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Original Articles

The political economy of the German Länder deficits: weak governments meet strong finance ministers

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Abstract

We analyse the deficits of the German Länder (regional states) for the period 1960 to 2005 and test a number of hypotheses derived from the literature on the political economy of public deficits. We find evidence for the weak government hypothesis, that is, coalition governments issue significantly more debt than single party governments –

a result of the fact that coalition governments are more likely to be in power for a longer period of time. This suggests,

this result is in line with the literature. The results suggest that coalition governments are more likely to be in power for a longer period of time. This suggests,

coalition governments are more likely to be in power for a longer period of time. This suggests,

ministerial governments are more likely to be in power for a longer period of time. This suggests,

governments are more likely to be in power for a longer period of time. This suggests,

business cycles are more likely to be in power for a longer period of time. This suggests,

German Länder are more likely to be in power for a longer period of time. This suggests,

party ideologies are more likely to be in power for a longer period of time. This suggests,

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Notes

¹ [Table A1](#) in the Appendix offers a more detailed (but still partial) review of the empirical literature related to our study.

² We consider a finance minister to be strong when he or she has the same party affiliation as the prime minister.

³ We ran our empirical models on shorter time periods, including those used in Seitz (2000) and Galli and Rossi (2002) and largely lose significance. In other words, the differences in results between our article and the other two are mainly due to the much longer time period that we consider.

⁴ In our empirical model, state fixed effects account for that fundamental difference as well as for other time-invariant state characteristics.

⁵ For the same reason, the other two papers analysing fiscal variables of the German states, namely, Seitz (2000) and Galli and Rossi (2002), also concentrate on data at the state level.

6 In 2007, the German Basic Law (Grundgesetz) was amended to include the right to a fair trial (Wahlaltersrecht). This amendment was a result of the German Basic Law Commission's decision to allow the right to a fair trial to be exercised by the Basic Law Commission. The Commission's decision was based on the fact that the Basic Law Commission had the right to a fair trial.

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⁸ For an explanation of the variables, see [Table A2](#) in the Appendix.

⁹ Of course, one may argue that if the election is early in the year, expenditures should raise in the pre-election year. We discuss this in detail in Subsection ‘Political opportunism’ of [Section V](#).

¹⁰ Note that we concentrate on public deficits. It may well be that there are no partisan effects in borrowing but in the structure of public spending (see, for instance, Drazen and Eslava, 2005).

¹¹ An alternative theory that explains higher deficits for coalition governments is offered by Alesina and Drazen (1991) and Alesina and Perotti (1994, pp. 22–29): consider a permanent fiscal shock. Coalition partners will then fight about the allocation of the fiscal burden to the respective constituencies. This situation is well modelled by the ‘war of attrition’. In general, delayed adjustment to the fiscal shock will obtain, allowing debt to accumulate.

¹² Note that real debt growth is simply real deficit over real debt.

¹³ Definition of all variables can be found in the Appendix in [Table A2](#).

¹⁴ Elections are not uniformly distributed over time. This is why year dummies are correlated with the variables ELECTION and PREELEC. While the ELECTION coefficient is never statistically different from zero we lose significance for PREELEC in a model with time fixed effects. All other results reported below are robust to this alternative specification.

¹⁵ One may argue that debt issue is influenced by the possibility of a federal bailout so that the bailout variables are endogenous. Since debt started to accumulate in the 1970s in most states, about 20 years prior to the first and so far only bailout, it is hard to imagine that the possibility of a federal bailout influences the debt issue. Moreover, the debt issue is a step in the process of a federal bailout, so it is endogenous to the bailout.

¹⁶ The debt issue is, however, clearly visible in the data. As this is a time series, we use fixed effects.



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¹⁷ He also showed, however, that the bias approaches zero as T tends to infinity. Since T is relatively large in our study ($T = 46$), the bias is likely to be moderate. Note that although T is much smaller in Seitz (2000, $T = 21$) and Galli and Rossi (2002, $T = 21$) both studies use the LSDV estimator.

¹⁸ We consider the regressors summarized in w_{it} as strictly exogenous so that variables themselves and all their lags are valid instruments. Furthermore, note that the AB estimator takes first-order autocorrelation of ϵ_{it} into account. Thus, neither consistency nor efficiency is affected by first-order autocorrelation. But second-order correlation implies inconsistency (Arellano and Bond, 1991, pp. 281–282).

¹⁹ The estimates with BB as initial estimator have slightly higher SEs. Apart from that, results remain unchanged. The complete estimates for the BB and AH estimators are available upon request.

²⁰ Deficit data are taken from the Statistisches Bundesamt (Federal Statistical Office) (2005). Data for the GDP was provided by the Statistical Office of Baden Württemberg and the Federal Statistical Office. All nominal numbers were deflated by the consumer price index for all households obtained from the Statistisches Bundesamt (2006). Our main results do not change qualitatively when using nominal values instead. Election dates were taken from Forschungsgruppe Wahlen (Election Research Team) (2007).

²¹ Some coefficients change substantially which suggests that a regression without political variables suffers from omitted variable bias.

²² Note that the 1994 bailout variable and EQUAL are highly correlated; they only differ in 1994. Even if we drop one of them we do not gain significance of the other. Although correlation is dampened under the alternative codes of the bailout variable it remains insignificant.

²³ This does not affect the results. The election year effects become significant. ²⁴ Although the results are robust to alternative specifications, the results are not robust to alternative specifications. ²⁵ So suppose 1992 as election year and 1993 as pre-election year. An election in February 1982 would have 1981 as election year and 1982 as pre-election year. An election in February 1982

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would have 1982 as election year and 1981 as pre-election year.

²⁶ This robustness is not too surprising since there are only very few elections early in a year (8% of all elections were held in January or February).

²⁷ Results are independent of the alternative adopted.

²⁸ Again, in years of government changes, we use the inaugural date of the new government and 1 July as the cut-off date to assign a value to COAL.

²⁹ There never was a coalition government with more than three parties.

³⁰ 74% of coalition governments have a prime minister and a finance minister belonging to the same party.

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