

The current debate on fiscal federalism in Germany

Germany's fiscal federalism is in need of major reform. Not only is the legal basis of the fiscal equalization scheme phasing out in December 2019 but the much debated shortcomings of the system must be solved. Hence, key elements of Germany's fiscal relations between the federal and *Länder* level have to be re-negotiated. Contrary to the original idea of the fiscal equalisation scheme of evening-up the financial situation among the *Länder* (states), redistribution has been enforcing the disparities between rich and poor *Länder*. Several reform steps have not yet brought about the comprehensive reform that is needed. After an overview of Germany's fiscal federalism is given, its shortcomings and possible solutions to them are discussed.

I.

The basic principles of the fiscal constitution which was set up in 1949 and thoroughly reformed in 1969 still serve for today's financial distribution. They are far from adequate to meet today's needs. The fiscal constitution was designed under circumstances in which the economic and fiscal power of *Länder* was roughly equal, debt problems of the federal and *Länder* level uncritical. Hence, the equalisation scheme was only used sparingly.

Generally, fiscal powers in Germany are divided according to constitutionally assigned competencies in each sphere of government. Germany's constitution, the *Grundgesetz* (Basic Law), holds that as long as a legislative competency is not assigned to the federal government the legislative power lies with the *Länder*. In the case of concurrent legislation the *Länder* can only exercise legislative power if the federal level does not use its legislative power. However, the federal government only obtains jurisdiction in this area if the protection of "comparable living standards", as stipulated in the *Grundgesetz*, require it.

In praxis, the federal level decides on all revenue relevant taxes (art. 105 para. 2 Basic Law). Hence, the *Länder* have little real influence on their revenues. Their spending freedom is limited, too. Their main responsibility is to fulfil administrative tasks and they are obliged to cover the costs of tasks according to the "Konnexitätsprinzip" (principle of connexity, art. 104a para. 1 Basic Law).

II.

Rather complicated is the relation between the federal and the *Länder* government when it comes to fiscal equalisation. It is based on the *Maßstäbengesetz* (benchmarking law) and the fiscal equalization law which aims to maintain an adequate balance between the different financial powers of the *Länder*. In addition the *Solidarpakt II* (solidarity pact II) provides further means for East German *Länder* and Berlin to foster economic development by financially strengthening the local level and providing money to pay for infrastructural expenses. All three laws are the ones that are phasing out in 2019.

The fiscal equalisation scheme works in three phases. First, the revenue from joint taxes is distributed according to an explicit formula. In 2013, the total of the equalisation by VAT turnover (*Umsatzsteuerausgleich*) amounted to 7.3 bn Euros. Second, by the so-called horizontal fiscal equalisation revenues are redistributed according to an explicit and complicated formula, providing unconditional grants to the *Länder*. Third, a vertical fiscal equalisation sets in in cases in which the horizontal apportionment left a *Land's* fiscal capacity below 99,5 % of the country-wide average.

III.

The current system suffers from a number of shortcomings and has been widely criticised. The problems of the system came to the forefront in 1999, as indicated by the decision of the Constitutional Court on the fiscal equalization system. (Feld/von Hagen, 2007) This was initiated by Bavaria, Baden-Württemberg and Hesse who filed a lawsuit claiming the equalization scheme being in breach with the constitution and considering themselves overburdened. The latter argument is in line with one major critique, namely the fact that only three to four financially strong *Länder* pay for a large number of financially weak *Länder*. Recently, in March 2013, Hesse and Bavaria again filed a lawsuit. The system is perceived to trigger adverse incentives that hamper competition i.e. recipient *Länder* get used to a long-term subsidisation and are discouraged to improve their financial situation.

The problems, although partly exacerbated by reunification, have come to the forefront already in the early 1990s. In 1992 both the *Land* of Saarland and the *Land* of Bremen requested bailouts. Bailout claims were repeated again in 2005 and 2006 respectively by the two *Länder* and in 2003 by Berlin. Fear was great that others were to follow suit. (Feld/von Hagen, 2007) The financial consequences of re-unification, however, are still felt today as East-West disparity remains prominent e.g. Thuringia's revenues were the lowest among the new *Länder* in 2013 with only 53.3% of the average tax revenue of all German *Länder*.¹ (See table 1) Thus, they are unable to generate the necessary means to fully provide for public and social services (i.e. services of general economic interest).

The disparity between the donor and recipient *Länder* is also reflected in their demographic composition. Emigration from at best stagnating recipient *Länder* to economically thriving regions is identified as a side-effect of the deficient fiscal system. A tendency toward an East-West as well as a North-South emigration is witnessed. This further strains the situation of *Länder* which already struggle with demographic change. Unemployment is also in line with the demographic disparities i.e. unemployment is much higher in northern and eastern German *Länder* than in the western and southern ones. Despite some advances since the 1990s, a gap in the average welfare level continues to exist between the East and West. (Eichel, Fink, Tiemann, 2013) These factors exacerbate the already strained financial circumstances of recipient *Länder*.

Hereby, the fact that some of them are in serious financial difficulty is closely linked to the problem of old debt burdens. This is true in particular for Bremen and Saarland; both are overly indebted and unable to solve their financial crises. Moreover, social costs have increased in recent years by the introduction of new federal laws which are not paid for by the federal level but are to be paid for on the local or *Länder* level. This contributed considerably to the increasing debts of municipalities of recipient *Länder* (particularly North Rhein-Westphalia, eastern Germany, Saarland). A reform of the fiscal system, therefore, needs to tackle a number of issues, keeping in mind the concerns of donor countries and avoiding rendering the principle of solidarity ineffective.

Table 2

¹ <https://www.bundesfinanzministerium.de/Content/DE/Monatsberichte/2014/02/Inhalte/Kapitel-3-Analysen/3-3-ergebnisse-des-laenderfinanzausgleichs-2013.html>

Financial power in % of the states' average in 2013 (preliminary)									
	NW	BY	BW	NI	HE	SN	RP	ST	SH
Taxes of the <i>Länder</i> before VAT-apportionment (per inhabitant in % of the average)	99,3	128,3	116,8	87,9	121,6	53,8	95,6	54,1	93,8
Financial power in % of the <i>Länder</i> average (before fiscal equalisation)	97,6	115,9	111,2	99,1	113,4	88,3	96,4	88,2	96,5
	TH	BB	MV	SL	BE	HH	HB	Total	
Taxes of the <i>Länder</i> before VAT-apportionment (per inhabitant in % of the average)	53,3	65,8	54,1	79,4	91,8	147,6	88,0	100,0	
Financial power in % of the <i>Länder</i> average (before fiscal equalisation)	88,1	89,8	86,6	92,8	69,1	97,7	71,6	100,0	

Source: Federal Ministry of Finance (www.bundesfinanzministerium.de)

Abbreviations for Germany's *Länder* (constituent federal states)

BB Brandenburg	NI Lower Saxony
BE Berlin	NW North Rhine-Westphalia
BW Baden-Wuerttemberg	RP Rhineland-Palatinate
BY Bavaria	SH Schleswig-Holstein
HB Bremen	SL Saarland
HE Hesse	SN Saxony
HH Hamburg	ST Saxony-Anhalt
MV Mecklenburg-Western Pomerania	TH Thuringia

IV.

As these problems are not new reform of Germany's fiscal federalism, in particular of the fiscal equalization scheme, is a reoccurring topic on the political agenda. However, past federal reforms were always conceptualized incrementally and focused on single pillars of the (fiscal) constitution instead of big-bang-reforms. So, e.g., fiscal issues were almost completely excluded in the 2003 to 2006 negotiations between the Federation and the *Länder* during "Federalism Reform I". Although a new law was introduced in 2006 prohibiting the delegation of tasks (art. 84 para. 1 sent. 7 Basic Law), it left untouched the already delegated tasks and consequently, did not ease the situation of municipalities. This is in particular because the greatest financial burden for municipalities are related to the provision of social services and those had mostly been in place before 2006.

"Federalism Reform II" from 2009 focused mainly on the introduction of a "debt brake" to reduce future public debts. In June 2011 a reform of the local financial system failed in its second attempt since the Federation and the *Länder* could not find a solution to reform the local business tax ("Gewerbesteuer").

The debate on possible future designs of Germany's fiscal federalism has attracted much attention. Two representative reform proposals are briefly discussed. Both are calling for a radical reform of the fiscal equalization scheme and suggest strengthening the vertical mode of equalization. A study by Nathalie Behnke (University of Konstanz) stresses the following key problems of the current fiscal constitution: First, the wrong/missing incentives to increase a *Land's* revenues due to the logic of horizontal mode of equalization. Second, an erosion of solidarity is identified as a consequence of the overburdening of donor *Länder*. Third, the system's complexity and lack of transparency is

disadvantageous. Fourth, the fact that structural peculiarities are not included in the equalisation's calculations is defined as "structural blindness". Therefore, it is suggested to abolish the horizontal fiscal equalisation, to introduce a new distributive system for VAT revenues and that the federal level introduced new compensation payments declining over time as general allocation funds to compensate for a loss of income caused by the reform. The proposal, brought forward in 2012, was received rather critically because its implementation would cause many *Länder* to initially lose money.

Another reform proposal was formulated by the expert group around Hans Eichel (former federal minister of finance) based on the assessment that living standards are increasingly moving apart within Germany. As a key problem they have identified the above outlined issue of a great many municipalities suffering of severe financial crises. It is suggested that the federal level should take on all the social costs that the local level currently covers and, hence, to relieve the pressure from the local level and enable them to spend money where it is needed. The basic idea is to reform the fiscal equalisation scheme by strengthening the vertical equalisation, combined with elements of competition in the framework of solidarity in order to allow for regional development. Both reform proposals mirror the often voiced claim that the *Länder* should be given more autonomy in tax raising and spending matters.

If the *Länder* were given more legislative competences on corporate and income tax (VAT the most profit-yielding of all is dealt with on the EU level) this could in theory strengthen the financial powers. Yet, many argue that in praxis this is not viable because of the *Länder'* varying tax powers. Financially weak *Länder* would be forced to increase taxes to such an extent that it would likely trigger high-performance tax payers to leave the *Land*. Financially strong *Länder*, by contrast, could abstain from increasing taxes and, hence, would become even more attractive for high-performance tax payers. This would only worsen the disparity problems discussed above.

Last but not least, one important argument in support of the fiscal equalisation scheme is the key element of solidarity between the federal constituents and the aim to maintain "comparable living standards" as stipulated in the *Grundgesetz*.