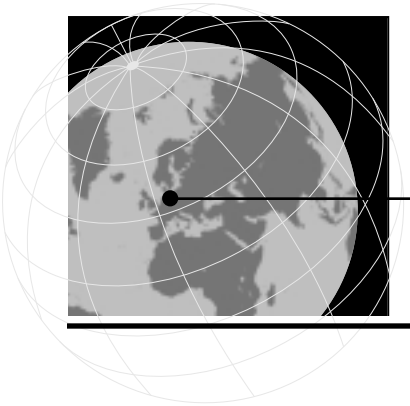

The German Constitutional Court takes on the principle of 'solidarity'

BY *PAUL BERND SPAHN*

A little more than two years ago three Southern states (Baden-Württemberg, Bavaria, and Hessen) launched a constitutional challenge to the system of intergovernmental fiscal arrangements in Germany.

Their quarrel with the system of interstate equalization was that it redistributes wealth to an excessive degree and creates negative incentives.

In its ruling of November 11, 1999 the German Constitutional Court declared the equalization law to be "transitory", and ruled that it should be phased out as of the 1st of January 2005.

The Court's verdict has given some support to an in-depth revision of the general philosophy of the German Constitution, and spurred farther-reaching discussions of intergovernmental fiscal relations.

This conflict on equalization is effectively a dispute over how far Germany should go to practice what Europeans call "interregional solidarity".

Can this "solidarity" be promoted without generating negative incentive effects?

The Court did not answer this question but took a formal approach to the *technical* aspects of the intergovernmental fiscal machinery.

Mechanisms for sharing the wealth in the German federation

In order to assess the Court's ruling, it is essential to have a basic understanding of intergovernmental fiscal relations in Germany (see box below).

Considering that income taxes are shared among tiers in fixed proportions, a balance between the states and the federal government (vertical fiscal balance) is mainly achieved by varying the states' share of the value-added tax. This is based on federal legislation, with the cooperation of states through the *Bundesrat* (the second chamber of the German parliament, consisting of appointed representatives of the state governments).

On the basis of an assumed fiscal balance among tiers of government, *horizontal fiscal balance* among states is then realized in three steps:

- the regional apportionment of the value-added tax;
- an interregional redistribution scheme;
- asymmetrical federal grants.

The Constitutional Court found that there is a lack of clear criteria for defining how wealth should be redistributed between

How the German fiscal constitution works

The almost complete lack of policy discretion of lower-level governments, and the inability of states to use their own tax instruments has promoted revenue sharing and intergovernmental transfers for fostering national homogeneity in Germany.

Taxes are basically uniform and their proceeds are often jointly appropriated among layers of government. This is true for about 75 percent of total revenue. Revenues from exclusive (but uniform) state taxes are only 4.4 percent of total tax. The sharing formulae are designed to balance fiscal resources between layers of government (vertical equalization), and to level out differences of regional tax potentials (horizontal equalization).

The constitution presumes that it is possible to define "necessary expenditures" at both levels and to achieve a "fair compensation" between them.

As regards the assignment of income taxes, the constitution is extremely rigid: half of the revenue falls to the federation, the other half to the states (with some participation of municipalities). The horizontal allocation follows the residence principle (with formula apportionment for the corporate income tax). "Fair compensation" between layers of government is primarily achieved through the vertical splitting of the turnover tax (VAT). Its allocation is governed by a federal law requiring the consent of the Bundesrat.

Vertical equalization was last revised in 1992 when the Eastern states were included in intergovernmental fiscal arrangements (taking effect in 1996). As a consequence, the states' shares of the VAT have considerably increased reflecting the need to reach consensus with the Western states. At present the federal share of the VAT is 50.5 percent.

The horizontal equalization mechanism consists of three stages:

At a first level, *the horizontal allotment of the VAT has a strong equalization element. Three quarters of the states' share are apportioned on population. Another quarter is reserved for states considered to be "financially frail". They receive supplementary transfers from the VAT to bring their fiscal potential per capita up to at least 92 percent of the average.*

At a second level, *there is a specific horizontal equalization scheme* (Finanzausgleich). *Regional equalization is arranged among states in a "brotherly" fashion. The "rich" states compensate the "poor" through financial transfers. The focus is on taxable capacity (as in Canada), with little or no concern for specific burdens.*

At a third level, *there are asymmetrical vertical grants: so-called supplementary federal grants. Such transfers have been widely used after unification—previously they were insignificant. In particular, "gap-filling grants" have been introduced that guarantee at least 99.5 percent of the average fiscal capacity for all states. Moreover, nine states out of sixteen receive federal grants to relieve the costs of "political management", and the new Eastern states (as well as some Western counterparts) receive federal grants in compensation for "special burdens".*

jurisdictions. And it requested greater transparency for fiscal equalization, both among the states and between the states and the federal government.

Vertical equalization

Regarding the sharing of resources between the federal level and the states, the constitution demands a definition of "necessary expenditures" at each level of government, and a "fair compensation" among jurisdictions. The Court deems this to be possible on the basis of objective statistical data and medium-term planning.

Unfortunately, this is likely to be an illusion.

It is impossible to compare the necessity of national defense at the federal level with education at the state level without relying on value judgments. Objective "needs criteria" are more easily established among entities with *comparable responsibilities* at subnational levels. It is perfectly feasible, for instance, to identify norms to allocate resources among states for primary education (e.g., the number of children of school age, and student-teacher ratios).

In a first reaction (of September 2000) to the ruling of the Court, the federal government has proposed to base the sharing of the value-added tax on the actual budget and financial planning exercise, in which the states are involved regularly. Moreover, the Finance Ministry regards a "law on general standards" redundant for that purpose. The existing machinery of value-added tax sharing would generate similar coverage ratios between "current income" and "necessary expenditure" at each level. It would also ensure fair compensation.

However, the Ministry considers an automatic rebalancing mechanism for the value-added tax share to be useful. But it is unclear how criteria for managing such a mechanism would be determined.

Horizontal equalization among the states

The mainstay of the Court's verdict is on equalization among the states. The German Constitution obliges lawmakers to take measures to equalize the differences in the financial capacity of states. This refers to *actual* financial resources, not to a relationship between revenue and specific expenditure needs.

The Constitution defines a yardstick for equalization between the states by the number of inhabitants.

The Court, in its decision, criticized the existing practice of weighting of population as a method to express specific burdens in certain cases—such as in the case of city states. The Court requested a scientific procedure of balancing, based on accurate data. But neither the federal government nor the states have seen the need to act.

Moreover, the Court questioned elements of "specific burdens" (for instance of harbours) that have crept into the state-to-state equalization system. The Court said they should either be abolished, or applied more generally on the basis of solid statistical criteria.

The Court points to a clear constitutional dilemma here.

On the one hand, the Constitution requests an objective quantitative approach for resource sharing between the federation and the states. (And it should be noted many experts argue such an "objective" approach may be, in fact, unattainable).

On the other hand, it says that population is the *sole criterion* for distributing resources among the states (whereas an approach based on needs could, in principle, be possible).

Given the German tradition, however, it is unlikely that more specific criteria for needs (as in Australia) will be used in the future.

The federal government is indeed prepared to abolish "needs related" elements in its equalization formula—such as the provision for harbours. However, it wants to retain the weighting in favour of city-states, arguing that there are peculiarities to be considered in the formula. Such peculiarities would be based on more reliable and objective criteria in the future.

Moreover, the Court wants "financial capacity"—the sole distribution criterion for equalization among the states—to be understood in a comprehensive way. Not only tax revenue, but also other non-market income of jurisdictions (such as royalties and concession levies) would have to be taken into account. Also municipal financial resources (now counted as elements of the states' financial capacity by only 50 percent) would have to be included *in full.*

The federal government seems to accept the Court's request to calculate the financial ability of states in a comprehensive sense.

But the reaction of the paying states remains to be seen. Some—in particular the richer "challengers"—would likely lose resources if this were done.

Federal intervention

The Court was particularly critical of federal equalizing grants.

It stated clearly that federal grants must remain exceptional and transitory measures to mitigate the financial stress of particular states.

At present, federal grants have a strong equalization effect on fiscal capacity per capita (99.5 percent of the state average for all states). They even have *perverse effects*—in that poorer states may end up at higher capacity levels than the richest ones.

The Court seems to have limited the degree of per-capita equalization to a level of 95 percent of the average. The federal government will therefore have to reduce the number of its grants as well as their magnitude.

In a first reaction, the Federal Finance Ministry has indeed announced that federal grants for relieving the costs of *political management* would no longer be made.

States in a situation of budgetary distress would still receive grants in the future, but only for a limited time—and on a regressive scale. States that are to receive such grants will have to present binding plans for financial reorganization. The federal government and the states will share the burden of such grants in relation to their spending.

Overall, the ruling of the German Constitutional Court will require a *fundamental review* of the existing German equalization law. But German lawmakers are unlikely to allow the existing model to disappear completely. Rather they will likely try to limit the changes, as much as possible, to minor revisions.

In the Germany of the new millennium interregional *solidarity*—the notion that there must be as great a measure of economic equality in the federation as possible—continues to exert a strong hold on the political culture, notwithstanding the stresses of unification.