Roads to Reform of German Fiscal Federalism

Lars P. Feld / Jürgen von Hagen

In theory, the German federal system is a cooperative one, but in practice, a lack of cooperation between the federal government and its constituent units has led to an impasse. The spending authority of Germany's 16 constituent units, the *Länder,* is restricted by federal mandates, and most legislation at the federal order requires the consent of the *Länder* in the upper chamber of parliament, the *Bundesrat*. This has allowed the *Länder* to acquire a veto on federal government legislation and has restricted the ability of the federal government to pursue its own policies. The veto power of the *Bundesrat* is often seen as a barrier to reform policies at the federal order, especially in times when each house of parliament is governed by a majority from a different political camp. Considerable control over levying taxes exists only at the municipal order, and it is of secondary importance. The most important taxes are decided jointly by the federal order and the *Länder* in the *Bundesrat*. The *Länder* cannot individually set tax bases or rates. Completing the system is a highly egalitarian fiscal equalization scheme to compensate poorer *Länder*.

During the last 25 years, the need to amend the fiscal constitution has become increasingly obvious. First, there have been calls for reforms of fiscal equalization because of

- disparities among the *Länder*,
- the highly egalitarian nature of fiscal equalization, and
- strong disincentives to invest in the improvement of the tax base at the *Länder* order.

Second, *Länder* in fiscal troubles due to excessive borrowing have taken the federal government to court to obtain bailouts of their debt. In 1992, the Federal Constitutional Court ruled that the federation must provide such bailouts for the *Länder* of Saarland and Bremen. These problems were already inherent in German federalism before unification, but have been exacerbated since then.

Politicians at the federal and the *Land* orders, their civil servants, and scholars from different disciplines have long been aware of the imbalance in German fiscal federalism. For the general public, the urgency of that situation became obvious after the *Land* of Berlin sued the federal order for a bailout in 2003 followed by another such claim by the Saarland in 2005.

In 2004, a federal commission made an attempt to develop reform proposals for German federalism, including fiscal relationships. Until the end of 2004, the commission was unable to come up with a compromise. On the basis of a new compromise between the *Länder*, prime ministers, and the work of the federal commission, the new Grand Coalition government of Christian Democrats and Social Democrats that was inaugurated in Berlin in November 2005 is trying to disentangle the responsibilities of the federal order and the *Länder*. In a declaration of intent, the new government is also proposing to discuss a reform of fiscal federalism at a later date.

Because the German fiscal constitution depends on the distribution of powers in the German federal system, a disentanglement of responsibilities ought to precede any reform of the financial relationships among the *Länder* and the federal government. The *Länder* and the federal order must each receive greater autonomy in several areas before the assignment of fiscal resources is possible. The reform proposal aims at reducing the share of legislation that requires approval by the Bundesrat from about 60 percent today to less than 50 percent after the reform. This would be accomplished by assigning more exclusive competencies for the *Länder*, for example in school and university education or the remuneration of public employees and civil servants, and for the federal order, exclusive competency in environmental legislation, among other areas.

The extent to which greater tax autonomy should accompany a greater responsibility of the *Länder* in several policy areas remains highly contested among the *Länder*, and also between them and the federal order, with no agreement on the direction the reform should take. Moreover, the net recipients from the fiscal equalization system are reluctant to accept changes in their relative positions. Finally, the *Länder* have depended on the federal government to bail them out of severe financial crises, and there is no agreement on how to end this dependency.

From an economic point of view, greater tax autonomy of the subnational jurisdictions and a greater responsibility to financial markets appear to provide a reasonable solution to re-establish the equilibrium of German fiscal federalism. However, no easy political solution to achieve greater fiscal autonomy is in sight. Exposing the *Länder* directly to an evaluation of their creditworthiness at the financial markets by denying a bailout is not feasible because some *Länder* would be subject to prohibitively high refinancing costs. However, the *Länder* are also reluctant to accept a reduction of their autonomy and provide the federal order with the power to enforce consolidation requirements for *Länder* that have accumulated excessive debt. In contrast, the net beneficiaries of the fiscal equalization system do not want to accept less fiscal equalization or greater tax autonomy. No matter how attractive it is to separate the distribution of powers from financial issues, in practice it will be difficult to discuss one without the other.

Some observers argue that a gradual increase in tax autonomy would be politically feasible. It could consist of four components. First, the extent and number of common fiscal responsibilities could be reduced. In particular, the shared responsibility for construction of university buildings could be abolished. Second, the legislative responsibilities for the tax sources, the revenue of which belongs to the *Länder* exclusively (e.g. motor vehicle, real estate purchase, and inheritance taxes), could be completely assigned to the *Land* order. Third, the *Länder* could obtain the right to levy a surcharge on personal and corporate income taxes. In addition, fiscal equalization could be reduced step by step to allow tax autonomy of *Länder* to induce its beneficial effects.

Greater tax autonomy would also be a precondition for solving the dependency of the *Länder* on federal bailouts or loans to meet expenses in the medium term. Today, the *Länder* seldom have an alternative to borrowing when they need to react to economic shocks. A short-term hardening of the *Land* budget constraints could be achieved by stricter rules to enforce consolidation of *Länder* with excessive debt. Solving the trade-off between more autonomy for each *Land* on the tax side and less autonomy on the borrowing side will render a reform of fiscal federalism difficult. Instead of discussing actual policy solutions, it may be better to consider procedures to diminish the dysfunctional elements of German fiscal federalism.