Germany – An Overview of Fiscal Arrangements

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The Federal Republic of Germany (FRG) consists of 16 states, or *Länder*. Its federal parliament consists of two houses: the *Bundestag*, to which the ministers are responsible, and the *Bundesrat*, which has regional representation. The *Bundesrat* consists of members of the governments of the *Länder* (ministers, permanent secretaries and heads of government) and plays a central role in the relations between the two main orders of government in Germany.

The federal government generally has legislative authority while the *Länder* and the Communes are generally responsible for the implementation and administration of policies. In accordance with this principle of shared responsibilities, the *Länder* administer roughly 75% of federal laws, including the collection of the main taxes (value-added tax and corporate and personal income taxes).

Federal authority is exclusive over foreign affairs, defence, citizenship, immigration, currency, and air transport, in particular. The *Länder* have jurisdiction over culture, health, education, public security and regional development. The Communes are assigned responsibility for various local public services, local health care delivery centres, school buildings, housing and roads.

Spending

Federal spending power is overseen by the *Bundesrat*, which must approve by an absolute majority of votes any use of the federal spending power that affects the *Länder*. The general breakdown of public spending by order of government in 1995 was: *Länder* 38 %; Federal government 35 %; Communes 27 %.

Taxation

Germany has a highly developed system of intergovernmental financial relations. Apart from the sharing of tax revenue, it includes a three-part equalization system - sharing of VAT, horizontal equalization, additional transfer payments - and a series of shared-cost programs. Taken together, the three components of the equalization system seek to achieve uniformity of living conditions for Germans throughout the Federation by equalizing the financial capacities of the *Länder*.

The proceeds of personal income tax (PIT) are shared by the Communes (15%), the federal government and the *Länder* (42.5% each). Corporate tax is shared equally between the federal government and the *Länder*. Revenue from the value-added tax (VAT) is also shared between the federal government and the *Länder*. A federal law, requiring the approval of the *Bundesrat*, determines the rules of sharing. These shared taxes are collected by the *Länder* on behalf of the Federation, which returns their shares to them according to rules of sharing set out in the Constitution (*Basic Law*) and in federal legislation. The federal government sets, collects and remits the proceeds of two taxes: customs duties, which it remits to the European Union, and duties on beer, which it pays in full to the *Länder*.

The federal government alone sets and collects excise taxes. The *Länder* alone set and collect taxes on gambling and gaming, estate taxes, taxes on real estate transactions, and the tax on motor vehicles. The Communes derive part of their revenue from property taxes.

Sharing of the VAT

The sharing of VAT revenue is one of the main instruments available to the Federation to balance the "current revenue" with the "necessary expenditures" of the two orders of government. Currently, 2.2% of VAT proceeds are paid to the Communes and 5.63% is earmarked for the federal government as compensation for improving its pension plan. Of the remaining 92.17%, the federal government receives 50.25% and the remaining 49.75% goes to the *Länder*. Three quarters, at least, of the share of the *Länder* is redistributed among them according to their demographic weight.

Equalization

Component 1: Sharing of the VAT

The portion remitted to the *Länder* that is subject to the rules of equalization, namely 25% of their share, is paid to the less affluent *Länder* to raise their per capita income to 92% of the national average. If the objective is achieved with less than the 25% stipulated for this purpose, the remainder is redistributed to all the *Länder* based on their share of the population. At this stage, only the revenue from the sharing of PIT, corporate income tax and the local business tax is considered in the calculations.

Component 2: Länderfinanzausgleich (LFA)

The LFA, or horizontal financial equalization, is a mechanism for equalizing the financial capacities of the *Länder* and is funded entirely by them. It consists of four distinct processes, the first two of which involve calculating the financial capacity and demographics of each *Land.* The third process involves the application of an equalization index, and the fourth involves collection of contributions from *Länder* in a surplus position and payment to *Länder* in a deficit position.

Component 3: Bundesergänzungszuweisungen (BEZ)

The BEZ, or additional transfer payments, are the third component of the German equalization system. Some BEZ were created following reunification with the GDR and, accordingly, meet the special needs of the new *Länder* that are much less affluent than those of West Germany. The federal government covers the cost of these programs, some DM26.1 billion in 2000.

Other transfer programs

The federal government and the *Länder* have developed a number of shared cost programs, in particular to improve institutions of higher education and develop the regional economies (federal share: 50%), to support agriculture and its infrastructure (federal share: 60%) and to preserve the shoreline (federal share: 70%).

Dispute settlement mechanisms

Although the *Basic Law* grants the *Bundesrat* a right of review on any federal draft legislation designed to amend the Constitution or affect the finance or administrative jurisdiction of the *Länder*, at times the two houses can fail to agree on the scope of this right, one arguing that it is entitled to oppose a bill while the other maintains that the bill lies outside its province. In such cases, the parties may ask the Constitutional Court to settle the dispute. In addition, it often happens that the two houses fail to reach a compromise on bills that require the approval of the *Bundesrat* and the *Bundestag*, i.e. bills affecting the *Länder*. In such cases, either house may call on the Mediation Committee. This committee consists of a representative of the government from each *Land* (member of the *Bundesrat*) and of 16 deputies of the *Bundestag*, in proportion to the seats held by each party, for a total of 32 members. It is chaired alternately by a member of each house. Furthermore, there are a large number of intergovernmental councils that coordinate the various policies of the three orders of government. While these councils have only an advisory role, their views are generally taken into account when formulating policy. The most important are the Financial Planning Council and the Economic Policy Council (consisting respectively of the federal minister of finance and those of the *Länder* as well as representatives of the Communes).

Source

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