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The German Fiscal Federalism: in a State of Flux

by

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Abstract

This paper examines the German fiscal federalism and especially the revenues structure of federal states and local authorities in Germany. Besides an illustration of tax sharing between the three tiers of government in Germany, the main part deals with the equalisation among the federal states and the different proposals of reforming the local taxation. In the framework of the reforming process of the "Solidarity Pact II", the distribution of tax revenues, vertical grants and fiscal equalisation among the federal states (narrow definition) were newly arranged. However, in the field of local taxation, only a few different suggestions exist, e.g. by the BDI / VCI or municipal associations, which do not solve the problems of local taxation completely. Therefore, this paper also introduces "The Three-Pillar Model" as a suggestion for a modern local taxation in Germany. All things considered, the German fiscal federalism was and is in an extreme state of flux.

JEL Classification: H7; H2; H1

Keyword: Fiscal Federalism, Tax Competition, Local Taxation

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1. Introduction

Germany is a federal state with a three-level administrative structure. In addition to the federal government, whose ministries are based both in Germany's capital, Berlin, and in Germany's former capital, Bonn, there are 16 federal states plus a number of regional administrative bodies in Germany.

Within the regional administrative bodies in Germany, a further distinction is made between the regional planning associations[2], the administrative districts, the cities which are administrative districts in their own right (=incorporated cities) and the municipalities, which form part of the administrative districts. The towns and municipalities, which after numerous territorial reforms in the respective federal states between 1970 and 1977 have become very compact[3] by now in terms of their inhabitant structures, are the smallest local units in Germany.

On 31st December 2000, there were 13,897 municipalities in Germany, which in terms of their inhabitant numbers can be sub-divided as follows:

Table 1: Numbers of inhabitants in Germany's municipalities in 2000

Number of inhabitants	Number of municipalities
less than 100	226
100-499	3,454
500-999	2,521
1,000-4,999	4,809
5,000-9,999	1,288
10,000-49,999	1,348
50,000-99,999	109
100,000-199,999	43
200,000-499,999	27
500,000 and more	12

Source: Statistisches Bundesamt, 2002, page 56

In Germany, tax revenues are distributed among the individual regional administrative bodies both according to the separating system[4] and the compound system. This, for example, means that the tax receipts from the real property tax are available to the municipalities in full, while they also receive a fixed percentage of the tax receipts from the

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[2] The regions of Stuttgart and Hamburg and the surrounding regional association of Frankfurt are called regional planning associations.

[3] In France, there were altogether 36,679 municipalities in 1999, of which about 32,000 municipalities had fewer than 2,000 inhabitants. Yet, Germany is far from creating a realigned municipal structure, which Denmark did when it reformed its territories in 1970. See Werner, 2003, page 19 and 30.

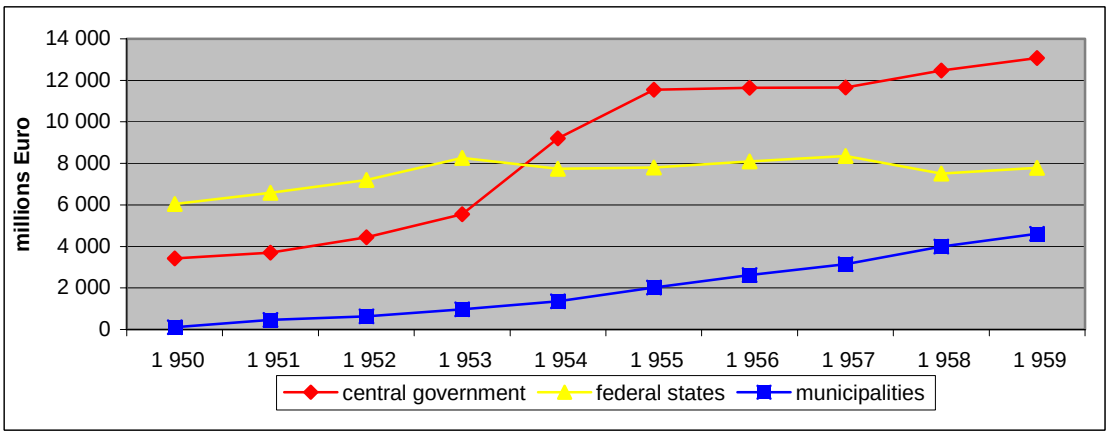
value added tax and the income tax. The powers to levy Germany's most important taxes are divided as follows:[5]

Table 2: Breakdown of tax revenues between the central government, the federal states and the municipalities in 2003

	Central Government	Federal States	Communities	Revenues in 2001
Consumption tax[6]	100 %			€ 60. 75 billion
Inheritance tax		100 %		€ 3.069 billion
Property tax			100 %	€ 9.076 billion
Income tax	42.5 %	42.5 %	15 %	€ 141.396 billion
Value added tax	51.4 %	46.5 %	2.1 %	€ 138.935 billion
Corporate Income tax	50 %	50 %		€ - 0.426 billion
Interest rebate	44 %	44 %	12 %	€ 29.846 billion
Trade tax[7]	14.8%	7.7%	77.5 %	€ 24.533 billion

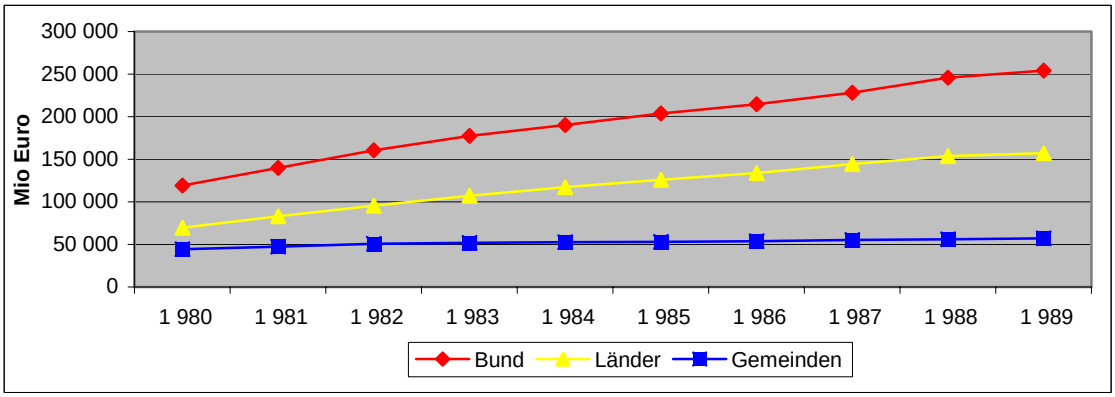
In the last few decades, the financial situation of the three regional administrative bodies has changed considerably. While the eleven federal states of West Germany had the highest amount of public debt at the beginning of the 1950s, the central government had accumulated the highest amount of public debt shortly before Germany's reunification.

Figure 1: Accumulation of debt for the period from 1950 to 1959



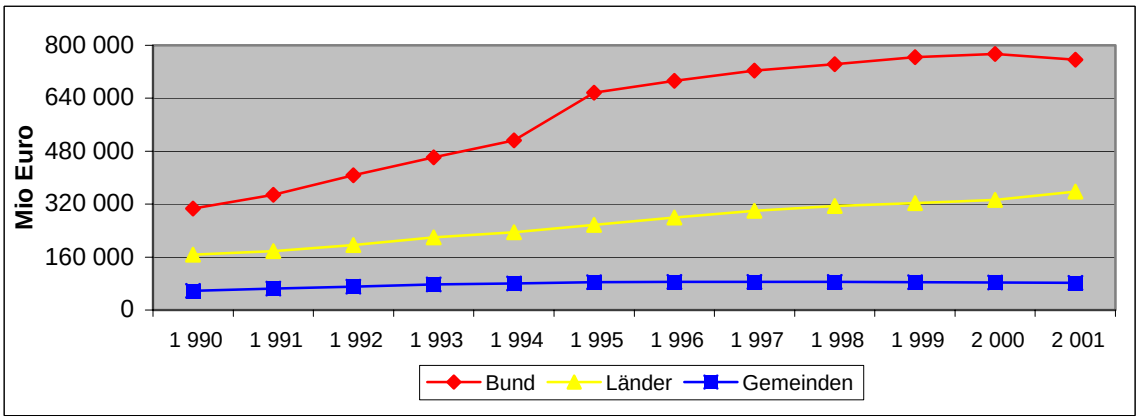
[4] According to article 106 of Germany's constitution.
[5] See BMF, 2002a, page 7 and BMF, 2002c, page 2,4,5 and 6.
[6] Tax on mineral oil, electricity, tobacco, spirits, coffee and sparkling wine.
[7] The breakdown refers to the 2001 tax year. The municipal share of the "German Unity" fund as well as the municipal share of the reformed fiscal equalisation system were added to the central government. A short survey of the equalisation between federal states and municipalities is located in the appendix.

Figure 2: Accumulation of debt for the period from 1980 to 1989



In the course of Germany's reunification, the federal government devised a number of shadow budgets[8] to finance the burden of German reunification, so that the financial situation of the federal government only became less constrained during the last few years, while the federal states at the same time incurred enormous amounts of public debt during the first decade after reunification.

Figure 3: Accumulation of debt for the period from 1990 to 2001

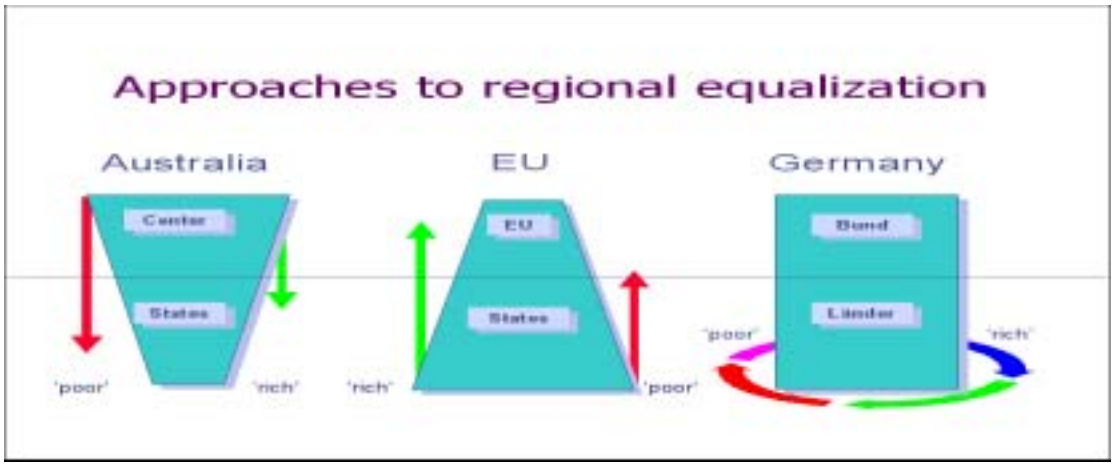


2. Fiscal equalisation among Germany's federal states – Problems and structural changes implemented up to now

Fiscal equalisation can take place both vertically and horizontally. The fiscal equalisation among Germany's federal states (Länderfinanzausgleich, LFA) is characterised by horizontal allocations of funds between the federal states – with the exception of the vertical allocations of additional funds by the central government. The following chart will provide a brief outline of the different international concepts:

Figure 4: Examples of fiscal equalisation among regional administrative bodies

[8] From 1990 to 1994, by creating a "German Unity" fund and the loan processing fund, from 1994 to 1998 by relying on the federal railway assets, from 1995 to 1998 by creating the inherited debt repayment fund and the "hard coal" equalisation fund, and from 1996 by creating the compensation fund.



2.1. Make-up and structure of Germany's fiscal equalisation up to 2005

Germany's fiscal equalisation among the federal states is based on article 107 of the German constitution and consists of several levels. Generally, the horizontal fiscal equalisation among the federal states can be classified as

- the distribution of corporation tax and income tax
- the distribution of value added tax
- fiscal equalisation among the federal states (narrow definition)
- and the allocation of additional funds by the central government[9]

Generally, the fiscal authorities in the respective federal states are entitled to receive, in full, the tax revenues from the state taxes and a percentage of both the income tax and the value added tax, according to the principle that taxes are collected in the place where they were generated.[10]

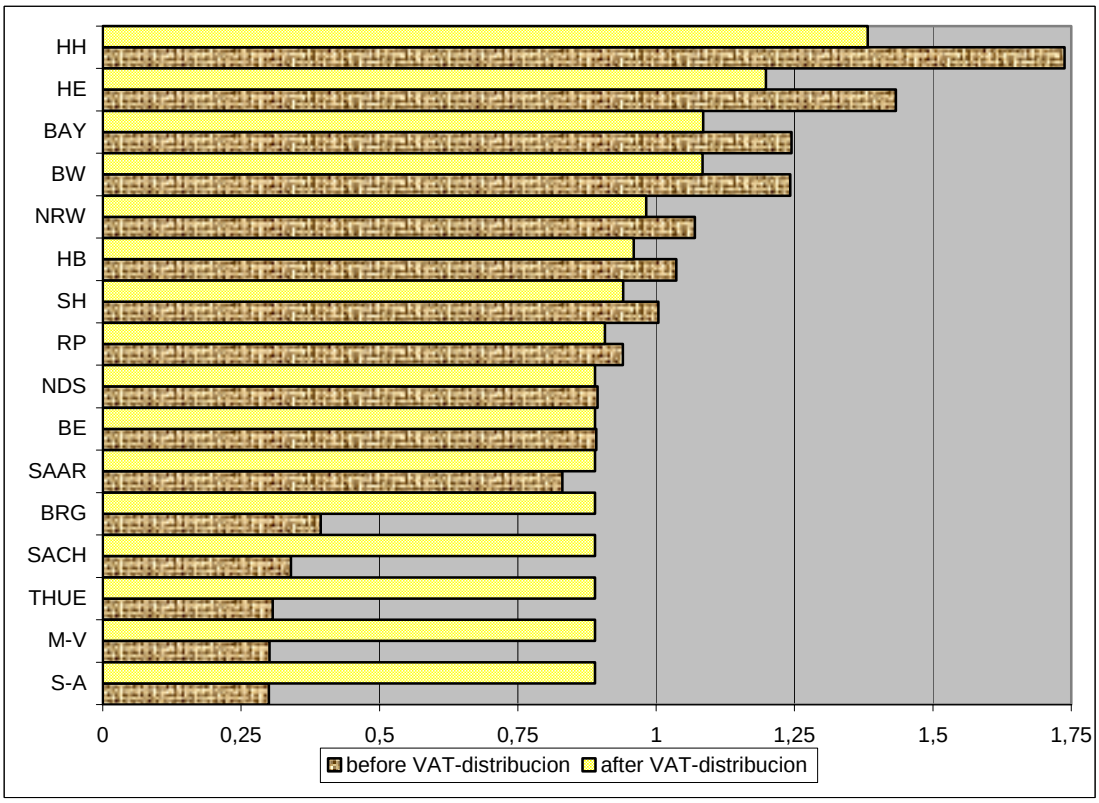
The principle of tax collection where generated runs counter to the law of tax entitlement and the breakdown of income and corporation tax. This is meant to prevent a company with several outlets in different federal states from paying its taxes exclusively in the federal state where its head office is based,[11] while the remaining federal states are not able to take advantage of any tax revenues.

When breaking down the corporation tax, the principle of the business location of the trade tax applies, while the breakdown of the income tax between the federal states is based on the principle of the taxpayer's place of residence. This principle of breaking down the taxes is also applied when determining the percentage that the federal states

[9] See Andel, 1998, page 523.
[10] See Scherf, 2000, page 52.
[11] See Scherf, 2000, page 52.

receive of the value added tax. Article 107, section 1, clause 4 of Germany's constitution stipulates that at least 75% of the generated VAT to which the federal states are entitled has to be distributed among the federal states according to the number of their inhabitants. The remaining 25% is distributed as an additional percentage to the financially weak states. Particularly because of Germany's reunification and the resulting incorporation of the new federal states into the Federal Republic of Germany, this financial redistribution has gained enormous significance. The following figure[12] serves to better illustrate the instrument of VAT redistribution and its effect:

Figure 5: Effect that the redistribution of the remaining percentage of VAT had in 2001:



Source: own illustration based on dates from www.laenderfinanzausgleich.com

It is clearly recognisable that already by redistributing the VAT, the new and financially weaker German states have come very close to reaching the average level of financial strength of the federal states.

Under the narrow definition of the fiscal equalisation system among the federal states, there are direct horizontal transfer payments between the federal states. The legal basis of these transfer payments is section 4 of the fiscal equalisation law (FAG).

[12] Each of the 16 Federal States has an abbreviation, which is explained in the appendix.

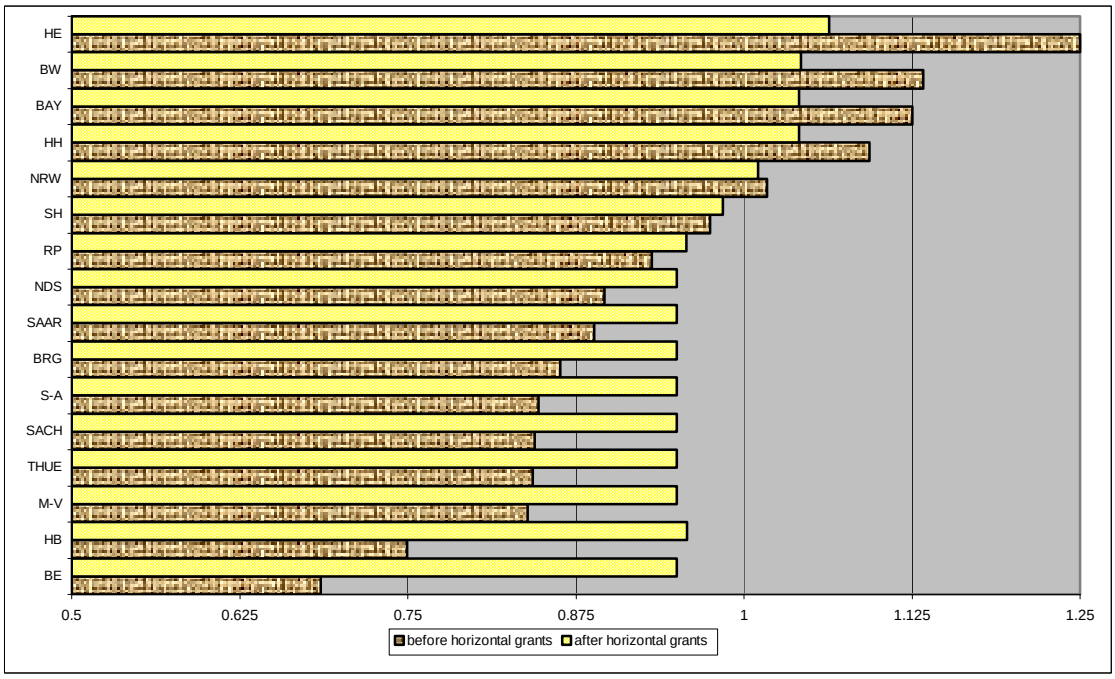
So as to determine the financial strength of every single federal state, one has to calculate the financial strength indicator in the fiscal equalisation system. This figure is composed of a state-specific total sum of state taxes as well as 50% of the municipal taxes.[13] The federal states of Bremen, Hamburg, Lower Saxony and Mecklenburg-West Pomerania are allowed to reduce their financial strength indicator on account of seaport charges, but the coastal state of Schleswig-Holstein is exempted from this regulation.[14]

Under the fiscal equalisation system, the financial requirements of each state are determined on the basis of an equalisation indicator. This equalisation indicator is calculated by multiplying the number of inhabitants of that state by the average nation-wide per-capita figure of the state and municipal tax revenues[15]. The inhabitant numbers of the city-states of Hamburg, Bremen and Berlin have been "readjusted", i.e. their inhabitant numbers have been multiplied by the factor 1.35.[16] Besides, there are additional allowances of 6% when calculating the financial requirements for densely populated regions.[17]

If the financial requirements of a federal state are higher than its financial strength, this state will receive equalisation funds from the financially strong states, whose financial strength is higher than their requirements. By means of these equalisation funds, the "recipient states" among Germany's federal states are able to increase their financial strength to at least 95%.[18] At the same time, the financial strength of the "donor states" must not fall below 100% of the average nation-wide financial strength, and the allocated funds have to correspond to the taxes of the financially strong states.[19] The following figure outlines the effect of the horizontal fiscal equalisation among Germany's federal states in 2001:

Figure 6: Effect of the horizontal fiscal equalisation among Germany's federal states in 2001:

[13] See Arndt, 1999, page 77.
[14] All in all, this reduction due to port charges amounts to a yearly total of around €150 million, which breaks down as follows: Lower Saxony €9 million, Mecklenburg-West Pomerania €25 million, Hamburg €71 million and Bremen around €45 million.
[15] The municipal taxes were only taken into account at 50 %.
[16] The „readjusted“ is a controversial issue; see Baretti / Huber / Lichtblau / Parsche, 2001, page 16-18 and Hickel, 2001, page 4.
[17] See Andel, 1998, page 524.
[18] See Thöne, 2001, page 39.
[19] See Scherf, 2000, page 56.



Source: own illustration based on data from www.laenderfinanzausgleich.com

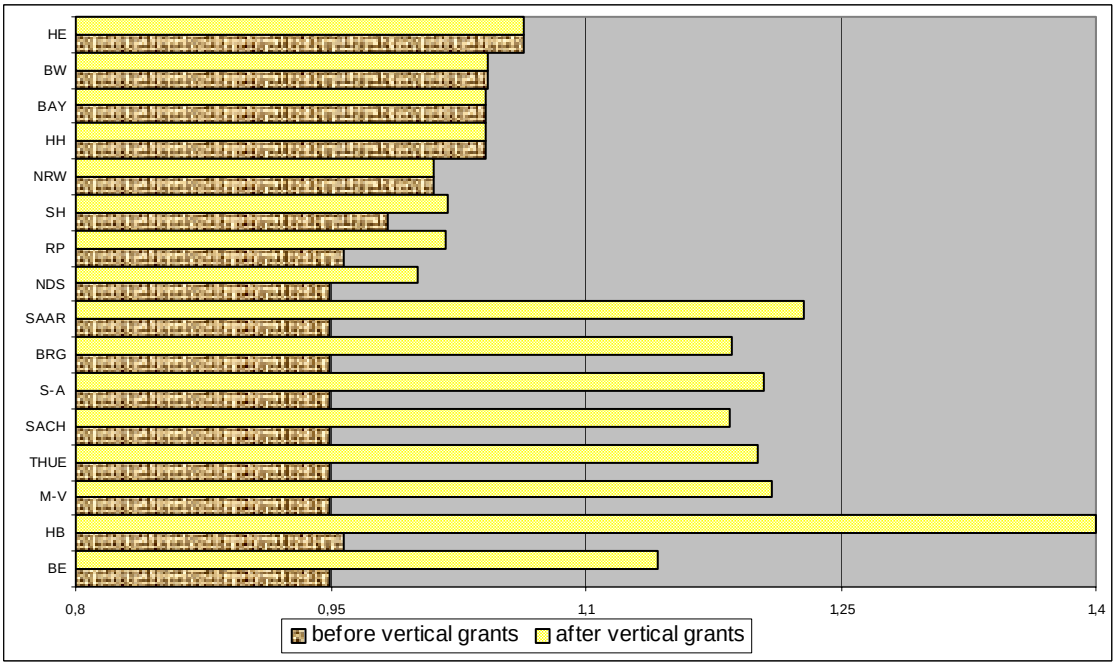
On account of the additional funds allocated by the central government, there are vertical grants from the federal government to the federal states. In 2001, the equalisation volume of the central government's additional funds amounted to about €12.6 billion in total.

Regarding the central government's allocation of additional funds, a distinction can be made between the allocation of deficit-coverage funds and special requirement funds.[20] The deficit-coverage funds enable the financially weak "recipient states" to reach 99.5% of the average financial strength of the federal states.[21] The allocation of special requirement funds means that for particular reasons, some federal states receive additional funds from the federal budget. Thus, for example around €0.75 billion a year flows to all those federal states with less than four million inhabitants in order to compensate for the disproportionately high political and administrative costs. The Hanseatic city of Hamburg is exempted from this regulation. In addition, there are special allocations of funds for budgetary crises (Bremen and Saarland), for the abolition of special charges relating to Germany's division (Berlin and all new federal states) as well as for the integration of the new federal states into the fiscal equalisation system (Bremen, Saarland, Rhineland-Palatinate, Lower Saxony and Schleswig-Holstein).

The following table illustrates the effect of the vertical grants in 2001.

[20] See Scherf, 2000, page 61.
[21] See Sturm, 2001, page 107.

Figure 7: Effect of the vertical allocation of funds on the federal states in 2001



Source: own illustration based on data from www.laenderfinanzausgleich.com

The fiscal equalisation system in its current form is a highly contentious issue. The federal states of Baden-Württemberg, Bavaria and Hesse have filed successful lawsuits at Germany's Constitutional Court in Karlsruhe. For this reason, a reform of the fiscal equalisation system had to take place before the end of 2002, as otherwise the way it is currently practised would have been unconstitutional from 2003 onwards and thus it would have lacked legal legitimacy. On 23rd June 2001, the federal states and the central government agreed on a reform of the fiscal equalisation system, which will come into force from 2005 onwards and will last until 2019. The basic points of Germany's "Solidarity Pact II" will be outlined in the following section.

2.2. Germany's "Solidarity Pact II" – Regulations governing the fiscal equalisation system until 2019

With Germany's Solidarity Pact II and the corresponding changes to the law, numerous interconnected elements of Germany's fiscal federalism have been reformed. All in all, the following areas have been affected by the changes to the law:

- The allocation of the respective VAT proportion to the federal states,
- Fiscal equalisation among the federal states (narrow definition),
- The allocation of additional funds by the central government and
- The "German Unity" fund

From 2005 onwards, when allocating each federal state a proportion of the VAT, the current system of a replenishment rate of 100% will be replaced by a relative replenishment system. By changing this rate, a higher VAT volume altogether will be distributed, and more financially weak states will reap the financial benefits of the remaining share of the VAT.[22]

In the horizontal fiscal equalisation among the federal states, some parameters of the assessment basis will be newly defined. As a result, from 2005 onwards the coastal states of Hamburg, Mecklenburg-West Pomerania, Bremen and Lower Saxony will no longer be able to claim port charges as a factor in reducing their tax strength. At the same time, the central government will allocate vertical grants of around €35 million per year in financial compensation to the affected states.

The readjustment of inhabitants in the three city-states of Hamburg, Bremen and Berlin by a factor of 1.35 will persist; however, from 2005 onwards, thinly populated states[23] will also be taken into account when assessing municipal taxes. At the same time, the current municipal assessment of inhabitants, which was graded according to the size of the municipality and the density of its inhabitants, will be scrapped.

When assessing the real tax strength of the municipalities in the individual states, which until 2005 will be determined on the basis of uniform assessment rates regarding the trade tax and the real property tax, these fictitious assessment rates will no longer be applied under Germany's "Solidarity Pact II".

Another aspect to consider in the horizontal equalisation is the increase from 50% to 64% when taking into account the revenues from the municipality tax. This step allows for a stronger consideration of the financial strength of the municipalities and hence takes into account the fact that in financially strong states, there are usually also financially strong municipalities. From a financial and political viewpoint, it would be right to take into account 100% of the municipal taxes;[24] however, a reduction of 36% as an exemption has been stipulated in the law on measures (MaßstG), and one can indeed agree with Mr. Grossekettler that this percentage is completely arbitrary.[25] The increase from 50% to 64% constitutes the biggest change within the horizontal fiscal equalisa-

[22] See Lenk, 2002, page 8.

[23] The federal state of Mecklenburg-West Pomerania is taken into account with the factor 1.05, the state of Brandenburg is given the factor 1.05 and Saxony-Anhalt is allowed to multiply its municipal tax requirements by 1.02.

[24] See SVR, 2001, page 5.

tion. Yet the preference given to federal states with financially strong municipalities, which was inherent in the previous system, has thus only been reduced, and not completely abolished.[26]

A so-called premium model will be newly introduced from 2005 onwards, which is meant to provide positive incentives both to the donor states and the recipient states under the fiscal equalisation system. By disregarding a flat percentage of 12% of above-average tax receipts and below-average tax shortfalls, the respective federal states are to be rewarded for positive developments regarding their tax revenues.

The rates governing the horizontal equalisation figures among the federal states have also been modified, and from 2005 onwards, there will be a change from the graduated tariff to a steady and linear tariff with considerably lower siphoning-off rates as far as the donor states are concerned. Consequently, the donor states no longer have to expect a siphoning-off rate of up to 80%, but only a rate of 75% at the most. [27]

There are also a number of new regulations concerning the vertical allocation of additional funds from the central government. For example, the vertical allocation of additional funds from the central government of €770 million in total per year, which go towards the costs of political administration and are paid to the thinly populated states, will be lowered to €520 million annually from 2005 on. Besides, in addition to the nine federal states, which already receive this money, the federal state of Saxony will also receive these vertically allocated funds from 2005 onwards.

The vertical grants for budgetary crises, which the federal states of Bremen and Saarland receive, as well as the central government funds for the integration of the new federal states into the fiscal equalisation system, which the federal states of Bremen, Saarland, Rhineland-Palatinate, Lower Saxony and Schleswig-Holstein receive, will last be granted in 2004 and discontinued in 2005.

The allocation of central government funds for the burden placed on the states by the division of Germany, which the east German states receive, will be set at €10.5 billion in 2005 and will gradually be reduced over the period of the "Solidarity Pact II" to €2 billion annually in 2019.[28]

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[25] See Grossekettler, 2001, page 3.
[26] See Lenk, 2002, page 15.
[27] A more detailed description is located in the appendix.
[28] A detailed apportionment is located in the appendix. However it could be criticised that distribution key is based on population figures of 1990. Therefore contortions are generated; See Kitterer, 2002, page 8.

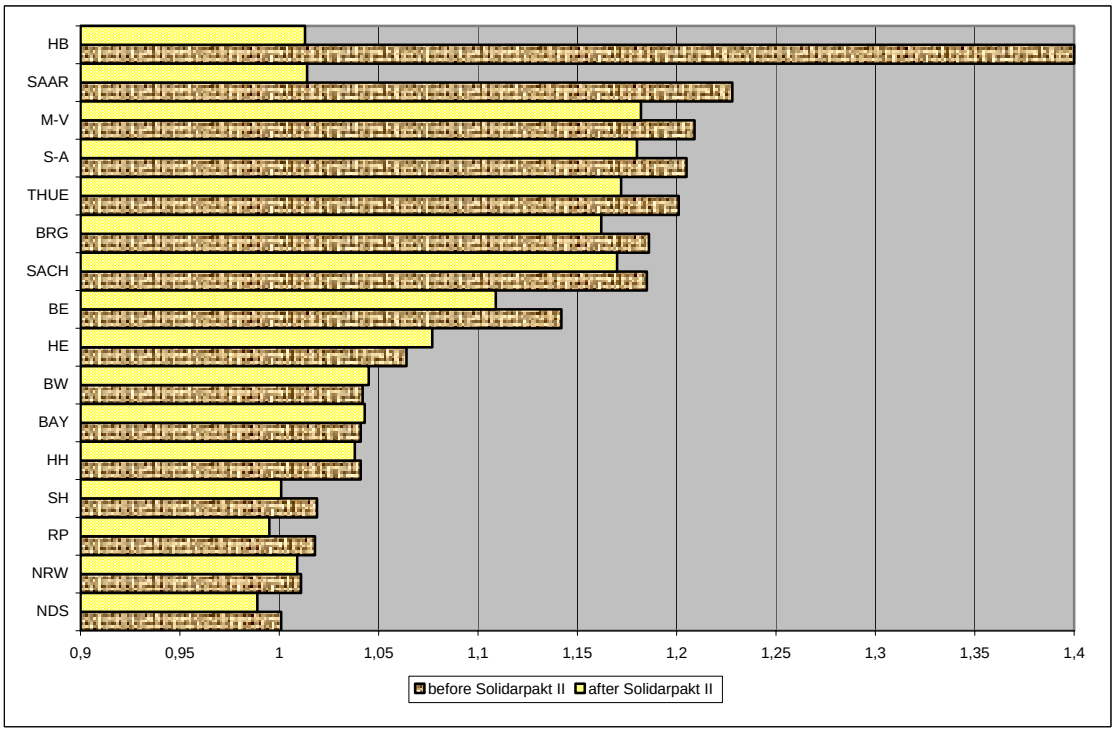
The tariffs relating to the deficit-coverage funds allocated by the central government have also been reviewed and will provide positive incentives, due to their lower replenishment level combined with an increased number of federal states entitled to receive these funds.

In addition to the above-mentioned new regulations, Germany's central government will also take over all annual debt repayments of the "German Unity" fund, thus relieving the west German states of this burden.

All in all, the new regulations mentioned above constitute an additional financial burden on the central government, and for this reason the central government and the federal states have agreed on a yearly compensation of around €1.32 billion to be paid to the central government from the VAT tax revenues.

The following chart illustrates both the impact of the horizontal as well as the vertical equalisation among the federal states up to 2005 (before the Solidarity Pact II) and from 2005 onwards (after the Solidarity Pact II) and is based on the tax receipts of 2001. It is easy to see that particularly the removal of the vertical allocation of funds for budgetary crises to Bremen and Saarland, and the first-time consideration of Saxony as a recipient of vertical funds towards the costs of its political administration have an enormous effect:

Figure 8: Effects of the Solidarity Pact II, based on the data of 2001



Source: own illustration based on data from www.laenderfinanzausgleich.com

3. The financial situation of the regional administrative bodies – Problems and reform proposals presented so far

Along with the central government and the 16 federal states, the 13,897 municipalities constitute the third level of Germany's fiscal federalism. The following section will therefore outline the income structure and the taxation powers of Germany's municipalities. After that, the different reform proposals will be classified and my own suggestion for reform will be presented.

3.1 Revenue structure of Germany's municipalities

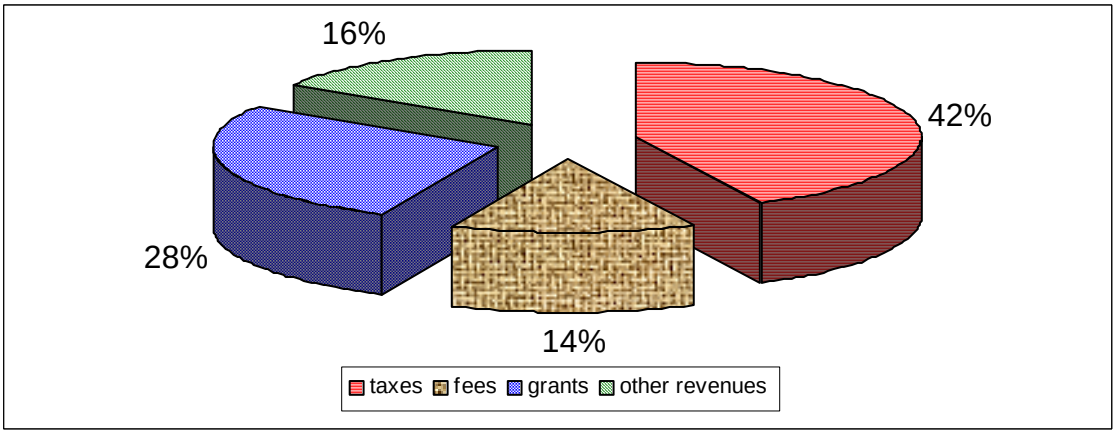
Although the two parts of Germany were reunited more than a decade ago, there are still enormous inequalities between the west and east German states in many aspects of every day life. In addition to a different unemployment rate – in west Germany, the unemployment rate was 9.0% in February 2003, while it was at 19.9% in east Germany during the same month[29] – there are also enormous differences as far as income and private wealth is concerned. While in 1998, every household in west Germany had average assets of DM 254,000 (€130,890), east German households had, on average, assets of only DM 88,000 (€44,990).[30] In terms of income levels, the relation is similar. In 1998, the gross annual income of a salaried west German employee was DM 54,603

[29] See BfA, 2003, page 2.
[30] See BMA, 2001a, page 67.

(€27,290), while in the new federal states people only received a comparable gross income of DM 39,993 (€20,450) annually.[31]

Due to these economic disparities, the income structures of the west German and east German municipalities are not compatible. In 2001, west German municipalities had revenues of €105.1 billion, which can be sub-divided as follows:

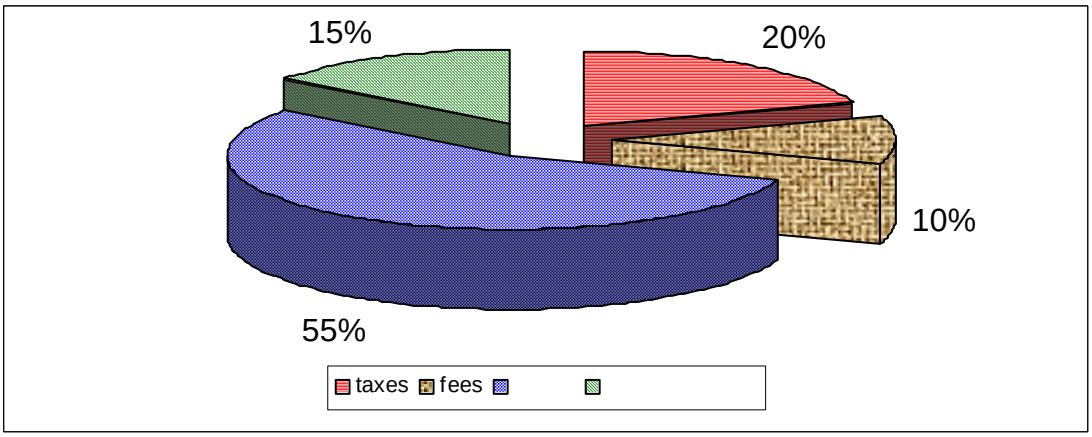
Figure 9: Revenues of west Germany's municipalities in 2001



Source: BMF, 2002b, page 1

East German municipalities had revenues of €19.9 billion in 2001, which consisted of the following revenue items:

Figure 10: Revenues of east Germany's municipalities in 2001



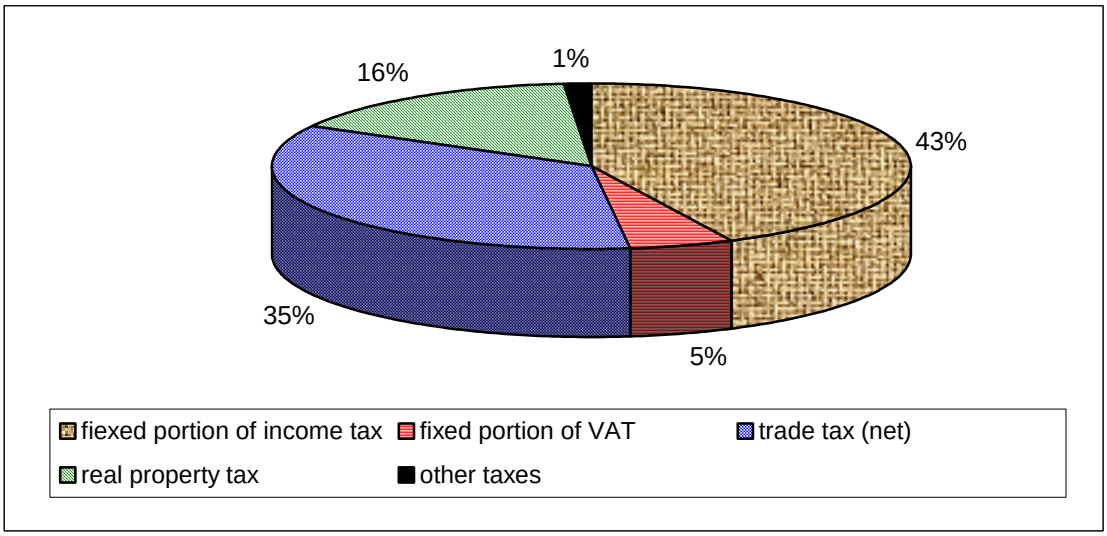
Source: BMF, 2002b, page 1

For the west German municipalities, the tax revenues are the biggest revenue item, while the east German municipalities are mainly funded by the allocation of money from the federal states. Within the tax revenue section, the biggest source of income for the west German municipalities is their fixed share of the income tax and the trade tax. For the east German municipalities, on the other hand, the trade tax and the real prop-

[31] See BMA, 2001b, page 42-46.

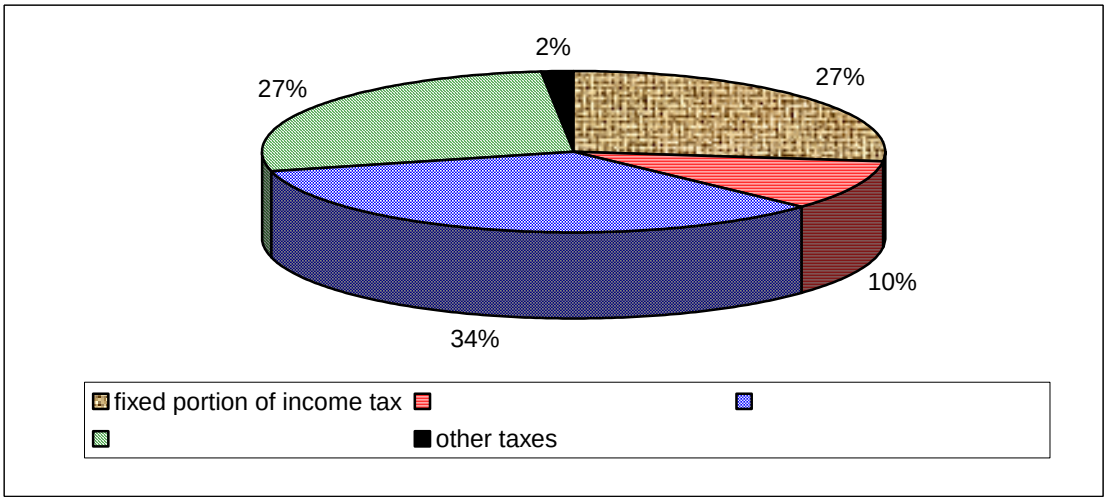
erty tax constitute the biggest revenue items. The following two illustrations show the respective structure of the tax revenues in 2001:

Figure 11: Tax revenues of west Germany's municipalities in 2001



Source: BMF, 2002, page 7

Figure 12: Tax revenues of east Germany's municipalities in 2001



Source: BMF, 2002b, page 7

3.2 Taxation rights of Germany's municipalities

In addition to their fixed share of the income tax and value added tax, the municipalities in Germany are entitled to stipulate municipal assessment rates within the real property tax and the trade tax, which ensures that at least some basic elements of fiscal autonomy are guaranteed.

3.2.1 Trade tax

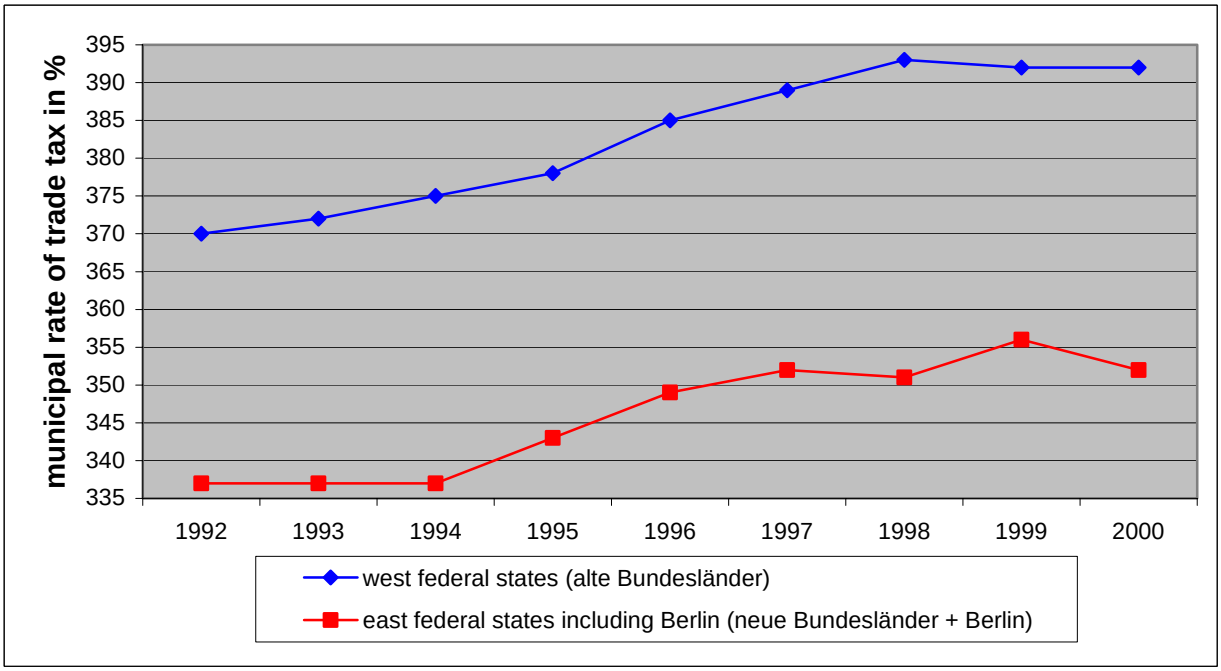
All German businesses are subject to the trade tax; however, freelance work is exempted from this tax.

Originally, the German trade tax used to have three tax assessment bases: the payroll tax, the trading capital and the trading profit.

As of 1st January 1980, the payroll tax and as of 1st January 1998, the trading capital tax as a component of the trade tax were abolished. As a financial compensation measure for the abolition of the payroll tax, the municipalities received a higher share of the income tax, and as regards the trading capital tax, the municipalities for the first time received a proportion of the VAT.[32]

The trade tax is determined by deducting the tax-exempt amount from the trading profit and then multiplying this figure by the tax assessment figure, which is at most 5 per cent and fixed by a federal law.[33] This interim result, also known as tax assessment amount, is then multiplied by the respective municipal tax rate. The municipal tax rates, which the municipalities are allowed to determine independently, have seen the following development in the last few years:

Figure 13: Development of the assessment rates of the trade tax



Source: BMF, 2002b, page 14

3.2.2 Real Property Tax

Under the German real property taxation system, the value of the property – irrespective of the economic profit generated on this property – is taxed.

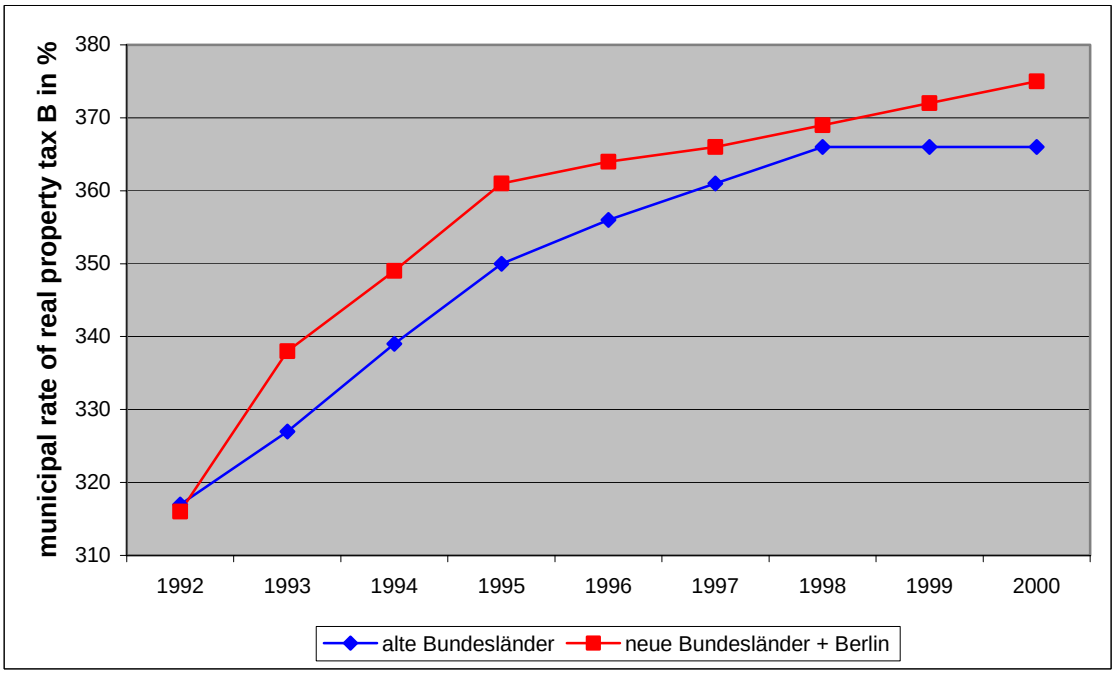
[32] See Zimmermann, 1999, page 183.
[33] See Brümmerhoff, 2001, page 520.

Property used for agriculture or forestry is subject to real property tax A, while all other properties are subject to property tax B. Publicly-owned real property is not taxed.

Similar to the trade tax, under the real property tax system the value of the property is multiplied by a tax assessment figure,[34] which is determined by the central government. This tax assessment figure is then multiplied by the municipal tax rate.

Although the tax assessment amount of real property tax B is lower than under property tax A, the tax revenues from real property tax B are significantly higher than from real property tax A, as the municipalities usually set a higher tax rate for real property tax B. During the last few years, the German municipalities have raised their rates for real property tax B considerably.

Figure 14: Development of the assessment rate of the real property tax:



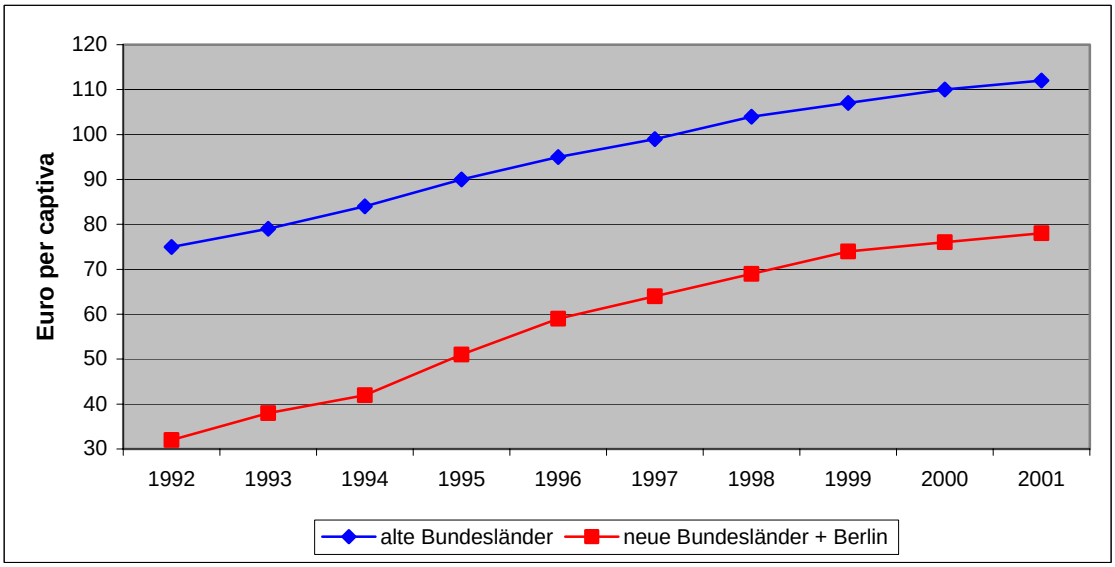
Source: BMF, 2002b, page 18

In an international comparison, the taxation of real property by the German municipalities is very moderate,[35] as can be seen in the following chart:

[34] Which is 0.6 per cent for real property tax A and 0.35 per cent for real property tax B.

[35] In Scotland, Croatia, Denmark and France, real property is taxed at a much higher level than in Germany. See Werner, 2003, pages 11-39.

Figure 15: Tax burden inflicted by the real property tax



Source: own illustration based on dates from BMF, 2002b, page 9 and 10

3.2.3 Other municipal taxes in Germany

There are a number of other taxes in Germany, which can be summarised under the heading of "petty taxes". These petty taxes include the alcohol tax, the entertainment tax, the dog licence tax, the pub licence tax, the hunting licence tax, the fishing licence tax and the second home tax.

According to the laws of their statutes, which are determined by the municipal tax laws of the respective federal states, the municipalities are free to decide whether to levy these petty taxes and how high they should be.

The tax receipts from petty taxes amounted to €628 million in 2001.[36]

3.3. Proposals for the reform of Germany's municipal finances

The financial situation of Germany's municipalities has deteriorated considerably during the last few years, due to the partly dramatic drop in revenues from the trade tax.

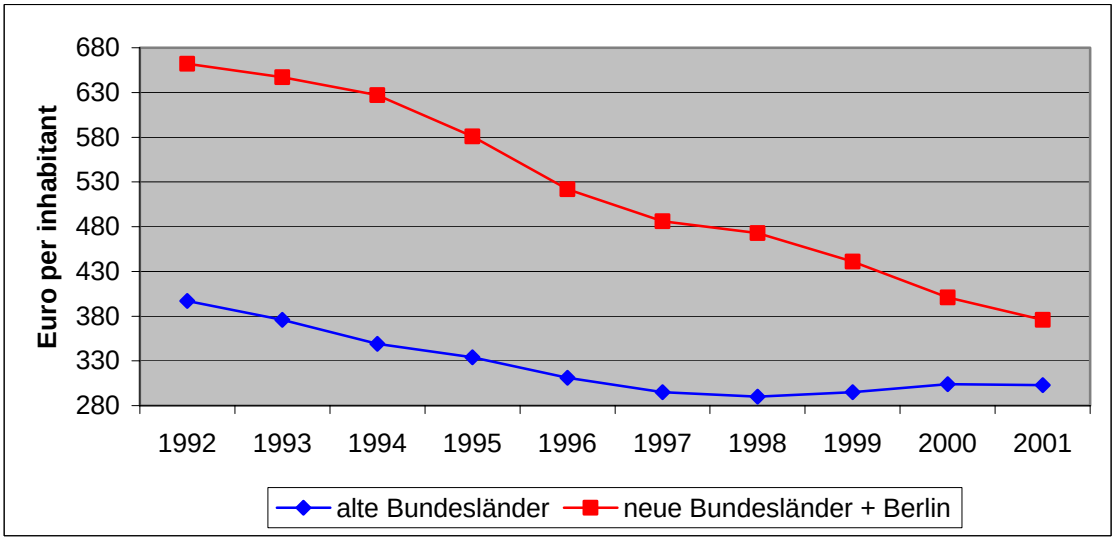
The reasons for the decline in municipal trade tax revenues were the weak economic situation on the one hand, but also the increase in the share of the trade tax which the municipalities have to hand over to the states and the central government (trade tax hand-over rate) and which is set by the central government.[37]

Germany's municipalities responded to the dire municipal budget situation by cutting back their spending on fixed-asset investments.

[36] See http://www.destatis.de/basis/d/fist/fist02.htm.

[37] In 2000, the share of the trade tax which the municipalities had to hand over to the states and the central government was approx. €5.52 bn, and in 2001 it was approx. €5.51 bn. During the same time, the municipalities' trade tax receipts fell by €2.5 bn; see BMF, 2002c, page 2,4,5 and 6.

Figure 16: Development of fixed-asset investments



Source: BMF, 2002b, page 21

The following sections will outline two main suggestions for reforming the municipal finances as well as my own reform proposal.

3.3.1 BDI Proposal: Municipal Income and Profit Tax

Together with the Association of Germany's Chemical Industry (VCI), the Federal Association of German Industry (BDI) has submitted a proposal for a municipal income and profit tax model.[38] The proposal of the two associations was elaborated by a "Research Group for the Reform of the Trade Tax", led by Professor Wolfgang Ritter.

The municipal income and profit tax does not envisage the municipalities to have their own tax, but entitles them to impose proportional and uniform surcharges on the income and corporation tax. On the one hand, this concept is meant to minimise the administrative burden, while simultaneously extending the municipal tax obligation from the business community to all taxpayers.[39] The BDI model envisages the abolition of the trade tax, of the trade tax hand-over rate, and of the municipal share of the income tax of 15%.

[38] As early as in 1968, the Scientific Advisory Council at the BMF had looked at, reviewed and approved a municipal income tax with the right to levy a proportional surcharge. In its report on reforming the municipal taxes, the Scientific Advisory Council at the BMF in 1982 looked at this possibility again and did not come up with a satisfactory solution regarding the distribution key and the problem of the municipal surcharge rates. For this reason, it rejected its introduction. See BMF, 1982, page 115 and 123.

[39] See BDI / VCI, 2001, page 18

So as to avoid double taxation because of the surcharge rates, the dividends are to be exempted from this regulation, as they are already taxed by means of the corporation tax and the income tax.[40]

The abolition of the trade tax would constitute a financial relief for both the central government and the federal states, as the current general possibility to offset the trade tax against the income tax liability as well as the possibility to deduct it from the corporation tax liability would be scrapped. This would more than compensate for the shortfall caused by the abolition of the trade tax share, which the municipalities pay to the states and the central government.

In addition, the BDI model proposes a change in the tax rates for 2005:

- The entry level of the income tax of the central government is to be lowered to 11.5 per cent, and the maximum taxation rate for the income tax is to be decreased to 32.2 per cent.
- At the same time, the corporation tax rate is to be raised to 28.6 per cent.

The implementation of these measures is meant to boost the financial and political scope for the municipalities when imposing surcharges on the income and corporation tax in order to ensure that nobody is left with a higher tax burden because of the fiscal reform.[41]

Putting the outlined BDI model into practice requires a constitutional change, and Germany's Constitutional Law would have to be changed in accordance with all political players. Article 106, section 5 in Germany's constitution would have to be changed in the sense that the municipalities will no longer receive a proportion of the income tax, but levy a surcharge on the income tax. Article 106, section 6 in Germany's constitution would then have to be changed in the sense that the municipalities themselves will be able to determine the rate of the surcharge tax on the income and corporation tax in the future.[42]

The model proposed by the BDI and the VCI has the massive disadvantage in that the municipalities, once this kind of municipal fiscal reform has been successfully implemented, will no longer have the incentive to encourage companies to settle in their area.

[40] At corporation level, the dividend income is taxed by a municipal profit tax, in addition to the corporation tax, and it is also taxed at shareholder level because according to the so-called semi-income taxation system, income tax is payable and hence the municipal income tax is also payable. See Fuest / Huber, 2001 page 31.

[41] See Müller-Seils, 2002, page 7.

Rather, the tax burden would be shifted from the business community to the residential community, and the municipalities would concentrate in particular on the taxation of the around 30 million people required to pay income tax – with the exception of the low income generated by the moderate surcharge on the corporation tax.[43] Although the supporters of a municipal rate on the income and corporation tax have partly conceded that this problem exists, the suggested solutions, such as the right to impose surcharge rates on trade income paid for by the business community instead of the residential community, are in reality very impractical indeed and would thus cancel out precisely one of the benefits of the BDI model – i.e. the simplification of the German tax law.[44]

It also needs to be taken into account that when scrapping the trade tax while simultaneously introducing a municipal surcharge rate on the income and corporation tax, this might lead to enormous taxation differences within densely populated areas between the core cities and the surrounding municipalities. The profitable belt of municipalities surrounding Germany's major cities would be boosted at the expense of the densely populated areas. In their simulation calculations[45] for the municipalities in the Saarland, Messrs. Fuest and Huber arrived at the conclusion that the state capital of Saarbrücken would have to levy a municipal surcharge rate of 21.0%, while the administrative district of St. Wendel would be able to generate the same tax revenues with a municipal surcharge rate of as little as 8.4%.[46] Whether or not such fiscal disparities will be tolerated both socially and politically in Germany in the long run, is more than doubtful. Up to this point, the goal of Germany's constitution, which aims to create the same living conditions for everyone, has been the highest maxim, and consequently heavy tax competition as it is practised in Switzerland, for example, has been ruled out. Yet in spite of all the economic differences[47] and problems, one should not belittle the success of the Swiss fiscal federalism but rather look at it in the context of the positive influence of direct democracy.[48]

3.3.2 Jarass Proposal: A Municipal Business Tax

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[42] See BDI / VCI, 2001, page 25.

[43] Particularly the corporation tax has seen a very negative development in terms of its fiscal yield following the change from the system of total income taxation to a system of semi-income taxation.

[44] See Fuest / Huber, 2001, page 18.

[45] Based on the tax receipts of 1999.

[46] See Fuest / Huber, 2001, page 37.

[47] The differences in the average per-capita income of the two neighbouring Swiss cantons of Jura (€21.839) and the city of Basle (€53.602) in 1999 are more than indicative of the economic differences. See Werner, 2003, page 12.

The model of the Bavarian Convention of Municipal Authorities, which was developed jointly by Professors Lorenz Jarass and Gustav Obermair, and which in a slightly modified manner has been favoured by other leading municipal associations[49] since March 2003, moves into a completely different direction.[50]

In contrast to the BDI, Mr Jarass does not want to scrap the trade tax but rather develop it further as a municipal business tax and thus "revitalise" the trade tax.[51] Mr Jarass' model for a reform of the trade tax is based on the notion of a municipal tax on value added,[52] but under the municipal business tax as defined by Mr Jarass the wages[53] are exempted from the tax assessment basis.[54] Mr Jarass suggests the following components as an assessment basis of a municipal business tax:

- the profits,
- all net-paid debt interest,
- as well as a yet to be defined percentage[55] of the paid rents and leases for real estate and licensed products.[56]

Employers' associations have rejected this proposal, which by fully counting the debt interest and by partially counting rents and leases consists of two non-earnings-related components, as they see a further weakening of medium-sized companies on account of this asset taxation.[57]

In addition to increasing the tax assessment basis, the municipal business tax aims to extend the tax obligation from the businesses that are currently taxable to self-employed people and agricultural and forestry businesses.[58]

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[48] See Feld / Savioz, 1997, Page 529 as well as Freitag / Vatter 2000, page 598.

[49] German Convention of Municipal Authorities, German Convention of Administrative Districts and German Confederation of Cities, Towns and Municipalities.

[50] See Federal Association of Leading Municipal Associations, 2003, page 2-3.

[51] See Bavarian Convention of Municipal Authorities, 2003, page 5.

[52] The idea of a tax on value added has often been floated in financial science. See BMF, 1982, page 135 as well as SVR, 1995, clause 346. The "tax on value added" ought not to be confused with the conventional "value added tax" or VAT, which is basically a tax on the sale of products and services. The aim of the "tax on value added", on the other hand, is to impose a levy on the total amount of all the additional values a business itself has generated over a period of time. It consists of the net output minus all previous investments, indirect taxes and the depreciation of assets, plus all governmental subsidies.

[53] In his plan for a municipal tax on value added eligible for inclusion, Scherf does actually want to tax wages. See Scherf, 2002, page 605.

[54] See Jarass, 2003, page 12.

[55] Up to now, Mr Jarass has only talked of an appropriate share and not yet fixed any concrete percentage rates.

[56] See Jarass / Obermair, 2003, page 159.

[57] See DGL, 2003, page 1.

[58] See Jarass, 2003, page 12.

By extending the tax obligation and broadening the tax assessment basis, new financial scope is meant to be generated in order to lower the rates of the municipal business tax and increase the tax-exempt amounts.[59]

The general tax-exempt amount for sole proprietorships of currently around €24,500 is to be increased to €40,000, while trading partnerships are excluded from this increase. However, partnerships are to receive a special tax-exempt amount of €10,000 and the sole proprietorships of €20,000 for offsetting debt interest against tax.[60]

The model of a municipal business tax further envisages the abolition of affiliations, which are subject to trade tax,[61]as well as some special regulations for financial companies.[62]

The model of a municipal business tax may become tricky when it comes to cross-border trade, as in many business sectors it is very difficult to fiscally trace the extent to which the respective value enhancement was generated in the corresponding business location. The problem of the municipal rates and the resulting lack of tax competition between the municipalities has not yet been coherently explained in the model of the municipal business tax, either. Despite all the protests from the relevant lobbies, it is sensible to tax self-employed people, as both a baker in his capacity as a businessman and a lawyer use the municipal infrastructure to their advantage, and hence both professions have to equally bear the costs of establishing and maintaining this municipal infrastructure.

3.3.3. Werner – The Three-Pillar Model

A large majority of all the models for reforming the municipal finances in the Federal Republic of Germany do not take into account important areas of municipal finances. For example, although they have either developed a variety of modernised trade tax models or the abolition of the trade tax and subsequent replacement models, these considerations nevertheless lack the inclusion of the real property tax.

Both the BDI model, which would shift the tax burden from the local companies to the residential community, and the municipal business tax model as developed by Messrs. Jarass and Obermair, whose assessment basis rests to a large extent on non-earnings-related components, show structural flaws. On the one hand, they aggravate the problem

[59] See Bavarian Convention of Municipal Authorities, 2003, page 10.
[60] See Bavarian Convention of Municipal Authorities, 2003, page 60.
[61] See Jarass / Obermair, 2003, page 160.
[62] See Bavarian Convention of Municipal Authorities, 2003, page 65.

of the city and its surrounding area (BDI model), on the other hand they burden the companies with a tax on assets, whose assessment basis is difficult to define in administrative terms. Despite this criticism, however, both models have a number of positive aspects, which have influenced the three-pillar model.

So as to be able to rest on solid financial foundations even during fluctuations in the business cycle, the municipalities will need three reliable tax sources, which they are able to influence themselves directly with their own tax rates in order to guarantee municipal self-government and financial autonomy in Germany:

- the municipal real property tax,
- the municipal income tax,
- and the municipal corporation tax.

Up to now, the German tax burden on property and real estate assets has been more than moderate. In an international comparison, the current real property taxes A and B are more than low if e.g. set against the north American and Canadian property tax, the British council tax, the Danish *grundskyld*, *daekningsafgigt* and *frigorelseafgift* as well as the French *taxe sur le foncier bâti* and the *taxe sur le foncier no bâti*.

The evaluation of real property assets in Germany is more than outdated, due to the uniform rates that are no longer up to date. Leaving the assessment to the municipalities and providing the following general guidelines through federal legislation could solve the problem of newly evaluating real property relatively easily:

1. The tax assessment basis for real property is provided by the three benchmark indicators of a) the maximum ground space, b) the maximum floor space and c) the size of the property. All three figures, which are fixed in every municipal building plan and/or the land registry office, are multiplied. In doing so, it is irrelevant whether the respective property really has buildings on it or whether building was restricted to a minimum when the building permission was granted.
2. The municipalities can divide individual building sections into special building zones, to which they allocate individual building zone factors. The municipal parliaments themselves decide on how high this building zone factor should be as well as how big the zone itself should be.
3. The municipal parliaments also set the municipal rates for the real property tax, with all zones being subject to the same municipal assessment rate.

4. All properties are subject to the municipal real property tax, i.e. private property, commercial property, property for agricultural and forestry use, and public property. However, for public properties, the zone factor is 1.0.
5. The central government will not impose a uniform tax assessment rate, so as to eliminate the current distortion among the tax rates of up to 375 percentage points.

Hence, the municipal real property tax is calculated in the following manner:

Ground space * Floor space * Size of property in square metres * Zone factor * Municipal tax rate = Tax liability in euros.

The municipal real property tax deliberately creates tax incentives for making the best possible use of the property, so that more investments in constructions on vacant properties can take place more quickly. Moreover, the municipal real estate tax promotes further density in urban development.

The municipal income tax includes the positive aspects of the BDI model. The municipalities are given the right to impose a further tax surcharge on the income tax and simultaneously give up their entitlement to a fixed percentage of the income tax revenues of 15%. The municipal right to impose a tax surcharge on the one hand increases the tax competition between the local administrative bodies, and at the same time makes the inhabitants contribute directly towards the costs of the municipal infrastructure. For the inhabitants, in particular, this makes things much more transparent, as they no longer contribute towards the financing of communal facilities (kindergartens, club subsidies, municipal roads, public swimming pools, social and cultural facilities) in an indirect fashion via a fixed percentage of the income tax, but via the "noticeable" municipal tax rates.

Unlike the BDI model, however, the municipal tax surcharges on the income tax have to have a lower and an upper limit.[63] On the one hand, this restriction will avoid a municipal "race to the bottom", and on the other hand there will be no enormous municipal tax rate divergence between the municipalities. However, the three-pillar model does not solve the city-cum-surrounding area problem. Although Croatia, for example, has a statutory regulation saying that the upper limit of the municipal tax rates is tied to the

[63] The practical implementation in Denmark, where the combined tax rate of the central government, the municipalities and the administrative districts is restricted to altogether 59%, can be mentioned as a relevant example.

number of inhabitants,[64] this measure nevertheless does not really eliminate the distortions between the surrounding area and the core cities. Rather, a feasible fiscal equalisation system at municipal level has to even out these tax disparities. Particularly the negative experience with the tax competition in Switzerland should be an incentive to ensure that the tax disparities between the municipalities are not too big to make sure that there is sufficient acceptance of the three-pillar model particularly among the leading municipal associations.

The third pillar of a workable municipal fiscal system is the municipal corporation tax. This tax is a modernised version of the trade tax, which rests on two components:

1. the profit component and
2. the minimum component.

Under the local corporation tax system, the current businesses as well as self-employed people and agricultural and forestry businesses are subject to taxation, as all these professional groups benefit from the municipal infrastructure.

Under the local corporation tax system, all taxpayers are taxed according to their declared taxable profits. However, there is a tax-exempt amount for all taxpayers, and this amount is twice as high for trading partnerships than for public limited companies. On the one hand, the tax-exempt amounts are meant to exclude very small businesses from taxation, and secondly, the higher amount for trading partnerships is designed to strengthen these partnerships altogether, as the recent possibility to offset debt interest will be scrapped to facilitate administration. It is intended that the principle of the business location will continue to apply; however, the municipal corporation tax would have to prohibit any kind of affiliation.

If a business or a freelancer does not report a profit, the minimum component of the local corporation tax will apply, which is intended to ensure minimum taxation. Such a kind of minimum taxation is not uncommon in comparison with other countries and has been introduced very successfully in Switzerland.[65] The assessment basis should be the

[64] See Werner, 2003, page 27 as well as Loncarevic, 2002, page 36.

[65] The minimum tax also taxes companies which do not aim to make a profit and yet at the same time benefit from public services. The minimum tax, which uses the turnover, real estate assets and the invested capital as its assessment basis, will only apply if the yields from the minimum tax are higher than those from other corporate taxes. The minimum tax is charged in 14 of the 26 Swiss cantons. The cantons of Nidwalden, Schaffhausen and Aargau impose a minimum tax along with the profit tax and the capital gains tax if the tax revenues they receive from the public limited companies and the co-operatives fall below a certain amount to ensure that a minimum taxation takes place. See Werner, 2003, page 15.

number of employees and the turnover, with very small businesses of up to three employees being exempted from the minimum component.

While the profit component should be taxed with a municipal rate by the municipalities themselves, the minimum component would have to be fixed centrally by the federal legislators. In addition, the tax burden inflicted by the minimum component has to be very moderate and should use the interest on equity as fixed by the rates of interest on long-term treasury bonds as a guideline.

The regulations of the profit component do not require further complication by a uniform nation-wide tax assessment figure, and any involvement of the central government and the federal states – as in the case of the percentage of the trade tax which the municipalities have to hand over to the central government and the states – should be avoided. Germany's towns and municipalities, in particular, have largely had to pay the price for recent reforms[66] and were allocated new tasks while the connection principle was disregarded. For this reason, a reform of the municipal finances will also have to ensure that the flow of funds is shifted in favour of the municipalities.

4. Conclusion

During the last few years, Germany's fiscal federalism has undergone a process of perpetual reform. On the one hand, the relative tax revenues have decreased due to the economic development in Germany, on the other hand, tax receipts that have existed up to now – the Corporate Income tax is a good example in this context – will shortly be phased out because of changes in the system. In addition, other incidents, such as the judgement by the Constitutional Court in Karlsruhe, require a constant renewal of Germany's fiscal federalism.

While the court's orders have already led to the implementation of some initial reforms in the fiscal equalisation system among Germany's states following the "Solidarity Pact II", there is still no workable solution when it comes to the problem of Germany's municipal finances. Although the reform commission set up by the German Finance Ministry is working on a proposal, it is unlikely that the members of the commission, given their different views, will arrive at a unanimous decision. The two proposals submitted by the BDI/VCI and by other leading municipal associations are so different from each

[66] Particularly the explanations given by Messrs. Fehr and Thöne clearly show that when fiscal reforms take place, the municipalities quickly have to pay the price for compromise proposals between the central government and the federal states. See Fehr / Thöne, 2003, page 10 and Fehr / Thöne, 2002, page 8.

other in their conceptual orientation that one may rightly doubt whether all commission members will be able to agree on one work result. The three-pillar model as outlined above could be regarded as a compromise between these two proposals, which encompasses the advantages of the models presented up to now and largely minimises their disadvantages.

In the field of the fiscal equalisation among Germany's federal states, an amicable settlement has been reached between the central government and the 16 federal states; however, the municipalities were not included in the negotiations. As a result, it would not be surprising if both the central government and the federal states saw themselves as the winners of the new arrangement, whereas the municipalities will only realise from 2005 onwards that they will be paying the price of this reform. Admittedly, from 2005 onwards, there will be more financial incentives both for the donor states and the recipient states when it comes to generating tax revenues and offsetting them under the fiscal equalisation system, and the often criticised port charges for some northern German states will also be abolished. However, in this area, too, Germany's fiscal federalism needs to be further reformed. Particularly, the consideration of the municipal revenues at a level of 64% and the vertical grants for special requirements will need to be re-examined.

At the moment, however, the reform of Germany's municipal finances forms part of the political agenda, and up to now it seems as though this reform project, unlike Germany's "Solidarity Pact II", will not be solved by means of an all-party consensus. As a result, Germany's fiscal federalism will continue to remain in a constant state of flux.

5. Appendix

The local financial equalisation between federal states and municipalities in 2001:

	Obligatory tax sharing	Gew.St.	motor vehicle tax	conveyance duty	wealth tax	LFA	BEZ-1	BEZ-2
S-A	24,00	23,00	23,00	23,00	23,00	23,00	23,00	26,30
MV	26,99	-	26,99	26,99	26,99	26,99	26,99	26,99
THUE	23,00	23,00	23,00	23,00	23,00	23,00	23,00	40,00
SACH	25,799	25,799	25,799	25,799	25,799	25,799	-	25,799
BRG	25,00	25,00	25,00	25,00	25,00	25,00	25,00	25,00
SAAR	20,00	-	20,00	20,00	20,00	20,00	20,00	20,00
NDS	17,01	-	17,01	17,01	17,01	17,01	17,01	17,01
RP	21,00	-	21,00	21,00	21,00	21,00	21,00	21,00
SH	19,78	19,78	19,78	19,78	19,78	19,78	19,78	19,78
NRW	23,00	-	-	13,43	-	-	-	-
BW	23,00	23,00	23,39	55,00	-	23,00	-	-
BAY	11,54	11,54	65,00	38,00	-	11,54	-	-
HE	23,00	23,00	23,00	23,00	23,00	23,00		

BEZ-1: vertical grants for deficit coverage
BEZ-2: vertical grants for special requirement
Gew.St: federal portion on trade tax (without the portion of the central government)
LFA: fiscal equalisation among Germany's federal states.
Obligatory tax sharing: obligatory portion of the municipalities at the compound system according Article 107, section 1 GG

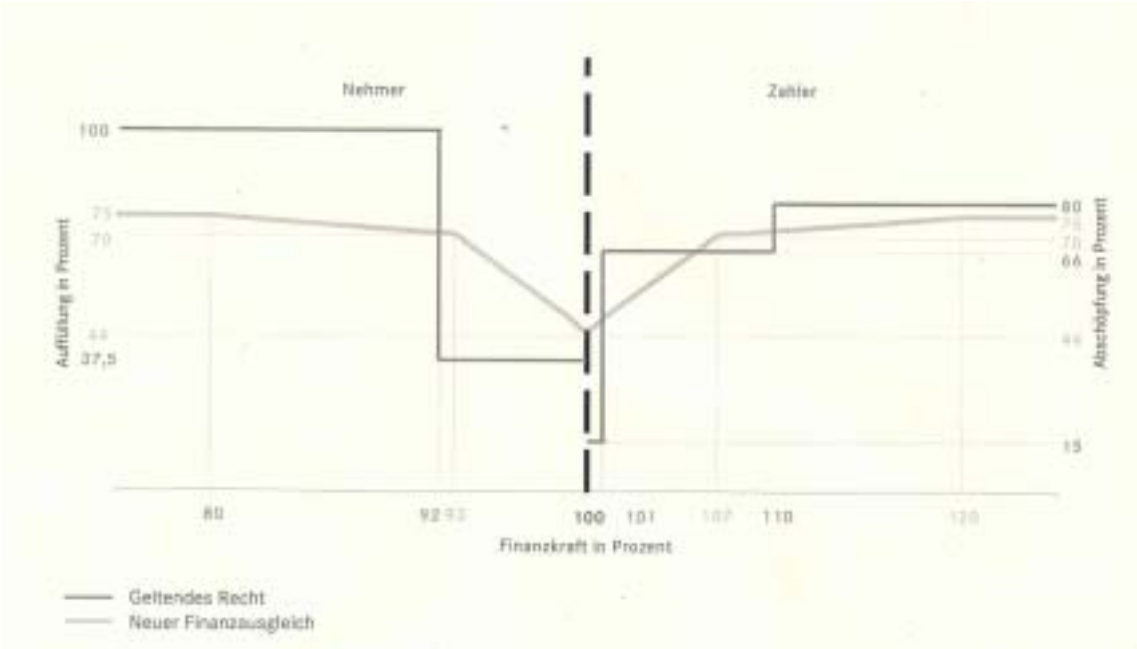
Source: Karrenberg / Münstermann, 2002, page 26 and Fehr / Tröger, 2002, page 5

Abbreviations of the German federal states:

	German	Englisch
S-A	Sachsen-Anhalt	Saxony-Anhalt
MV	Mecklenburg-Vorpommern	Mecklenburg-Western Pomerania
THUE	Thüringen	Thuringia
SACH	Sachsen	Saxony
BRG	Brandenburg	Brandenburg

SAAR	Saarland	Saarland
NDS	Niedersachsen	Lower Saxony
RP	Rheinland-Pfalz	Rhineland-Palatinate
SH	Schleswig-Holdstein	Schleswig-Holstein
NRW	Nordrhein-Westfalen	North Rhine-Westphalia
BW	Baden-Württemberg	Baden-Wuerttemberg
BAY	Bayern	Bavaria
HE	Hessen	Hesse
BE	Berlin	Berlin
HH	(Hansestadt) Hamburg	(Hanseatic city) Hamburg
HB	(Hansestadt) Bremen	(Hanseatic city) Bremen

Modification of the tariffs for horizontal grants among the federal states:



Source: Bayerisches Staatsministerium der Finanzen, 2001, page 9

Development of the vertical grants for the burden placed on the states by the division of Germany until 2020:

Year	Amount
2005	€10.53 billion
2006	€10.48 billion
2007	€10.38 billion
2008	€10.23 billion
2009	€9.51 billion
2010	€8.74 billion
2011	€8.03 billion

2012	€7.26 billion
2013	€6.54 billion
2014	€5.78 billion
2015	€5.06 billion
2016	€4.29 billion
2017	€3.58 billion
2018	€2.81 billion
2019	€2.10 billion
2020	€0.00 billion

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