

# Reversed Bailout: Kaiserreich's Budget Policy Revisited

by

Charles B. Blankart, Christoph Priesmeier and Oliver Volckart  
Humboldt University Berlin

Paper submitted for presentation at the meetings of the  
Verein für Socialpolitik  
at the Ludwig-Maximilians-University of München.

October 9 to 12, 2007

Humboldt-Universität Universität zu Berlin  
Department of Economics  
Spandauer Strasse 1  
D-10178 Berlin

May 25, 2007

## *Abstract:*

Well known are bailouts of subcentral governments by central governments. In this paper we present a reversed case in which, during the Kaiserreich, the central government was bailed out by its subcentral governments. We reject the traditional hypothesis according to which the fiscal crises of the Kaiserreich emerged out of subcentral governments' myopic refusal to provide the central government with the necessary funds and argue that weak budget constraints allowed the imperial bureaucracy to spend excessively on defence. We come to a new interpretation of the causes of the World War I and to new conclusions on EU financing.

*“An immense influence on peoples’ destiny is caused by the economic bleeding which is caused by the requirements of the state and by the way how the proceeds of this bleeding are allocated. The immediate forging influence of the fiscal needs and the fiscal policy of the states broadly conceived on the development of the economy and hence on all ways of life and cultures explains in many eras of history fairly all great characteristics of things and in most very much of them – only in a few cases nothing.”*  
(J. Schumpeter, 1918, 1976, p. 331, own translation)

## **Reversed Bailout: Kaiserreich’s Budget Policy Revisited**

by

Charles B. Blankart, Christoph Priesmeier and Oliver Volckart  
Humboldt University Berlin

### **I. Suspicious Unity of Doctrines**

Historians and economists rarely agree on their explanations of history. Their life is one of a contest among alternative hypotheses. They disagree out of passion and self interest, and following Adam Smith (1776) they are “in this ... led by an invisible hand” which continuously improves their perception of the reality

When disagreement and contest is the normal course of a researcher’s life, then consensus must be an exception, which requires closer consideration especially when it lasts for a longer time. Consensus raises the suspicion that there must be an undiscovered opportunity of contest, a new view of an old problem which, given our improved general knowledge, has to be evaluated against our traditional view.

In this paper we want to reconsider a hypothesis relating to the German Kaiserreich, specifically its federal budgetary process, from its beginning in 1871 up to the eve of the First World War in 1913. There is an astonishing unanimity of views on this subject. In the academic literature of the last 80 years, which we examined, we found a few researchers who commented neutrally, the vast majority, however, was highly critical in the sense that they argue that *the budget of the German Kaiserreich was permanently under-endowed because the states were unwilling to provide the federal government with the necessary means to fulfil its tasks. Therefore the federal*

government was allegedly forced to accumulate large amounts of public debt pressing it to the edge of bankruptcy. Such debt crises are the more astonishing as the Kaiserreich started with a federal government net wealth of 120 million marks representing the federal share of the French reparation payments of the war of 1870/71. However, this so called imperial war treasury (Reichskriegsschatz) was spent within a few years and followed by massive deficits resulting in a net federal debt of 5,2 billion marks by 1913<sup>1</sup>. In percent of NNP, the federal debt increased from zero in 1871 to about 10 percent in 1913 (excluding state and local debt), see figure 1. According to Niall Ferguson (1994, p. 160) the strain on the capital market due to government borrowing was substantial. He notes that German government bond yields were not only higher than those of the well established British and French government bond yields, but also, up to 0,5 percentage points above the Italian bond yields).

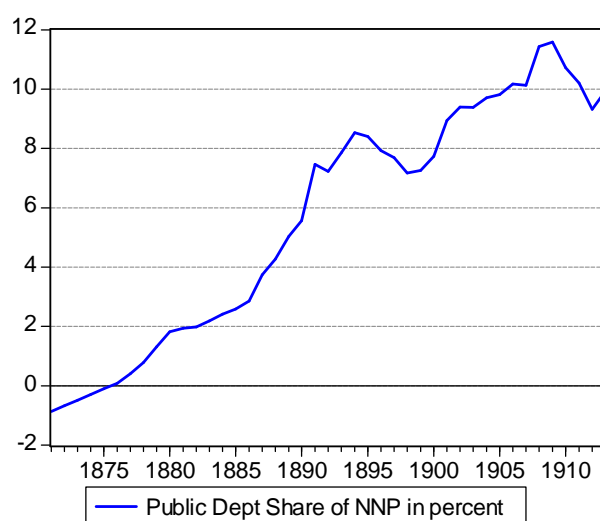


Figure 2: Federal debt share 1871 – 1913 in percent of NNP<sup>2</sup>

Such figures led researchers to believe that the federal budget was indeed under-endowed. We shall, however, question the “under-endowment hypothesis” in this paper. For this purpose we start in section II from the traditional view that the under-endowment hypothesis is correct, and we show how, from this perspective, under-endowment allegedly came about (II.1), why Reichstag and Bundesrat were “stubborn” and unwilling to contribute the necessary means to the federal government, what reforms were made to gradually overcome under-endowment (II.2), how this has been defended by contemporaneous and later economists (II.3) and how it can be illustrated econometrically (II.4).

In section III we reconsider the under-endowment theory with the tools of modern public choice theory. We take a closer look at the political process that generates the

<sup>1</sup> The total of French reparation payments was 5 billion French francs equivalent to about 4,05 billion gold-marks. Only 0,12 billions went to the federal treasury, a smaller part of the remainder was used to pay back the debt of the North German confederation a larger part went to the federal states. (Reichsgesetz vom 11. Nov. 1871). See: Meyers Konversationslexikon, 4th ed., 1888, vol 13, p. 684, Leipzig, Wien, Bibliographisches Institut.

<sup>2</sup> Debt from Deutsche Bundesbank (1976), NNP from Walther G. Hoffmann (1965, pp. 825 sqq.) and Material in footnote 1.

collective demand for defence as compared to other public services, particularly those provided by the states, and we find that the central government's deficits are rather a consequence of its soft budget constraints allowing the federal government to overdraft its budget allocations, to accumulate debt, to generate the aforementioned crisis and eventually to elicit a bailout by the lower level governments. Thus, we find a new species of a bailout, a "*reversed bailout*" bottom up by the subcentral governments in favour of the central government different from the conventional bailouts which are top down from the central in favour of the subcentral governments. Our econometric illustration of II.4 looks institutionally more plausible when now considered through the reversed bailout theory. In section IV we draw the conclusions of our theory and briefly reconsider two conclusions made under the under-endowment theory; Niall Ferguson's hypothesis on the outbreak of the First World War and Carsten Hefeker's conclusions on financing the European Union.

## **II. The Under-Endowment Theory**

### *II.1 Why Under-Endowment?*

The idea that the federal government's budget was under-endowed in the Kaiserreich originates from article 70 of its constitution of 1871 which enumerates the sources of financing the federal expenditures:

All common expenses shall be met first by previous years' disposable surpluses, by the common revenues accruing from customs duties, from common excise taxes and from posts and telegraphs. Insofar as they are not covered by these revenues, they have to be raised – as long as federal taxes are not introduced – through individual states' contributions according to their population size [matricular contributions] to be posted in the budgeted amount by the federal Chancellor. (own translation)

This article was intended to delineate the federal from the state local tax bases. For the time being the federal government had the power to raise customs duties and the hitherto existing excise taxes of the North German Confederation (such as taxes on tobacco and tobacco products, spirits, sugar, salt and stamp duties), whereas the state and local governments were entitled to raise direct taxes, in particular direct income taxes. In addition, the states were obliged to support the federal government with matricular contributions, which were calculated on a per capita basis. Hence, unlike in most other nation states, the Germans financed their government bottom up and not top down. Under-endowment is said to be due to the reluctance of the states and their representatives to provide the federal government with the necessary tax bases and matricular contributions to fulfil its tasks, i.e. mainly to provide national defence (and to some extent social security) without a massive resort to federal debt.

### *II.2 A Series of Cumbersome Reforms to Overcome Under-Endowment*

It is sometimes said that Chancellor Bismarck wanted to overcome the financial under-endowment by federalizing the state income tax. But as this plan turned out to be unsuccessful, he and his followers turned towards an extension of the federal

customs and excise tax bases and towards higher rates.<sup>3</sup> However, the way towards securing a sufficient fiscal base for the federal government was long, cumbersome and full of obstacles generated by the states who, allegedly, out of myopic self interest, pursued their own political goals at the costs of the common federal goals.

The following chronology of events summarises the traditional view. It replicates the arguments brought forward by the proponents of the under-endowment theory. Seen from this perspective, the federal government appears to have needed six attempts, so called “reforms”, to extend its tax base vis-à-vis the stubborn legislature in the two chambers in order to overcome its under-endowment and to acquire the means to meet the federal budgetary needs.

1. The reforms began with the *customs and tax reform act of 1879*. Customs were ideal means in Bismarck’s hands to protect the Eastern agrarians and the Western and Eastern industry from cheap imports and to generate revenue. Hence wheat, cattle, pulse, and malt, iron, steel, yarns, engines etc. were subjected to high protective import tariffs. In addition to that, products which were demanded, but not produced in Germany such as tropical fruits, rice and petroleum etc. were also subjected to tariffs for fiscal reasons. The overall rates increased by about 40 to 60 percent, leading to an increase of fiscal revenues of about 70 percent from 1879 to 1881. Chancellor Bismarck’s intentions to obtain a fiscal relief through the reform were, however, thwarted by the states. They enforced the so-called Franckenstein Clause (§ 8 of the customs act) according to which tax and customs revenues exceeding 130 million marks per year had to be handed over from the federal to the states’ treasuries. These sums were then offset against the states’ matricular contributions, so that their net contributions to the federal government dropped from about 80 million marks per year before the legislation to very small, sometimes even negative amounts.
2. In order to compensate for these relative losses, the federal government planned in 1882 to make available more means by increasing taxes on spirits and on tobacco. Again, due to political resistance, only the levy on spirits succeeded in the 1887 reform.
3. It required another six years to increase taxes on tobacco and tobacco products and to introduce stamp duties (on playing cards, lottery and security emissions). This was the result of so called Pasadowsky-Miquel<sup>4</sup> reform of 1893/94, while at the same time, the proposal of a wine tax failed.
4. Minister Stengel’s tax reform of 1906 focused on an inheritance tax on accrual and several stamp duties in a political exchange for a limitation of the matricular contributions to 0,40 marks per inhabitant. With the inheritance tax, the federal government succeeded in making first inroads into the states’ domain of direct taxation.<sup>5</sup>
5. Minister Sydow’s “great tax reform”<sup>6</sup> of 1908/09 focused on increases of the inheritance tax, the taxes on spirits, beer, tobaccos and tobacco products, electricity and gas, matches, coffee, tea and an increase of the matricular

---

<sup>3</sup> Consequently, the reference to “federal taxes” in art. 70 of the Constitution, the so-called “Clausula Miquel” (from the former minister of the Prussian Treasury), has been removed in 1904.

<sup>4</sup> Both were members of the Imperial Diet (the Reichstag) and Miquel also Prussian minister of the treasury 1890-1901.

<sup>5</sup> Hermann Freiherr von Stengel was secretary of state in the federal treasury (Reichsschatzamt) 1903 – 1908.

<sup>6</sup> Reinhold von Sydow was secretary of state in the Federal Treasury (Reichsschatzamt) 1908 – 1909.

contributions to 0,80 marks per inhabitant. This reform was successful for the federal government.

6. Finally, in 1913 it was decided to raise a defence contribution based on personal wealth above 10.000 marks and on personal income over 5.000 marks per year over a period of three years.

It would, however, be premature to say that this last decision before the First World War was the final breakthrough of the federal government into states' domain of direct taxation. For as the new legislation was limited to three years, nothing would have prevented the states from further defending their tax territory.

### *III.3 The Under-Endowment Theory as Seen by Traditional Scholars*

The under-endowment theory is held by nearly all authors we have found between the 1910s up to the first decade of the new century.

*Wilhelm Gerloff* (1913, 1929), one of the first commentators, refers to the offsetting of revenues from taxes with matricular payments according to the Franckenstein Clause and writes: "At first sight the whole system (of tax reimbursement) seems somewhat confusing, but basically innocuous. This is, however not the case. ... Though the Imperial Diet did not approve of all taxes, monopolies and tariffs proposed by the Chancellor, it nevertheless accepted a federal debt year after year for expenditures which in fact should have been covered by matricular contributions. .... Meanwhile the federal debt kept growing." (W. Gerloff, 1929p. 33 sq., own translation)

*Fritz Neumark* (1976) who, for many years, was regarded as the "Doyen of German public finance" comments the fiscal rules of the Kaiserreich as follows: "The federal government was deprived of the alternative to attract, exclusively or in competition, the most affluent of all taxes, the income tax ... Therefore one had to be content with measures which had, notwithstanding their other deficiencies, only a short run (modest) success, and that therefore required new adjustments of the financial system within a couple of years (F. Neumark, 1976, p. 63, own translation).

*Karl Häuser* (1977) gives the following summary under the heading of "The German Empire's Bismarckian Constitution": "Essentially, the federal government suffered right from the start of an insufficient financial endowment." (K. Häuser, 1977, p. 45)

*Niall Ferguson* (1994) advances the argument of a financial under-endowment even further. He argues that it was causal for pushing Germany into the First World War: "Germany did not go to war in 1914 to 'escape' from a domestic political crisis; rather the significance of the financial wrangles of 1908-14 lies precisely in their financial insignificance: the meagre direct taxes voted by the Reichstag scarcely solved the public financial impasse. ... On the contrary, it was domestic politics which limited the size of the German army before the First World War, and hence determined the degree of national security, and hence increased the willingness of Germany's leaders to gamble on a first strike." (N. Ferguson, 1994, p. 163 sq.)

*Gerhard Lehbruch* (2001) characterizes the fiscal strain of the federal government as a consequence of a dysfunctional federal fiscal constitution: "The permanent fiscal strain of the central government led into the backdoor of an ever increasing

government debt. ... Eventually the states had to give in. Since the turn of the century, the federal government increasingly ran into difficulties to finance its costly defence programs and, under the pressure of the crisis, it succeeded to draw on the tax base traditionally occupied by the states. ... Eventually, under the pressures of the First World War, this contradictory and conflict-generating financial construction of 1867 [1871] became absurd.” (G. Lehmbuch, 2001, p. 49 sq., own translation)

*Carsten Hefeker* (2001) argues in a recent paper that under-endowment of the federal government not only generated a financial crisis in the Kaiserreich, but that there may be similar problems in the European Union: “The German fiscal system before First World War illustrates this consideration. Lacking adequate sources of finance, the centre was forced to cover its budget to a large extent via debt, running ultimately into a serious debt crisis when expenditures increased during and after the war. The conclusion for Europe is that unification will need to give sufficient financial resources to the central power.” (C. Hefeker, 2001p. 119)

II.2 An empirical record of the Under-Endowment Theory

The following figure 2 graphically depicts what was verbally presented in the previous sub-section. The expenditures have a permanent lead of about two to three years on the average since the late 1870s, indicating that the expenditures pulled the revenues after political opposition by legislatives of the Reichstag and the Bundesrat was overcome. We build up our hypothesis on this obvious relationship and try to find out whether the expenditures were driving the revenues of the Reich.

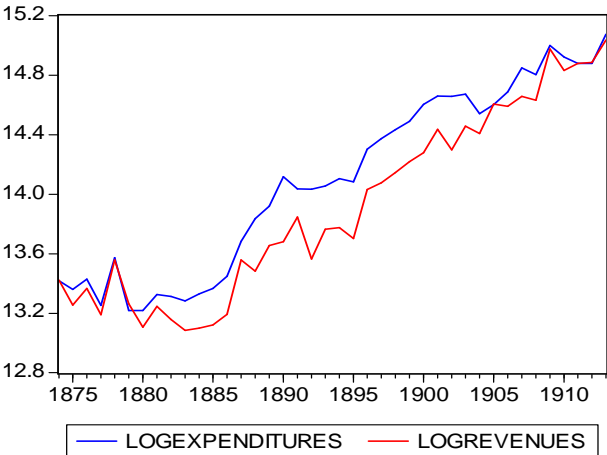


Figure 2: Expenditures versus Revenues

In order to see whether the graphically shown longterm-relationship could also be demonstrated within the statistical data base, we have tried to test for cointegration between expenditures and revenues. In this, we used the logs of aggregate federal revenues and expenditures between 1874 to 1913 as published in the Statistical

Yearbook of the German Empire (Statistisches Jahrbuch für das Deutsche Reich) as the only consistent source we found.<sup>7</sup>

Empirical analysis: Both variables, expenditures and revenues (respectively in logs) are merely stationary in first differences (  $I(1)$  ), which was shown in Augmented Dickey-Fuller tests<sup>8</sup>. This postulates that any given relationship between the variables in levels is spurious. As we are interested in longterm relation, cointegration could provide useful information in this case.

Following the concept of Engle and Granger [1987]<sup>9</sup>, we tested whether the residuals of the static regression of the two variables are stationary in levels, which would indicate that expenditures and revenues are cointegrated. The modified Augmented Dickey-Fuller test that takes into account the MacKinnon criterion [MacKinnon 1991]<sup>10</sup> shows that the hypothesis of a unit root can not be rejected on a five percent level of significance.

This result reveals that there exists no cointegration relationship between our two variables. Accordingly, it is not possible to take the next step of the Engle/Granger concept. Inventing an error-correction-model providing information about long-term as well as about short-term relations within the variables would have led us directly into spurious solutions.

Explicitly this does not mean that we can not make any quantitative statement about the (short term) relationship between expenditures and revenues at all. As Rehkugler and Jandura [2002]<sup>11</sup> stated, an estimation in first differences seems to be the best option within a scenario of obviously not-cointegrated  $I(1)$ - variables. Even though on the one hand we will lose some valuable information of the levels through their differentiation, on the other hand, one of the classical methods of estimating and testing remains efficient, and the regression could lead to non-spurious results.

However, the explanatory power of the estimation of the underlying linear model in first differences depends on the validity of the model-specific assumptions<sup>12</sup>. In our case, a linear model, least-square estimation provides the best results, but only under certain assumptions made. The regressions` residuals have to be gaussian-(normal)distributed, homogeneous and not autocorellated which means there must be no systematic structure in the residuals. Against this background of preconditions, we specified the following model (1):<sup>13</sup>

---

<sup>7</sup> Other sources we have investigated: P.-C. Witt (1970), S. Andic and J. Veverka (1964).

<sup>8</sup> We used the Augmented – Dickey – Fuller (ADF) Test with the assumption of a constant and trend within the time series and tested the hypothesis of the existence of an unit root on a 5 percent level of significance.

<sup>9</sup> R.F. Engle and C.W.J Granger (1987).

<sup>10</sup> J. G. MacKinnon (1991).

<sup>11</sup> H. Rehkugler and D. Jandura (2002).

<sup>12</sup> The base model refers to the hypothesis assuming that expenditures are driving revenues. In a linear specification it has the following structure with revenues as dependent and expenditures as independent variable:  $\ln(R_t) = \beta * \ln(E_t) + \varepsilon_t$

<sup>13</sup> 1. We tested the residuals for being gaussian-distributed with the Jarque-Bera test, whereas we clearly could not reject the hypothesis of an underlying gaussian-distribution on a five percent level of significance. Furthermore the assumption of a homoskedasticity in the residuals is true. This is based on a White-test for heteroskedasticity. Autokorrelation of order 1 which was firstly found in the original model could be prevented by using the lags of the first differences of the dependent and independent variable in the modified model (1). The correlogramm of squared residuals shows that there is no

$$\text{Model:} \quad \Delta \ln(R_t) = \beta_1 \Delta \ln(E_t) + \beta_2 \Delta \ln(E_{t-1}) + \beta_3 \Delta \ln(R_{t-1}) + \varepsilon_t \quad (1)$$

$$\text{Estimation:} \quad \Delta \ln(\bar{E}_t) = 0,914 \Delta \ln(E_t) + 0,622 \Delta \ln(E_{t-1}) - 0,613 \Delta \ln(R_{t-1}) \quad (2)$$

( 7,88 )
( 3,57 )
( - 4,65 )

The coefficient of determination valued 0,7 indicates that the quality of the regression is very high. The t-values (each written in brackets under the referring coefficient) show that all coefficients are highly significant on a five percent level. And particularly with regard to the result that no assumptions failed, this estimation is not spurious.

To summarize: The empirical analysis confirms the hypothesis that the federal revenues were significantly related to the expenditures of the German Kaiserreich from 1874 to 1913. Due to missing cointegration in the data we can not say anything about the long-term relationship between the variables and their causality based on an error-correction-model. Nevertheless, in first differences the estimated model provides useful information for the interpretation of their short-term relation. We can see that the expenditures of the current and the previous period and also the revenues of the previous period are significantly driving the current revenues.

The revenue elasticity of the growth rate of the expenditures is 0.914. In other words, a ten percent change in in the growth rate of expenditures leads to a 9.14 percent change in the growth rate of returns. The same holds for the expenditures of the previous period. Here, the reaction to a 10 percent increase in the growth rate was a slightly weaker 6.22 percent increase. The only significant factor leading to a decrease in the revenues growth rate is the revenues growth rate of the previous period. This indicates a gradual adjustment process in the revenues. In this case 10 percent more growth in revenues in t-1 were followed by 6.13 percent smaller growth rate of the revenues in period t.

#### IV. A Reconsideration of the Under-Endowment Theory

Though the under-endowment theory has a good record in the literature and can nicely be illustrated econometrically, it suffers from severe theoretical weaknesses. Its basic message is that something went wrong in politics. The federal budget was persistently too small and only under compulsion and step by step, the pertinacious resistance of the Federal States against granting more means to the federal budget could be overcome (section II.2). The members of the Reichstag and the Bundesrat allegedly were irrationally myopic. Immediately this raises the question: irrational in which sense? With regard to the needs of the nation, one might answer the question as if a benevolent dictator reminds the government and the representatives to spend more. But the benevolent dictator model is too weak to serve as a normative basis for justifying higher expenditures. It would be much better to look at the constitutional rules and to investigate whether the actual budget lies inside or outside these rules (art. 5 I, 69 – 73 of the 1871 constitution of the Kaiserreich). The underlying budget cycle according to this constitution consists of three steps, Firstly, the Chancellor as the executive branch of the government sets the agenda on which in a second step the two Houses of Parliament decide how far the proposed budget can be executed

---

correlation left in this specification. For autocorrelation of order 1 this result is also supported by a Durbin Watson-Test.

by the administration which then submits a proposal on her part of next year's budget to the Chancellor in a final step.

It is true that the federal Chancellor had some discretionary power in accommodating the expenditures because, due to his agenda setting power, he could play off one minority against the other in the 15 party Reichstag. Nevertheless the representatives of the two Houses of Parliament had to consider the opportunity costs of granting more money to the federal government vis-à-vis their own tasks at home. As the German population grew rapidly from 41 million in 1871 to 66 millions in 1912 thus by 61 percent overall, and remarkably faster in the cities, the state and local governments had to construct infrastructures (water, gas and electricity networks, sewer systems, schools universities, hospitals etc.) for which they needed large sums of money. All this generated pressure to allocate larger funds to the state and local level of government, and an aversion against central government spending especially against the so-called "fleet dreamers" who allegedly wanted to increase defence spending in particular for the fleet.

There was nothing irrational about the standpoints of the states' representatives. They had collectively to decide on collective (federal) public goods, mainly on defence. However, they were weak in enforcing their constitutional rights. If the Federal Parliament, e.g. granted less money in the form of taxes and matricular contributions to the federal government than required, the administration was only formally tied to balance the budget. Expenditures should be reduced, but the administration often preferred debt instead of expenditure cuts. The ensuing budgetary gap could also be filled by debt. But the administration created its own interpretations of budget balancing supported by influential public law scholars who argued that the budget is only formally an "act of legislation" (see below). This view of the budget legislation was then further extended to next year's budget and so on. The deficit increased year after year and government debt dared to deteriorate. Two contemporaneous observers, Wilhelm Gerloff (1929) and Philipp Zorn, (1923) criticized this practice.

1. Gerloff comments on the deficits as follows: „The extremely rapid growth of the federal debt cannot, however, be explained by purely substantive causes ... it has also formal [i.e. institutional] reasons. Article 73 of the old constitution [of 1871] said that extraordinary needs may be covered by raising debt. But for a long time, there were no firm principles binding the administration and the Reichstag on when a case of an extraordinary need (as provided for in art. 73), is given. So it came about that a large amount of expenditures which, according to their character, should have been covered by ordinary revenues was in fact covered by bonds. It is true that as early as 1889 balanced budget rules were set up. But their implementation was often enough avoided because of the financial situation. Only gradually it became manageable, in the 90s, to enforce stronger rules in the yearly budgetary debate in order to balance the federal financial needs, rules which were, however, less contested by the Reichstag than by the federal fiscal administration. .... Hence, new balancing principles have been established in 1907 which were reformed upon the experiences since then in 1911. The goal of all these principles was a reassessment of the extraordinary needs. Then came the war, and all financial balancing principles were abandoned.” (Gerloff, 1929, p. 35 sq., own translation)

Gerloff clearly shows that the federal government was confronted with soft budget constraints for most of the time up to 1914, giving leeway to overdraft budget allocations. Apparently opposition against strict rules came from the administration who feared to lose discretionary leeway. When the second fleet act was under debate the administration demanded credits of such a size that even the some MP's of the Reichstag had to warn the executive of dubious indebtedness (see W. Gerloff, 1913, pp. 344-54).

2. Where budgetary rules are missing, ideologies are given a boost. Philipp Zorn (1923) nicely describes in his handbook article how the theory developed by the famous law scholar, Paul Laband (1888), became a dominant officious opinion in the political establishment within the Reichstag and within its political sphere.<sup>14</sup> According to Laband's theory a budget is only formally and not materially an act of legislation (as required by art. 5 and 69 of the constitution; see above) and it is therefore not legally binding, but only of an indicative nature. Budget balancing is not strictly required in his idealistic view of the government. Though scholars such as Philipp Zorn (1923) vigorously criticized Laband's theory, they were unable to uncover its detrimental influence on budget balancing and deficit spending. Obviously such theories or ideologies weakened the budget constraint and increased the discretionary power of the federal bureaucracy to overdraft the budget and to run into public debt.

With this policy the federal administration increasingly contributed to the growth of federal public debt up to the edge of bankruptcy and hence put the federal states under pressure to grant bailout.

We do not claim that our explanation of the budgetary process 1871-1913 is the unique one. Our econometric analysis cannot exclude the under-endowment as an alternative theory. We only propose an alternative way to read the history. But our explanation is consistent with homo oeconomicus and in this respect superior to the under-endowment theory which is based on the benevolent dictator theory. In the concluding section we shall show that our view has important consequences of explaining policy decisions in the past and today.

## **V. Conclusions**

In this final section we shall restate our conclusion that the under-endowment theory of financing the Kaiserreich should be dismissed (V.1). From this point of view we shall reconsider the claims made by Fergusson and Hefeker (V.2 and V.3).

### **V.1 Under-Endowment versus Inversed Bailout**

Nearly all authors who studied the public finances of the Kaiserreich come to the conclusion that its budget was substantially under-endowed. The federal government was characterized as a "boarder" at the table of the state governments who was kept at a minimum level of subsistence and who was therefore inadequately equipped to

---

<sup>14</sup> Note that around the turn of the century a law tradition was lacking as the Reich had no constitutional court.

fulfil his tasks. In a nutshell: Myopic representatives of the Bundesrat and the Reichstag were obstinate to furnish the federal budget with the necessary means. The budget remained under-endowed, driving the federal administration into ever increasing deficits. Only gradually and reluctantly did the representatives of the Bundesrat and the Reichstag allow for tax reforms in which they granted the national government the necessary tax bases – so far the “traditional” view.

In this paper we take a radically different position. We argue that rational representatives evaluate their opportunity costs when they consider to shift tax bases from the state/local to the central government. The national bureaucracy, however, has no such opportunity costs. Its utility grows the larger its budget is (Niskanen, 1971). In the Kaiserreich the antinomy between the two agents was solved constitutionally by giving the former the right to decide on the budget to be proposed by the latter. In practice, however, the power of the representatives to enforce their budgetary appropriations vis-à-vis a self interested bureaucracy was weak. Budget rules were replaced by ideologies. As a result, the bureaucracy retained the initiative, overdrew the budget and triggered financial crises, inducing the representatives to grant one tax reform after the other, in fact to bail out the bureaucracy.

In our analysis we want to draw the readers’ attention to a new form of a bailout. Whereas in public finance literature bailouts are usually conceived as actions in which higher level governments rescue lower level governments, in this paper we discussed “a reversed bailout” bottom up with lower governments rescuing an upper level government. The reversed bailout theory applied to the Kaiserreich contrasts with the traditional under-endowment theory, according to which budget deficits, during this period, came about by the stubbornness of the states and their representatives. We can see that both hypotheses can be illustrated by the same regressions. Equation (1) describes the traditional view of the budget process as well as the reversed bailout hypothesis. In either case, revenues were driven by the expenditures. But in view of the fact that our interpretation is based on modern economic theory instead of spurious ideologies, we can dismiss the under-endowment theory.

## V.2 Niall Ferguson Reconsidered

Niall Ferguson supports the under-endowment hypothesis too. Remember his claim that “... it was domestic politics which limited the size of the German army before First World War, and hence determined the degree of national security, and hence increased the willingness of Germany’s leaders to gamble on a first strike.” (see section III.3) If these constraints had not existed, the German army and navy would have grown much faster, and the probability of a (large) war would have been smaller. Two comments can be made: First, given the soft budget constraints and the activities of the bureaucracy to circumvent them and to incur public debt, it is not clear whether the German defence budget really was as restricted as assumed by Ferguson. Second, it can be argued that the German budget was not restricted enough. At any rate, the argument that, without the permanent overdrafts and the increases of the military power, the German general staff would not have had the courage “to gamble on a first strike” is much more plausible than Ferguson’s claim that a stronger German army and navy would have prevented the outbreak of the war.

### VI.3 Carsten Hefeker Reconsidered

Carsten Hefeker compares the budgetary rules of the Kaiserreich with those of the European Union and concludes:

“Beyond this historical analysis, there is another and broader conclusion that is particularly relevant for European unification. Inasmuch as tasks and responsibilities are transferred to the European level, member states must also ensure that the centre has the financial resources to fulfil those tasks. The German example has made clear that any other solution is unsustainable. But like the German states that were reluctant to transfer fiscal power to the centre, it is likely that the member states of the EU will be reluctant to grant more fiscal powers to the Commission. ... The impossibility of increasing EU central finances could become a problem if it were not possible to constrain the growing demand for funds<sup>15</sup> channelled through Brussels.” (C. Hefeker, 2001, p. 139 sq.)

It is true that the financing of the German Kaiserreich has some similarities to the financing of the European Union: they are both bottom up. But it seems to us that there is more to learn from the differences than from the similarities. Consider first expenditures and further below revenues.

Hefeker does not answer the question why the EU budget should be “unsustainable” (i.e. would lead to excessive deficits<sup>16</sup>). The sole reason that the EU budget is financed bottom up is obviously neither necessary nor sufficient. Bottom up financing is a method to find out how much each state should pay to the common budget. Whether federal authorities will spend more than that only depends of the budget constraint. At this point Hefeker should consider the differences: The Kaiserreich had very soft budget constraints as shown in section IV. The European Union in contrast has a very strong budget constraint. Art. 269 EC requires strict budget balancing and prohibits any debt. Moreover, in order to be on the safe side, it has been stipulated in the financial perspectives 2000-2006 as well as 2007-2013 that the Commission has to provide for a reserve margin in the budget which must not be overdrawn. These constraints turned out to be very effective. Up to now, the European Union has no public debt.

Hefeker’s argument that the Member States pay too little to the EU because they are allegedly as myopic as the Federal States of the Kaiserreich is also mistaken. Why should the EU Member States be ready to pay more as long as most of the budget is spent for distributive purposes? As long as there is no quid pro quo, no one is willing to pay more. In fact it is one of the fundamental deficiencies of the EU budget that it does not allow exchange. What a Member State contributes to the EU budget is completely independent of what it receives. Member State governments are locked in a fixed coalition. Neither the net payers are willing to contribute more (because of unanimity rule), nor the net receivers ready to forgo some of their transfers (because of qualified majority rule). In this sense the EU budget is balanced and stable, but on a very low level of efficiency.

---

<sup>15</sup> With “funds” the author means the resources of the cohesion, agricultural and structural funds (see C. Hefeker, 2001, p. 139).

<sup>16</sup> Cf. The quotation on p. 7 above: “Lacking adequate sources of finance, the centre was forced to cover its budget to a large extent via debt”.

#### VI.4 A Final Remark on the Kaiserreich versus EU Financing

All in all, the idea to finance federal states and associations of states bottom up is a valuable alternative compared to traditional top down financing. It may promote federalism and freedom, but it requires hard budget constraints as well as a collective decision making rule which makes the budget dependent of individual preferences in the member states.

The Kaiserreich was well organized in the sense that new national tasks could only be undertaken if the states and their representatives were willing to grant the incremental tax base for their financing, which made the opportunity costs visible. It was detrimental, however, that the budget constraint was not strictly enforced.

The European Union, in contrast, is strong in its budget constraint, but weak in organizing rational budgetary choice; for what is spent in the EU is independent of what a member state contributes. Quid pro quo is missing. The actual EU rules merely organize rent-seeking processes to distribute common funds for member state specific issues. In this respect EU authorities could learn from the Kaiserreich.

## References

- Andic, S., and J. Veverka (1964), The Growth of Government Expenditure in Germany since the. Unification, *Finanzarchiv*: 23, pp. 169-278.
- Blankart, Ch. B. (2005), *Öffentliche Finanzen in der Demokratie* (Public Finance in Democracy) München: Vahlen, 6<sup>th</sup> ed.
- Deutsche Bundesbank (1976), (Hrsg.) Deutsches Geld- und Bankwesen in Zahlen 1876-1975, Deutsche Bundesbank, Frankfurt; Knapp..
- Engle, R. F., and C.W.J Granger (1987), Co-Integration and Error Correction: Representation, Estimation and Testing, *Econometrica* 55, pp. 251 -76.
- Ferguson, N. (1994), Public Finance and National Security: The Domestic Origins of the First World War Revisited. *Past and Present* 142: 141-68.
- Gerloff, W. (1913), *Die Finanz- und Zollpolitik des Deutschen Reiches nebst ihren Beziehungen zu den Landes- und Gemeindefinanzen*. Jena: Gustav Fischer.
- Gerloff, W. (1929), Der Staatshaushalt und das Finanzsystem Deutschlands. In: W. Gerloff und F. Meisel (eds.), *Handbuch der Finanzwissenschaft*, vol. 3, Tübingen: Mohr, pp. 1-69.
- Hefeker C. (2001), Thae Agony of Central Power: Fiscal Federalism in the German Reich, *European Review of Economic History*, 5, pp. 119-142.
- Hoffmann, W.G: (1965), *Das Wachstum der Deutschen Wirtschaft seit Mitte des 19. Jahrhunderts*, Berlin-Heidelberg-New York: Springer-Verlag.
- Laband, P. (1888), *Staatsrecht des Deutschen Reiches*, Tübingen: Mohr, 5. Aufl. 1911-1914.
- Lehmbruch, G. (2001), Der unitarische Bundesstaat in Deutschland: Pfadabhängigkeit und Wandel, in: A. Benz und G. Lehmbruch (eds.) *Föderalismus. Analysen in entwicklungsgeschichtlicher und vergleichender Perspektive*, *Politische Vierteljahresschrift*, Special Issue, vol. 42, pp. 53 – 110.
- MacKinnon, J.G. (1991), Critical Values for Cointegration Tests. In: R.F. Engle and C.W.J. Granger, (eds.) *Long-Run Economic Relationships. Readings in Cointegration*. Oxford: Oxford University Press, pp. 267-276.
- Mueller, D.C. (2003), *Public Choice III*, Cambridge: Cambridge University Press.
- Neumark, F. (1970), Die Finanzpolitik in der Zeit vor dem I. Weltkrieg. In Deutsche Bundesbank (ed.) *Währung und Wirtschaft in Deutschland 1876-1975*, Frankfurt/Main: Knapp.

Rehkugler, H., and D. Jandura (2002), Kointegrations- und Fehlerkorrekturmodelle zur Finanzmarktprognose, in: J. Kleeberg und C. Schlenger (eds.), *Handbuch Portfolio Management*, Bad Soden/Ts.: Uhlenbruch.

Schumpeter, J.A. (1918), *Die Krise des Steuerstaates*, Graz und Leipzig: Leuschner & Lubensky, reprinted in: R. Hickel, ed., Rudolf Goldscheid, Joseph Schumpeter. *Die Finanzkrise des Steuerstaats. Beiträge zu politischen Ökonomie der Staatsfinanzen*, Frankfurt am Main: Suhrkamp 1976, pp. 329 – 379.

Smith, A. (1776), *The Wealth of Nations, An Inquiry into the Nature and Causes of the Wealth of Nations*, Online version.

Witt, P.-Chr. (1970). *Die Finanzpolitik des Deutschen Reiches von 1903-1913*. Lübeck: Matthiesen.

Witt, P.-Chr. (1986) „Patriotische Gabe“ und „Brotwucher“. Finanzverfassung und politisches System in Deutschland und im Kaiserreich 1871-1816. In U. Schulz (ed.) *Mit dem Zehnten fing es an*, München: Beck, pp. 189-199.

Zorn, Ph. (1923). Budgetrecht, in: *Handwörterbuch der Staatwissenschaften*, 4th ed., Jena: Gustav Fischer, 1923-1929, pp. 118-126.