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Keeping a coalition in line: German Chancellor Angela Merkel moderates a meeting of coalition members with Peter Struck of the Social Democratic Party, who was named co-chairman of the parliamentary joint commission to reform Germany's fiscal federalism.

German *Länder* to control own taxes?

Reform of fiscal federalism “one of the most difficult issues since unification”

BY FELIX KNÜPLING

LAST YEAR, THE FEDERAL Republic of Germany introduced the most extensive constitutional reform since its birth. The constitutional overhaul, which Germans call *Federalism Reform I*, established a new division of legislative powers between the federation and its constituent units, the *Länder*.

This year, *Federalism Reform II* is starting where *Federalism Reform I* left off. In its coalition agreement to form the federal government after the October 2005 elections, the Christian Democrats and

Social Democrats agreed that the first stage of reform should be followed by a further step – to adapt financial relations between the Federation and the *Länder* to the new underlying economic conditions in Germany and elsewhere.

In the first stage of this reform, legislators in Berlin barely touched on the constitutional provisions governing state finances, knowing that to do so would have made the process an impossible task. But even now, the challenge is big. The reform is being handled by a parliamentary joint commission of the lower

house – the *Bundestag* – and the upper house, the *Bundesrat*. As Christian Democrat leader Norbert Lammert, the Speaker of the federal parliament, put it during the first meeting of the commission in March 2007, the fiscal reform “is surely one of the most difficult issues the federal government and the *Länder* have had to tackle since German unification.”

Commission to decide on reform

The joint commission is co-chaired by Peter Struck, chairman of the Social Democratic parliamentary group in the *Bundestag*, and Christian Democrat Günther Oettinger, the premier of Baden-Württemberg. Each house of parliament

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has delegated 16 regular members to the commission. Four of the *Bundestag* delegates are members of the federal government. Almost all of the *Länder* have sent premiers.

The two chambers have agreed on a group of measures in a resolution that ties in with approval of the first stage of the reform. The commission's mandate includes the tasks of:

- Developing effective mechanisms to prevent and manage budgetary crises in the face of Germany's enormous public debt, which totals more than 1.5 trillion euros (more than \$2 trillion U.S.).
- Drafting proposals for the modernization of Federation-*Länder* financial relations, particularly in the areas of growth and employment policy.
- Strengthening the responsibilities of regional and local authorities, and ensuring they have the necessary financial resources to carry out their duties.
- Modernizing the administration and grouping together of public services with the aim of enhancing efficiency and reducing red tape.
- Easing the requirements for voluntary mergers between *Länder*.

Thus far, the commission discussed financial issues during a public hearing in June 2007, with 18 experts it appointed. A second public hearing focusing on administrative issues is planned for November. The aim is to enact final legislation in 2008.

More autonomy for the *Länder*?

Fiscal law in Germany is predominantly federal law, and the *Länder* are subject to many restrictions on raising revenues and carrying out expenditures. The country has a mixed revenue collection and distribution system. The most important taxes – the value added tax, and personal and corporate income taxes – are shared revenue sources for the *Länder* and the federal government. The basis of these taxes is decided jointly in the *Bundestag* and the *Bundesrat*. But the rates and basis for other tax sources belonging exclusively to the *Länder*, such as inheri-

tance or automobile taxes, also have to be passed by both chambers. Experts estimate that only two per cent of total *Länder* revenue is autonomous. This comes from the beverage tax (beer tax), entertainment tax, dog tax, and hunting and fishing tax. The only notable exception for total tax harmonization is the local business tax, which each community and city can set independently according to its needs.

Germany's fiscal federalism is also marked by a very complex financial equalization system aimed at providing comparable standards of living for people in the entire country, as the German Constitution requires. After distributing revenues to the *Länder*, a system of transfer payments kicks in, bringing the fiscal capacity of each *Land* to 97.5 per cent of the average. Critics contend that because

public services have led the *Länder* to rely on transfers from the federal government and to use borrowing as the instrument of choice to finance any spending shortfalls. This has contributed to the enormous debt the country has amassed.

The politics of fiscal reform

Some of the wealthier and more economically powerful *Länder*, ruled by Christian Democratic-led governments, are demanding more autonomy over the raising of income taxes. They prefer to raise their own tax rates on the share of income tax they are entitled to. Obviously, remodelling the revenue system in this fashion would encourage competition. This approach is largely supported by Christian Democrat politicians in the *Bundestag* and in the richer *Länder*, and by the Free Democrats.

However, the poorer *Länder*, especially in East Germany, whose economic capacity is about two-thirds of the average, are very reluctant to introduce more competition. As well, many Social Democrats remain skeptical, referring to the structural differences between the *Länder*. "Competition requires that the federation, the *Länder* and the communities are in the same position to fulfill their duties," Berlin mayor Klaus Wowereit of the Social Democrats said during a *Bundestag* debate on March 8, 2007. The premiers of the six *Länder* in the former East Germany accordingly made it clear they do not want to introduce changes to the

equalization system. Part of the equalization system is the Solidarity Pact II, negotiated in 2001. Under the terms of the pact, the East German *Länder* will receive special federal grants totalling 159 billion Euros until 2019, on a yearly declining scale, to enable them to cope with the challenges of unification.

Applying a "debt brake"

One proposal to deal with the debt crisis is to introduce a "debt brake," or a halt to



The beer tax is one of the few independent sources of revenue for the German regional governments. Drinking this beer is Guenther Oettinger, Baden Wuerttemberg's Christian Democratic Premier and co-chairman of the parliamentary joint commission to reform Germany's fiscal federalism.

the degree of fiscal equalization between the states is extremely high, the richer states are discouraged from increasing their efficiency because most of the gains would be transferred to the poorer states. It is also a disincentive for the poorer states to improve efficiency as that would decrease the amount of transfers they received.

The lack of *Land* autonomy on the revenue side and the strong restriction on the spending side which requires the *Länder* to provide a minimum quality of

Flores (1997), the Court declared this law unconstitutional. According to the Court, Congress's powers under the Fourteenth Amendment did not extend to the "intrusion at every level of government, displacing laws and prohibiting official actions of almost every description and regardless of subject matter." It was the Court's responsibility to determine whether Congress had overstepped its bounds. This seemed to promise a continuing judicial scrutiny of congressional legislation affecting the states. However, the Court has since retreated from a confrontation with Congress, and its rulings show considerable deference to congressional judgment.

Accused of commandeering

In other cases, the Supreme Court ruled against the federal government when it dictated specific behaviours to state governments.

For example, the court found that part of a law dealing with radioactive waste was unconstitutional. The provision required a state that had failed to provide for the disposal of low-level radioactive waste to take possession of the waste and become liable for damages associated with it. Justice Sandra Day O'Connor held that the Constitution simply does not give Congress the authority to require the states to regulate.

"Where a federal interest is sufficiently strong to cause Congress to legislate, it must do so directly; it may not conscript state governments as its agents," she held.

The court followed with a ruling striking down provisions of a handgun law that commanded state and local law-enforcement officers to conduct background checks on prospective handgun purchasers. The justices held that conscripting state officers to carry out a federal program violated the states' sovereignty.

But despite the publicity generated by these rulings, they had little impact on American federalism. For one thing, Congress has only rarely relied on commandeering state officials to achieve its ends. For another, as the court noted in *New York v. United States*, Congress could still regulate directly and to pre-empt contrary state regulations. Or Congress could establish grant programs that


would induce states to adopt the policies it favored as a condition for receiving federal funds.

States invoke immunity against lawsuits

The Supreme Court has given a mixed message when it comes to whether Congress can enact laws allowing state governments to be sued without their consent. The Court struck down seven federal statutes in the 1990s in which Congress had authorized persons to sue the states. In one case, then Chief Justice Rehnquist wrote that "each State is a sovereign entity in our federal system" and that "it is inherent in the nature of sovereignty not to be amenable to suit without its consent."

However, the justices have since ruled that Nevada employees could sue their employers in federal court for violation of the Family and Medical Leave Act. And in subsequent rulings the Court has continued its deference to Congress, upholding a federal law that guarantees that disabled persons can sue states in federal court. And in a Virginia case the justices ruled that the Bankruptcy Clause of the Constitution gives Congress the authority to take away the immunity that usually protects states from private suits.

Judges divided

The Supreme Court's federalism initiatives in the 1990s have proved less revolutionary than most commentators had predicted. In part, this may reflect the divisions among the justices. Many of the Court's federalism rulings have been 5-to-4 decisions, and efforts to pursue a more fundamental break with existing judicial doctrine might have splintered the Court majority. In part, however, it may reflect a lack of judicial commitment to federalism itself. Some commentators have suggested that the Court's rulings reveal less a principled attachment to federalism than a desire to enhance judicial power at the expense of Congress. Certain decisions support such an interpretation. Whatever the case, the recent replacement of two strong advocates of federalism – Chief Justice Rehnquist and Justice O'Connor – suggests that the final word on the question respecting the extent of the powers actually granted to the federal government has yet to be written. 

all borrowing. Another is the introduction of an "early warning system" to avoid unhappy budgetary surprises. But such moves would only help to prevent future indebtedness. Legislators still need to deal with the current debt of the *Länder* and the federation. Günther Oettinger, co-chair of the commission, proposed the introduction of a special solidarity fund to assist the *Länder* in reducing the debt. Some *Länder* argue there first must be agreement about how to avoid accumulating even more debt in the future before considering how to deal with the accumulated debt.

However, the *Länder* – especially the poorer ones in the east – obviously will face a huge challenge if a debt brake is introduced. Currently, they have had only two ways of balancing their budgets: cutting expenditures, or borrowing more money, thereby increasing their total debt. But cutting expenditures is not a viable option because most expenditures are prescribed by federal law. And if a debt brake is introduced, they will not be able to borrow money any more.

It seems like a no-win situation, but Hans-Peter Schneider, executive director of the Institute of Federalism in Hannover, argues that the East German *Länder* might be interested in receiving more fiscal responsibility because they know that this will be their salvation. "The *Länder* need greater fiscal autonomy," Schneider said. "First, they should have the competency to legislate on those taxes which are attributed to them. Second, they should be empowered to (place a) surcharge on shared revenues to finance specific tasks for a restricted period of time. Finally, they should be able to deal more flexibly in administering federal laws and to deviate from federal standards, which often are very costly for the *Länder*." In general, he argued that Germany's form of federalism needs to be shifted more from an administrative one to a creative, constructive model.

Federalism Reform II will not be completed until 2008 at the earliest. The grand coalition needs to be able to compromise with the *Länder* to reach agreement on legislation and get it passed in Berlin. When it is, it will represent more than a major step in the development of German federalism. 