their budget, an external entity will investigate the case and, possibly allow for an adjustment period of five years maximum. To further incentivise municipal efforts, every community shall have an individual account with their respective amount of debts within the fund. That means, for every community the financial transactions carried out during the 10-year period are registered. When the debt reduction fund phases out, the remaining debts will be transferred back to the owner.

In sum: the debt reduction fund is a very comprehensive instrument improving the financial situation of the communities while simultaneously incentivising individual consolidation efforts. What is more, all the actors which contributed to the development of the municipal debt problem would be involved in its solution. While the state government may be more cautious in the future

concerning violations of the principle of connexity, citizens might understand that growing demands for social welfare cannot be met without consequences for tax levels. Since they will not be too keen to bear the proposed temporary tax hike, they will probably impose more pressure on the local government to adjust to fiscal shocks in the future.

2.4.2.2 Creating awareness among citizens

Overall, the citizen's role in the consolidation process was neglected by more than 2/3 of the internal experts, while their lack of understanding has been mentioned by most of the interviewees as posing heavy constraints on efforts to keep the budget in balance as well as to consolidate debts. Nevertheless, some of them pointed out:

> "It is time to tell the people the plain truth: that we cannot uphold this high level of welfare anymore, that certain services cannot be offered anymore and that there will be cutbacks in the future" (EE_5).

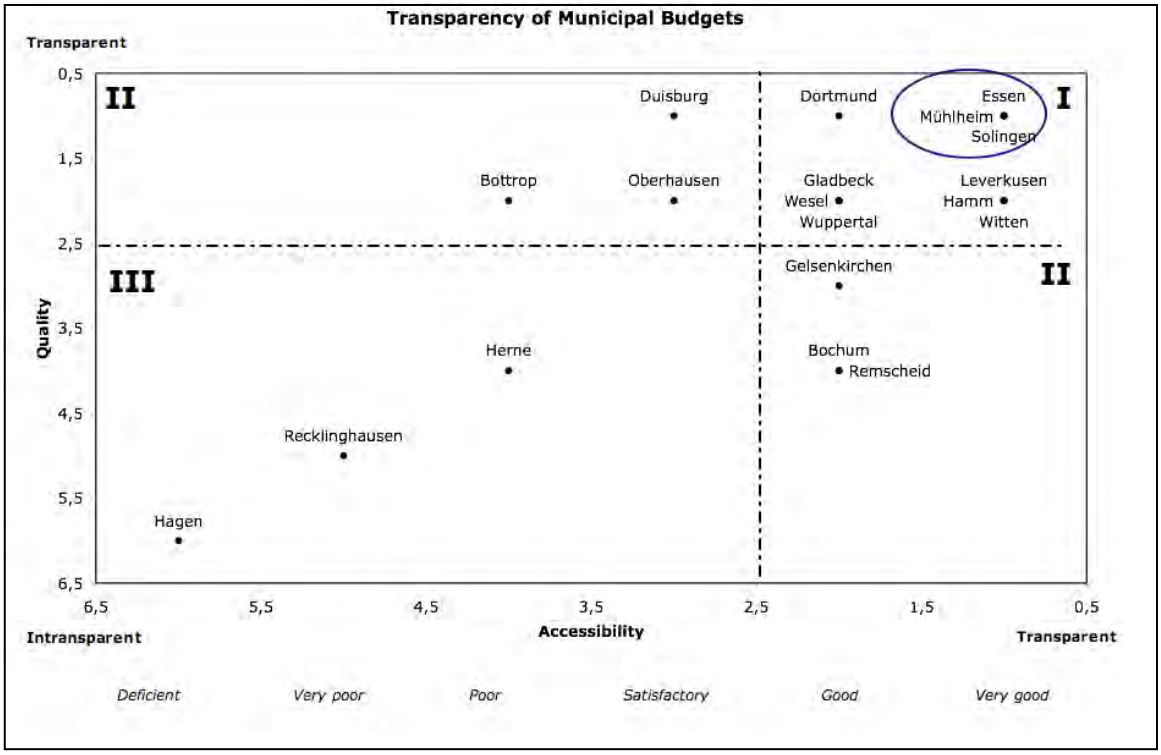
Very often, citizens are simply unaware how much a theatre ticket or the entrance fee for the zoo is subsidised by the town. Hence, it is not surprising if their demands increase without limit. As one expert put it:

> "Understanding is a question of awareness. That's why we are trying to explain to the people that we *have* to make these cutbacks. We have to make them see that it is absolutely essential for us not to lose the last scope of action" (AIE_8).

In order to accomplish this kind of awareness, the municipal budget needs to be made more transparent and accessible to laypersons. Figure 13 shows the level of transparency achieved by the communities of the Memorandum Group (as measured by the online accessibility of municipal financial data and the quality thereof).[36]

Figure 13: Accessibility and quality of municipal budgetary data

[36] For further details on this small self-experiment refer to the appendix page VII.



SOURCE: OWN ANALYSIS

According to Haubner (2008), public disclosure of the municipal budget can lead to more acceptance of unpopular proposals and enhance identification of the citizens with their town. Moreover, the dialog with the citizens can serve as a guideline for decision-makers in understanding a) which products and services they need and desire, and b) which of those they value most.

While it is positive that the data provided by 10 of the 19 communities were good or better on both the dimensions (group I ≈ 53%) – six failed in one of the two dimensions (group II ≈ 31%) and three failed altogether (group III ≈ 16%) – there is still room for improvement. What is more, only three of the top-ranking communities have a participatory element, allowing for citizens to actively contribute in budgetary processes (Essen, Mühlheim, and Solingen). The so-called 'Bürgerhaushalt' or *participatory budget* recommended by Holtkamp (2000, 2001a, 2001b) is, thus, far from being a reality. Further improvement would be desirable.

2.5 *Recommendations to the state government*

Which final move should the state government make in the bailout game? Or alternatively: *'What can be done to break through dysfunctional incentive structures and sustainably solve the municipal debt problem'?* Due to its complexity and certain trade-offs between different measures aiming to solve it, there can be no singular patent remedy for the municipal debt problem.

Therefore, the state government should introduce a whole set of different measures aiming to simultaneously accomplish the four objectives displayed in Figure 11,

1) Consolidation of existing debts,

2) Prevention of future debts,

3) Improvement of the financial basis, and

4) Improving the incentive structure.

Special attention should be paid to No.4, in order to ensure fiscal prudence and consolidation efforts on the part of the communities.

Firstly, the state government should target the worst effects of the municipal debt problem and implement a debt reduction fund as proposed by the Memorandum Group. This will improve the communities' financial situation by giving them back some scope of action through debt service aid, measures to partially relieve them of existing debts and assistance in paying off debts on their own. Since the provision of aid is conditional on the individual community's consolidation efforts, the emergence of dysfunctional incentives is minimised. Hence, this measure mainly fulfils the objectives No. 1, 3, and 4.

Secondly, the state government should target the structural financial weakness of the communities by permanently improving the financial basis of the communities, for example through avoiding future violations of the principle of connexity. General standards for the provision of every public good or service delivered by local governments as well as the adequate financial contribution provided by the state government should be agreed upon (and regularly re-evaluated). This measure is mainly intended to fulfil the objective No.2 and 3.

Thirdly, the state government should target the disincentives created by the lack of transparency and monitoring in order to incentivise the communities

to economise and operate efficiently in the future. For this purpose, an independent supervisory authority should be created, which closely monitors the investment activities of the communities, for instance with the help of an Early Warning System. Furthermore, citizens should not only be made aware of the true costs of the public goods and services they claim, but also given a chance to participate in budgetary processes. These measures are mainly intended to fulfil the objectives No. 2 and 4.

Finally, strategies to solve the municipal debt problem should not only target all the dimensions of its origin, it is also essential that all the actors involved – federal, state and local governments (and to a certain extent even citizens) – recognise the situation as their joint responsibility, credibly commit and begin to act in concert. Only then can behavioural dilemmas and collective action problems be avoided and the municipal debt problem sustainably solved.

VI. What needs to be done to solve the municipal debt problem? – Concluding remarks

This thesis has discussed the causes, consequences and potential measures to solve the municipal debt problem. The analysis of the situation currently faced by 19 highly-indebted North Rhine-Westphalian communities showed that a fatal interplay of both exogenous and endogenous factors has led to the municipal debt problem. Due to its complexity no singular patent remedy could be delivered. However, the findings of this thesis seem to speak in favour of a holistic approach taking both structural and behavioural factors into account.

In any attempt to solve the municipal debt problem, several different instruments should be employed, simultaneously targeting the consolidation of existing debts, the prevention of future debts, and the improvement of the communities' financial basis. When choosing potential measures, their prospective impact on the incentive structures of local actors should be invariably heeded, as certain trade-offs exist. Measures incentivising local actors to operate cost-efficiently, make consolidation efforts and avoid unsustainable debts in the future should be an integral part of any strategy to solve the municipal debt problem.

Furthermore, all the actors involved in the development of the municipal debt problem should be made part of its solution. It is crucial that federal, state and local governments recognise the situation as their joint responsibility and begin to act in concert. Also, the role of the citizens should not be neglected. If awareness levels are raised and possibilities for civic participation provided, chances are that some of the responsibility formerly carried by the state will be readily assumed by civil society. This would not only disburden municipal budgets, but also considerably empower citizens and strengthen the democratic political culture in Germany.

BIBLIOGRAPHY

Aggarwal, V.K., 1996. Debt Games: Strategic Interaction in International Debt Rescheduling, Cambridge: Cambridge University Press.

Baranowski, F., 2010. Sparen – aber wo noch? Kolumne von Oberbürgermeister Frank Baranowski, Gelsen-kirchen.

Berry, C., 2010. Piling on: Multi-Level Government and the Fiscal Common-Pool. American Journal of Political Science, 52(4), 802-820.

Besfamille, M. & Lockwood, B., 2008. Bailouts in Federations: is a Hard Budget Constraint Always Best? International Economic Review, 49(2), 577–593.

Bogner, A., Littig, B.,Menz, W., 2005. Das Experteninterview. Theorie, Methode, Anwendung, Wiesbaden.

Borchert, H., 2004. Beschränkte Insolvenzfähigkeit für Kommunen? KGSt INFO, 10.

Buchhorn, R., 2009. Haushaltsrede Oberbürgermeister Reinhard Buchhorn zur Einbringung des Haushaltsplanentwurfs für das Jahr 2010, Leverkusen.

Bundesland Nordrhein-Westfalen, 2009. Protokoll der Anhörung im Landtagsausschuss für kommunalpolitik und Verwaltungsstrukturreform am 21.01.2009.

Die Städte des Ruhrgebietes und des Bergischen Landes, 2001. Memorandum zur Reform des Gemeindefinanzsystems.

Die Städte des Ruhrgebietes und des Bergischen Landes, 2002. 2. Memorandum: Verantwortung für die Zukunft unserer Städte – Forderungen der Ruhrgebietsstädte zur Gemeindefinanzreform.

Die Städte des Ruhrgebietes und des Bergischen Landes, 2006. 3. Memorandum: Finanzielle Zukunftsfähigkeit der Städte sichern – Forderungen der Städte des Ruhrgebietes und des Bergischen Landes zur Gemeindefinanzreform.

Die Städte des Ruhrgebietes und des Bergischen Landes, 2008. 4. Memorandum: Wege aus der Schuldenfalle - Forderungen der Städte des Ruhrgebiets und des Bergischen Landes zur Gemeindefinanzpolitik.

Die Städte des Ruhrgebietes und des Bergischen Landes, 2009. Aktionsbündnis: Raus aus den Schulden! – Vorschläge für eine nachhaltige Lösung des kommunalen Altschuldenproblems und der Unterfinanzierung der Kommunen in Nordrhein-Westfalen.

Duve, T., 2010. Kommunale Verschuldung und Ansätze zu ihrer Prävention. Informationen AWV, 56(1).

Edling, H., 1995. Non-tax Revenue of Subnational Governments: Theoretical Background, Experience from the International Perspective and Recommendations, Osnabrück.

Feld, L.P. & Baskaran, T., 2009. Federalism Commission II Recent Reforms of Federal-Länder Financial Relationships in Germany, Heidelberg.

Fischer, E. & Gnädinger, M., 2009. Generationengerechte Haushaltswirtschaft. Schuldenverbot, HGrGMoG und Ergebnisausgleich. Verwaltung & Management. Zeitschrift für moderne Verwaltung, 15(6), 283-292.

Gup, B.E., 2004. Too Big to Fail: Policies and Practices in Government Bailouts, Westport, CT: Greenwood Publishing Group.

Hagen, J.V. et al., 2000. Subnational Government Bailouts in OECD Countries: Four Case Studies. RES Working Papers, (No. R-399).

Haubner, O., 2008. Der Bürgerhaushalt – Den Bürgern den Haushalt transparent machen, Gütersloh: Bertelsmann Stiftung.

Haug, F. & Weeke, R., 2008. Etatreden zur Einbringung des Haushaltsplanentwurfes für den Doppelhaushalt 2009/2010, Solingen: Stadt Solingen.
Hayek, F.A., 1945, The Use of Knowledge in Society, American Economic Review, 35, 519-30.

Heppke-Falk, K.H. & Wolff, G.B., 2007. Moral Hazard and Bailout in Fiscal Federations: Evidence for the Ger-man Länder, Bonn, Pittsburgh.

Hindmoor, A., 2006. Rational Choice, Hampshire, New York: Palgrave Macmillan.

Holtkamp, L., 2000. Bürgerbeteiligung in Städten und Gemeinden – Praxisleitfaden für die Bürgerkommune, Berlin.

Holtkamp, L., 2001a. Der Bürgerhaushalt – Ein Konzept für Klein und Groß und Arm und Reich? in: Der Gemeindehaushalt, 5/, 104-107.

Holtkamp, L., 2001b. Kommunale Beteiligung an Entscheidungsprozessen der. Bundesländer, in: Zeitschrift für Parlamentsfragen, 1/, 19-32.

Holtkamp, L., 2009, Governance-Konzepte in der Haushaltskrise: Eine Analyse am Beispiel der beratenden Sparkommissare, in: Verwaltung und Management, 15(3), 146-159.

Innenministerium des Landes Nordrhein-Westfalen, 2009. Kommunalfinanzbericht September 2009.

Jungfer, K., 2005. Die Stadt in der Krise. Ein Manifest für starke Kommunen. Bundeszentrale für politische Bildung. Bonn.

Junkernheinrich, M., 2007a. Stellungnahme zur Öffentlichen Anhörung der Kommission von Bundestag und Bundesrat zur Modernisierung der Bund-Länder-Finanzbeziehungen Gliederung 1 Vorbemerkung, Münster.

Junkernheinrich, M., Micosatt, G. & Boettcher, F., 2007b. Kommunaler Schuldenreport Nordrhein-Westfalen. Bertelsmann.

Junkernheinrich, M., Micosatt, G. & Gnädinger, M., 2008a. Kommunaler Finanz- und Schuldenreport Deutschland 2008. Ein Ländervergleich.

Junkernheinrich, M. & Boettcher, F., 2008b. Gemeindefinanzpolitik, Bertelsmann Stiftung.

Junkernheinrich, M., Micosatt, G. & Gnädinger, M., 2009. Kommunalstrukturen in Deutschland – Eine Analyse zur länderübergreifenden Vergleichbarkeit kommunaler Finanzkennzahlen.

Junkernheinrich, M., Boettcher, F. & Micosatt, G., 2010. Kommunaler Finanz- und Schuldenreport Nordrhein-Westfalen.

Landtag Nordrhein-Westfalen, 2006. Antwort der Landesregierung auf die Kleine Anfrage 674 des Abgeordneten Horst Becker, Düsseldorf.

Langner, P., 2010. Einbringung des Haushaltsentwurfs 2010 in den Rat der Stadt Duisburg am 25.01.2010 Etatrede von Herrn Stadtkämmerer Dr. Langner, Duisburg.

Linssen, H., 2010. Perspektiven der Kommunalfinanzen aus Sicht der Landesregierung. Fachtagung 'Wege aus der Kommunalverschuldung' des Aktionsbündnisses 'Raus aus den Schulden' am 19 . Februar 2010 in Essen.

McAvoy, G.E., 1999. Controlling Technocracy: Citizen Rationality and the Nimby Syndrome, Georgetown University Press.

Meuser, M., Nagel, U. (1991): ExpertInneninterviews – vielfach erprobt, wenig bedacht. Ein Beitrag zur qualitativen Methodendiskussion, in: Garz, Detlef/ Kraimer, Klaus (Hrsg.): Qualitativ-empirische Sozialforschung. Konzepte, Methoden, Analysen Opladen, 441-471.

Micosatt, G., 2009. Hinweise zur Nutzung kommunaler Haushaltsdaten, Gütersloh: Bertelsmann Stiftung.

Müller, U., 1998. Finanzen der Kommunen – schwierig, aber nicht hoffnungslos. Kommunen können ihre Finanzen aus eigener Kraft konsolidieren.

Niederste Frielinghaus, St. (2007) Die kommunale Insolvenz als Sanierungsansatz für die öffentlichen Finanzen, Richard Boorberg Verlag, Stuttgart.

Qian, Y. & Weingast, B.R., 1997. Federalism as a Commitment to Perserving Market Incentives. The Journal of Economic Perspectives, 11(4), 83–92.

Ridder, H., Bruns, H. & Spier, F., 2005. Analysis of Public Management Change Processes: The Case of Local Government Accounting Reforms in Germany. Public Administration, 83(2), 443-472.

Rodden, J., 2000. Breaking the Golden Rule: Fiscal Behavior with Rational Bailout Expectations in the German State. In Workshop European Fiscal Federalism in Comparative Perspective. Cambridge, 1-36.

Rodden, J., 2001. And the Last Shall be First: Federalism and Fiscal Outcomes in Germany, Cambridge.

Rodden, J., 2002. The Dilemma of Fiscal Federalism: Grants and Fiscal Performance around the World. Political Science, 46(3), 670-687.

Rodden, J., 2004. On the Migration of Sovereignty. Political Science, 37(3), 427-431.

Rodden, J., 2009. Fiscal Discipline in Federations in the Aftermath of the 2008 Financial Crisis: Can Market Discipline Survive in the USA and EMU ? Insolvency Risk in Federations : The EMU in Comparative.

Sarcinelli, U. , Stopper, J., 2006. Demographischer Wandel und Kommunalpolitik in. Kommunen im Wandel. Aus Politik und Zeitgeschichte, (21-22), 3-9.

Schmidt, C.M., 2010. Vorrang für eine solide Haushaltspolitik. In Wege aus der Kommunalverschuldung – Fachtagung des Aktionsbündnisses "Raus aus den Schulden" 19. Februar 2010. Essen.Seitz, H., 1999. Subnational Government Bailouts in Germany, Bonn.

Schwarcz, S.L., 2002. Global decentralization and the subnational debt problem. Duke University School of Law, 51(4), 1179-1250.

Seitz, H., 2000. Fiscal Policy, Deficits and Politics of Subnational Governments: The Case of the German Länder. Public Choice, 102, 183-218.

Singh, R. & Plekhanov, A., 2005. How should subnational government borrowing be regulated? Some cross-country empirical evidence, International Monetary Fund.

Tiebout, C. ,1956. A Pure Theory of Local Expenditures. Journal of Political Economy, 64, 416-24.

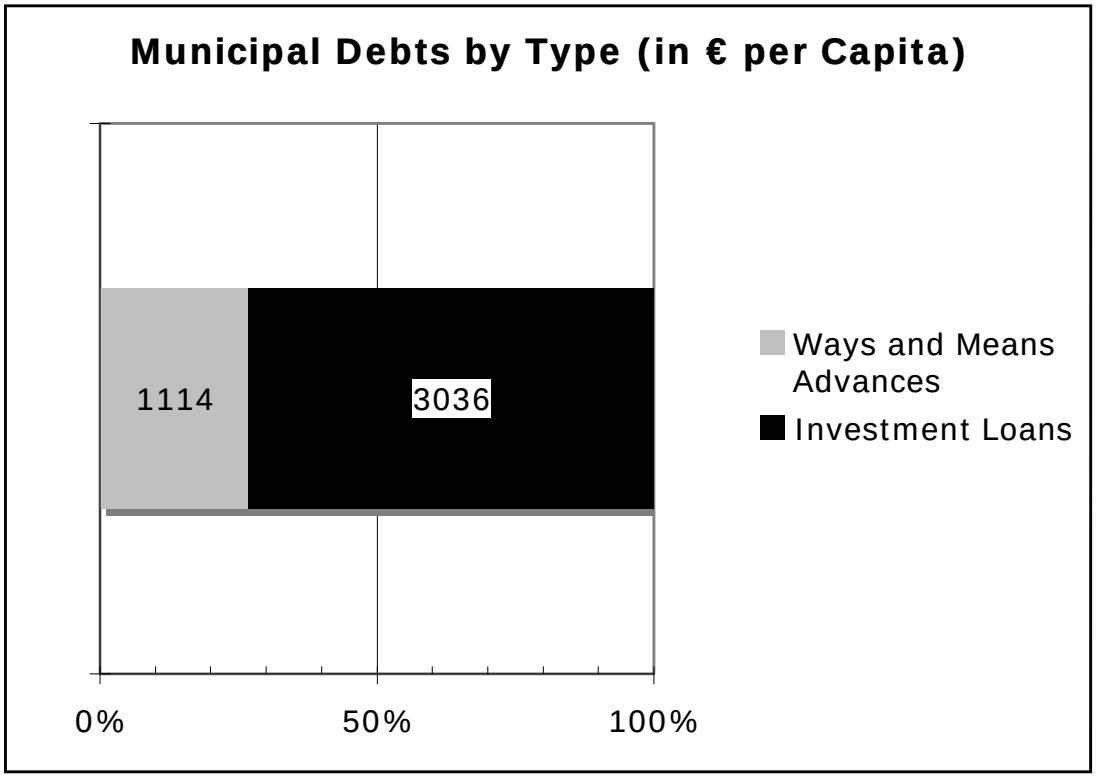
Tischler, B., 2009. Rede des Oberbürgermeisters Bernd Tischler anlässlich der Einbringung des Entwurfes der Haushaltssatzung 2010 mit ihren Anlagen in der Sitzung des Rates der Stadt, Bottrop.

Weingast, B., Shepsle, K., Johnson, C. 1981. The Political Ecnomy of Benefits and Costs: A Neoclassical Approach to Distributive Politics. Journal of Political Economy 89(4): 642-64.

Wildasin, D.E., 1999. Externalities and Bailouts: Hard and Soft Budget Constraints in Series 1843, Intergovernmental Fiscal Relations, World Bank, Policy Research Working Paper 12.

APPENDIX

Supplement 1: Proportion of municipal debts by type



SOURCE: MODIFIED AFTER BOETTCHER ET AL. 2010, 105.

Supplement 2: Causes of the municipal debt problem by number of mentions*

	Exogenous Factors				Side Effects	Exogenous Factors			Endogenous Factors	
City / Town	**Financial Crisis**	**No Con-nexity**	**Soc. Wel-fare costs ↑**	**Solidarity Pact II**	**Debt Service**	**Unreliable revenues**	**Econ. Structure**	**Social Structure**	**Local Misma-nagement**	**NLFM**
Bochum	•	•	•	•		•	•			
Bottrop	•	•	•	•	•	•				
Dortmund	•	•			•		•			
Duisburg	•	•		•	•	•		•	•	
Essen	•	•	•	•	•	•	•	•	•	
Gelsenkirchen	•	•	•			•				
Gladbeck	•	•	•	•	•		•	•		
Hagen	•	•	•	•	•			•		
Hamm	•	•	•	•		•	•			
Herne	•	•	•	•				•		•
Leverkusen	•	•	•							
Mühlheim a.d. Ruhr	•	•		•	•					
Oberhausen	•	•	•	•	•					
Recklinghausen	•	•	•	•			•	•		
Remscheid	•	•	•	•						
Solingen	•	•	•	•	•				•	
Wesel	•	•	•	•					•	
Witten	•	•	•	•	•	•			•	
Wuppertal	•	•	•	•	•	•	•	•		
Number of Mentions	**19**	**19**	**16**	**16**	**10**	**8**	**7**	**7**	**5**	**1**

*** in expert interviews (AIE_{1-8}; PIE_{1-3}) and e-mails with representatives of the municipalities**

SOURCE: OWN ANALYSIS

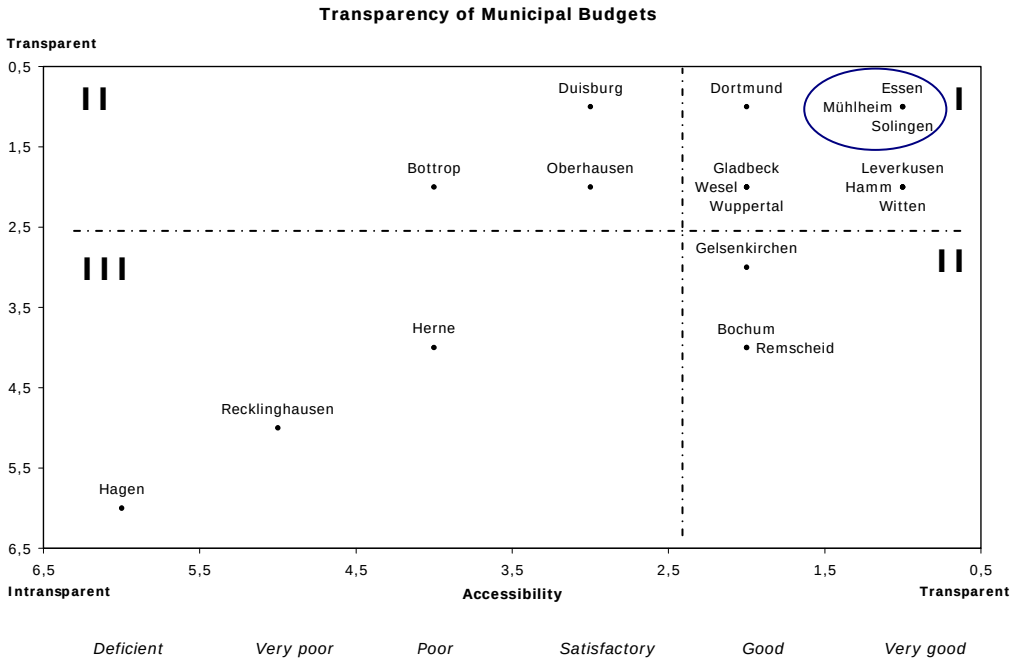
Supplement 3: Solutions for the municipal debt problem by category and number of mentions*

	Structural Reforms				(Partial) Bailout			Measures on the part of the municipality		Other
City / Town	Connexity	End of (old) Solidarity Pact II	Reliable revenues	Municipal equilisation	Debt reduction fund	Individual debt relief	Complete bailout	Individual saving efforts ↑	Creating awareness among citizens	Economic revival
Bochum	•	•	•		•					
Bottrop	•	•	•		•			•		
Dortmund	•		•	•			(•)	•		
Duisburg	•	•		•	•			•		•
Essen	•	•	•	•				•		
Gelsenkirchen	•		•		•					•
Gladbeck	•	•	•			•			•	
Hagen	•	•			•					
Hamm	•	•	•	•	•					•
Herne	•	•			•					
Leverkusen	•		•		•			•		
Mühlheim a.d. Ruhr	•	•	•	•	•			•	•	
Oberhausen	•	•	•	•	•					
Recklinghausen	•	•	•	•	•				•	
Remscheid	•	•			•			•		
Solingen	•	•	•		•			•	•	
Wesel	•	•						•	•	
Witten	•	•	•		•			•	•	
Wuppertal	•	•	•	•	•			•		
Mentions	19	16	15	8	15	1	1	11	6	3

*** in expert interviews (AIE_{1-8}; PIE_{1-3}) and e-mails with representatives of the municipalities**

SOURCE: OWN ANALYSIS

Supplement 4: Accessibility and Quality of Municipal Budgets – A Transparency Study



	"Access to financial data"	"Quality of financial data"
1 **Very good**	**1-2 clicks "instant access"** (e.g. Finanzen → Haushaltsplanung)	**5 or more useful* documents + participatory element**
2 **Good**	**3-4 clicks** in logical sequence or less clicks in less straight forward sequence	**3-4 useful documents** on current and last year's budget
3 **Satisfactory**	**5-6 clicks** in logical sequence or 3-4 clicks in less straight forward sequence	**1-2 useful documents**, i.e. more detail desirable
4 **Poor**	**7 and more clicks** or 5-6 clicks in less straight forward sequence	**3 or more useless** documents** i.e. less (technical) detail desirable
5 **Very poor**	**Search function only**, time-consuming process of clicking through various unrelated hits	**1 useless document**, e.g. full-length budget report only
6 **deficient**	**No information** online	**No information** online

* clear information for laypersons, e.g. non-technical executive summary, reports on current budget and budget of past years, speeches/statements of different stakeholders, etc.
**intransparent, technical data, e.g. full-length budget report of several hundred pages, without comments or explanations for laypersons

SOURCE: OWN ANALYSIS