Berlin's hangover: a € 61 billion city debt

With no federal bailout possible, Germany's capital looks for ways to save.

BY *KAREN HORN*

The court decision not to bail out Berlin "reminds me of the famous metaphor of the shipwrecked person: we all sit in the lifeboat, and a steamship comes by. We wave, but the steamship pursues its course. Now after that, it would be wrong not to try and row the lifeboat to the shore. Even if there is little hope, that's the only chance we have."
– Thilo Sarrazin, Berlin's Social Democratic finance minister

Photo: Kay Schmedes for Deutsche Oper Berlin

Opera is subsidized by the city of Berlin. Silja Schindler and Jean-Luc Chaignaud perform a modern version of Richard Strauss's Arabella at the Deutsche Oper Berlin, to be presented in March.

When the German Constitutional Court refused to order the federal government to bail out Berlin from its accumulated debt of 61 billion euros ($79 billion U.S.), the city was left to its own devices to dig itself out of this massive debt.

The court decision, rendered in October 2006, will have implications for years to come. Most of Berlin's debt, equivalent to more than three times the city's current annual budget, was created after Germany was reunited in 1990. At the start of the 1990s, Berlin – also one of the 16 *Länder*, or states that make up the country – had a manageable debt of 10.8 billion euros ($14 billion U.S.). At that time, Berlin received almost 10 billion euros in aid from the federal government and the EU. By 1995, that amount had shrunk to 5.5 billion euros.

Berlin's financial crisis has been attributed to financial misbehaviour after reunification, when federal "Berlin aid" was reduced significantly, especially before 1995, and the city did nothing to reduce its enormous administrative expenses. Also, Berlin failed to seriously invest in its business infrastructure, with the result that businesses have moved out of Berlin and unemployment has increased, raising the city's payments for unemployment benefits and social assistance. One additional problem was the scandal and collapse of a city-owned bank, the *Berliner Bankgesellschaft*, which dug a hole in the budget corresponding to eight per cent of accumulated debt at that point.

The court said no

This was the backdrop to the Oct. 20 ruling of the Constitutional Court which said Berlin will not receive extraordinary federal aid in its struggle to overcome its financial crisis. Berlin, the capital of the country, is not in a true "state of need," the court said, adding that "with high probability," Berlin should be able to solve its crisis alone. The judges also held that it is "alien" to the existing system of federal grants to claim that it is the duty of the federal government (the *Bund*) to bail out a *Land*, or state government. These kinds of subsidies – vertical transfer payments by the central government – are admissible only as a last resort; that is, when a financial crisis must be regarded as "extreme," which implies that the *Land* has already exhausted all other possible alternatives. In particular, the Constitutional Court said, the relationship between the interest charges of the debt that Berlin has to carry and the taxes it is able to raise is still not "bad enough" to warrant judicial action. The Court was unusually precise in its recommendations, urging that Berlin should raise its rate of trade tax levied on corporate profits, one of the few taxes for which city governments can not only determine the rates, but which they also are alone to

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pocket. The Court also recommended that Berlin privatize more, pointing particularly to the 270,000 apartments that are still owned by the city, and which are probably worth about 5 billion euros (about $6.5 billion U.S.).

After the ruling was handed down, Thilo Sarrazin, social democratic finance minister of Berlin, insisted that the city, on its metaphorical lifeboat, would not just sit and wait for the next steamship to come by. What he meant was that Berlin would not simply continue its usual financial behaviour, heading for what would sooner or later inevitably become an "extreme" financial crisis, and then turn to the Constitutional Court again. However, this seems to be exactly what is going to happen. Just before the court's ruling, elections were held to the *Abgeordnetenhaus* – Berlin's equivalent of a *Land* legislature – which gave a slim majority to the incumbent party, but with slightly different shades of red shared by the social democrats (SPD) and the socialist Left Party, the former ruling party of East Germany.

In their coalition negotiations following the decision from the Constitutional Court, the two parties agreed not to follow the Court's advice, conforming to SPD mayor Klaus Wowereit's proud saying that Berlin was "poor, but sexy." Wowereit insisted that Berlin "will not indulge in any radical cost-cutting masochism." The coalition agreed not to raise the trade tax, for fear of driving even more businesses away from Berlin, but to resort to a higher rate of real-estate tax. It decided as well to continue borrowing, albeit at a decreasing rate, and to initiate bailout negotiations with the federal government. The city of Berlin maintains that the cost of building the "Chancellor's" subway line between the Brandenburg Gate and Alexanderplatz should now be borne by the federal government, and that the *Bund* should also cover the entire cost of police in the area of the government institutions, as well as the reconstruction cost of the *Stadtschloss* castle and the budget of one of the city's three opera houses, the *Staatsoper*, including its coming renovation costs of 130 million euros ($169 million U.S.).

Photo: Agrarsoziale Gesellschaft e.V.

Kindergarten is free for many Berliners. Toddlers in Berlin enjoy the crêpes they made in the Sparrow's Nest kindergarten.

Cut staff or sell off property?

As for possible ways to cut spending, Berlin's finance minister, Thilo Sarrazin, only managed to get agreement for a slight further trimming of the still huge public service, with its tremendous administrative costs. Berlin will reduce its personnel to 95,000 from 115,000 by 2010. This is supposed to represent a saving of 200 million euros each year. It is estimated that Berlin has 40 per cent more administrative staff than similar metropolitan areas in Germany. Privatization of the 270,000 apartments has been ruled out, as has selling off some of the transportation companies, hospitals or the waste-disposal agency. The only item up for sale is the *Gewerbesiedlungsgesellschaft* or GSG, a subsidiary of the *Investitionsbank Berlin,* owned by the *Land*. The problem with selling the GSG, which supports small and medium-size companies by renting them production facilities at low rates, is that the revenue would not flow directly into the *Land* budget.

In early December, Sarrazin presented the city's financial plan for the period until 2010. He considers his budget of about 20 billion euros ($26 billion U.S.), one-quarter of which stems from federal subsidies, to now be "under control," given that Berlin will benefit from the general economic upswing that is expected to generate more tax revenues. This perspective has already spurred Berlin's spending proclivity. Berlin will be the first of Germany's *Länder* to introduce cost-free public kindergartens, which will be operated throughout the city, instead of privatizing them. This will involve an additional cost of 38 million euros until 2011. Also, the *Land* has ruled out cutting back significantly on its overall spending on universities and culture. Even the idea of raising tuition fees at the public universities has been rejected by the Berlin government for "social reasons." The result of all this is clear: Berlin cannot survive without further borrowing, even though this will be "in decreasing amounts," as Sarrazin hastens to point out. The amount of credit needed annually is supposed to shrink to 900 million euros ($1.2 billion U.S.) in 2010.

At this point, Berlin pays 2.4 billion euros in interest every year on its accumulated debt of 61 billion euros. This situation is likely to deteriorate in the future, given that the transfer payment that Berlin receives out of the *Solidarpakt II,* a federal redistribution scheme in favour of the eastern *Länder,* is set to move down from almost 2 billion euros now to zero in 2020. Estimates for the accumulated debt in 2010 are in the order of 65 billion euros; some observers predict as high as 80 billion euros. But to keep the deficit at no more than 900 million euros per year, Berlin has to cut its yearly budget enough to save a total of 1.7 billion euros by 2020.

Political parties stake out positions

Changes in financial planning, however, are not the end of the story. Many ideas circulate

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about how to get Berlin's budget back in shape. The Green party, for example, argues that the trade tax could be raised to the level of neighbouring Potsdam without driving more businesses away. That would create additional revenues of 100 million euros per year. Also, the public service should be rolled back more, with a combination of layoffs and increased part-time work at lower salaries. The Greens also advocate that kindergartens should be privatized. Today, one-third of the kindergartens in Berlin are public. The Greens also flirt with the idea of levying a tax on tourists. The Christian democrats (CDU) urge the sale of apartments to some of the private equity firms that seem interested; they also favour the privatization of Tempelhof airport.

Some more radical ideas are also being tossed around. For example, academics urge that a system of public bankruptcy should be created, making a debt moratorium possible for Berlin. The advantage would not only be that the city of Berlin could get a fresh start, but the system would also be advantageous in terms of incentives, in the sense that creditors would be able to downgrade Berlin as a debtor and become more careful in extending it credit. On the other hand, Eric Schweitzer, president of the Berlin Chamber of Commerce, pleads for Berlin to become a Special Economic Zone, with preferential tax rates and lighter bureaucracy to attract business. And Wolfgang Tiefensee of the SPD, the federal minister for transportation, would like to add a clause to the German Constitution giving Berlin more rights to federal subsidies, given its role as the nation's capital.

But, more generally, the Berlin case brings home that Germany urgently needs to provide itself with a financial system that gives *Länder* governments genuine fiscal autonomy, and thereby true responsibility. The good news is that talks are already under way within the reform commission which was created on Dec. 15, 2006, called "Federalism reform II". The aim of this commission is to disentangle the money flows and responsibilities between the federal and *Länder* governments, and to create powerful sanctions for unacceptable deficits. One of the more precise proposals in this regard, put forward by the prime minister of Saxony, Georg Milbradt (CDU), is to limit regional deficits to about 1.5 per cent of gross domestic product, beyond which *Länder* would be forced to raise taxes, to give up financial authority over their budgets or to limit the bailout obligation of the federal system, so that financial markets would eventually create their own sanctions for bad fiscal management.

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Fiscal rights for Communities in the Spanish constitution

Table 2: Taxes shared or devolved by Madrid to the Communities

Tax	Yield to Communities in per cent	Administration	Maximum legislative power of Communities
Personal income tax	33	Central government	• Tax rates (must have same number of tax brackets as the State tax) • Tax credits, under certain conditions
Tax on wealth	100	Communities	• Tax rates • Minimal deduction • Tax credits
Death and gift taxes	100	Communities	• Reductions in taxable income • Tax rates • Deductions and tax credits • Tax administration regulations
Taxes on transfers and official documents	100	Communities	• Tax rates • Tax credits • Tax administration regulations
Gambling taxes	100	Communities	• Exemptions • Taxable base • Tax rates • Tax credits • Tax administration regulations
Value Added Tax	35	Central government	None
Excise	40	Central government	None
Tax on wine	40	Central government	None
Tax on electricity	100	Central government	None
Tax on vehicles	100	Communities	• Tax rates (under certain conditions and limits)
Special tax on gasoline	100	Communities	• Tax rates (under certain conditions and limits) • Tax administration regulations

The table above shows the distribution of taxes as of January 1, 2002