

# REFORM AND FUTURE OF FEDERAL FISCAL RELATIONS IN GERMANY

BENEFITS FOR DEVELOPMENT COOPERATION

As a federally owned enterprise, GIZ supports the German Government in achieving its objectives in the field of international cooperation for sustainable development.

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## FOREWORD

GIZ is a federal enterprise in the field of international cooperation for sustainable development. It is active in more than 120 countries worldwide, supporting partner countries in implementing political, economic and social transformation processes for a better future. Over the past few years, our partners have increasingly sought a joint dialogue to exchange information on specific German policy experiences– for example decentralisation and in fiscal decentralisation, the social-ecological market economy or the dual system of administrative training.

Partner countries are keen to analyse these “Made in Germany” approaches, compare them with their own reform ideas and to examine which elements, approaches and experiences might be relevant for them. GIZ’s Governance Fund commissioned by the German Federal Ministry for Economic Cooperation and Development (BMZ) addresses this specific demand. Through a network of experts, it makes German experience and knowledge available to partner countries around the world, helping policy makers shape reform initiatives and thus supporting various reform processes. The aim is not the uncritical transfer of German policy experiences, but the joint identification of successful and useful elements and an analysis of their relevance for the respective partner country.

As a basis for a dialogue with our partners, the Governance Fund commissioned four studies which illustrate German policy experiences. The studies were discussed and revised in a peer review by experts with practical policy experience (e.g. former state ministers), with specialists from GIZ and from partner countries.

So far, the following studies have been prepared:

1. “Reform and Future of Federal Fiscal Relations in Germany – Benefits for Development Cooperation”, carried out by Dr. Michael Thöne (Executive Board Member of the FiFo Institute for Public Economics at the University of Cologne) and Jens Bullerjahn (Former Minister of Finance of Saxony-Anhalt)
2. “Federalism and Decentralization in Germany – Basic Features and Principles for German Development Cooperation”, carried out by the University of Potsdam: Prof. Dr. Kuhlmann, Prof. Dr. Fleischer and Prof. Dr. Fuhr
3. “Forming Civil Servants – Elements of Success and Ideas for Transfer Based on Germany’s Dual Public Administration Education”, carried out by the German Research Institute for Public Administration: Prof. Dr. Ziekow
4. “The Social-Ecological Market Economy in Germany”, carried out by DIW Econ, Prof. Dr. Alexander Kritikos, commented by Jost de Jager, Former Minister of Economic Affairs for the regional state of Schleswig-Holstein

Michael Thöne and Jens Bullerjahn, the authors of the study on Federal Fiscal Relations in Germany, bring together scientific expertise and political experience. Whereas Michael Thoene is an economist and academic policy consultant advising German politicians actively involved in financial affairs, Jens Bullerjahn was the Finance Minister of the regional state of Saxony-Anhalt for 12 years and played a decisive role in the recent reform of Germany's financial equalisation.

With the study, we want to encourage discussions with partner countries about the usefulness of the German experience in the field of fiscal relations. It addresses policy makers as well as the broader professional public interested in reform processes and development policy. Our thanks go to the two authors and to stakeholders and colleagues at home and abroad, whose valuable comments contributed to the success of the study.



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# REFORM AND FUTURE OF FEDERAL FISCAL RELATIONS IN GERMANY

## BENEFITS FOR DEVELOPMENT COOPERATION

More or less every ten years, Germany reforms the financial relations between the federal government and the sixteen *Länder*. After some start-up difficulties, the recent reform of 2017 was agreed upon remarkably consensually. In dialogue between politics and science, this short study examines, which experiences of the reform of the German federal fiscal relations can be made useful from the international perspective, particularly for the development co-operation. In addition, we discuss which topics need to be put on the German federal agenda next.

### The Authors

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**Dr. Michael Thöne** (\*1967) is managing director/CEO of the FiFo Institute for Public Economics at the University of Cologne (FiFo Köln). As an economist and scientific policy advisor he has worked for some twenty years inter alia on German fiscal federalism and its reforms.

### Acknowledgements

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GIZ-network, participants of the third network meeting of the Governance Fonds and, above all, Karen Losse for suggestions, encouragement, questions and critical input. All remaining errors are, as always, the authors'.

## OVERVIEW: THE CENTRAL FINDINGS

The German federal state has undergone numerous modernizations over the last fifteen years. After two major federalism commissions and the 2017 reform of fiscal equalization. The funding conditions will change fundamentally for all levels – especially for the states (the *Länder*) – from 2020 onwards. But not all upcoming challenges for the German fiscal federalism have already been taken care of with the reforms enacted so far – thus, after the reform is always before the reform.

With our paper, we look at the state and future of German federal finances from the perspective of development cooperation. As a cooperative effort of a former finance minister and a public economist, in their roles both involved in the recent reforms, we draw common conclusions on the strengths of the existing model of federal funding and its reform. Can we distil success factors that can be meaningfully pursued beyond the specific German conditions? In many ways, the German system of financing der federal level and *Länder* with its combination of equalizing differences in fiscal capacity and a solidarity-based bailout agreement between the federal government, the *Länder* and the municipalities is part of the German ‘brand’. The international appreciation for this model is high – not least on the capital markets. But which elements of this model are exemplary? Is it worthwhile to follow the German way?

In the report, we explain in detail the federal finances – also the special role of the municipal level –, both in terms of the financial mechanisms, and in terms of the political mechanisms behind it. We discuss the distribution of key joint taxes, the horizontal equalization mechanisms between the *Länder*, and the growing role of central government in federal funding. The reform of the equalization system adopted in 2017 is analysed from an insider perspective: why the reform was necessary, what goals were pursued and how they were achieved. We also show why no reform in the dynamic federalism can achieve all its goals and how to deal with the need for permanent further improvement.

Without being exhaustive, we identify six success factors that play a central role in the functioning of the German model of federal funding. Without any claim to general transferability, we describe them as structures that can also work well outside of the German context. These success factors are: (1) Semi-determined norms such as the equivalent living conditions of the Basic Law; (2) the integrated legislation of the federal finances; (3) common data and accounting standards; (4) partial equalization of horizontal differences through the central level; (5) homogeneous taxes of the *Länder*; and (6) soft law instruments such as the National Stability Council.

If one wants to draw conclusions from these success factors for development cooperation, even if the structural ideas are transferred directly into other national contexts, solutions will emerge that only remotely resemble the German way. Functioning federalism is a constant struggle for improvement, renewal and adaptation to new challenges. This is also the case in Germany – a Land undergoing demographic and economic change and that still has many future tasks to assume. The 2017 reform creates a solid basis. But at the same time, to a certain degree the relevance of fiscal equalization will take a back seat. When – also in the spirit of the coalition agreement of the new federal government – it comes to strengthening the equivalence of living conditions, to assist the local level more systematically and to enable sustainable, balanced budgets, the German federal agenda offers a number of milestones, to be addressed in short- or medium-term. We identify five issues that, in our view, should be placed high on this agenda – even if not all are originally federal matters: (1) social benefits and connectivity; (2) demographic change and domestic migration; (3) investive modernization; (4) debt management for bad times; and (5) pension and pension costs especially of the West German *Länder*.

Germany can take on and master these challenges well; provided it strengthens the sustainability of public finances at all levels faces up the multiple upcoming governance issues through more impact-oriented policies. If that succeeds, it will also strengthen the federation. Thus, on the ‘federal amplitude’, the current growth in significance of the central level can become the harbinger of a long-term strengthening of the *Länder* and their municipalities.

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## I. INTRODUCTION: FUNCTIONING FEDERALISM

Large countries are often federal countries. Size goes hand in hand with diversity – geographical, natural, social, economic, ethnic and/or religious differences translate into regional diversity. Federalism and decentralization in accordance with the principle of subsidiarity are regarded as the classic recipes to protect regional diversity and to combine community and coexistence politically.

Creating and sustaining functioning federalism is a permanent challenge for society and politics – a balancing act, as varied and changing interests have to be reconciled permanently. Not only must the social, economic, ethnic or religious differences of the respective regions be balanced over and over again. Also, the balance of power between the central state and the federal units is rarely static in democratic countries.

That this strenuous and at times exhausting balancing act is indeed very crucial becomes overly obvious whenever the adequate federal solution for regional diversity has not been found. In recent years, Europe has seen haunting examples of failed or foregone decentralization. Catalonia is trying to leave Spain, where it enjoys less independence than the particular autonomous regions, which display no such exit wishes. Just a few years ago, Britain narrowly escaped the Scottish secession; now it itself exits the European Union.

Against this background, the present paper analyses the German fiscal equalization between the federal government and the *Länder* as an important – real and symbolic – linchpin of the distribution of resources and thus power. More or less every ten years, Germany reforms the financial relations between the federal government and the sixteen *Länder*. After some teething troubles, the most recent reform of 2017 was received with strong mutual agreement among the political players. With our short study we review the experiences with the German federal fiscal relations in a dialogue of a practitioner and a scientist. Yet, we won't set the policy makers' and the economist's perspectives against each other. Our aim is to identify common conclusions on our federal fiscal relations and their recent reform – in the hope that some of the lessons may be made fruitful for international dialogue and for development cooperation.

*What kind of conclusions and 'lessons'*

Genuine federal countries – i.e. countries with significant regional differences and diverse identities in the different area of the nation – are constantly struggling to strike

the right balance between equality/uniformity/centralism on the one hand and divergence/regionalism/autonomy on the other hand. This tension constitutes the nature of federalism; it never settles down to a stable equilibrium. The same is true for the relationships of self-confident local communities to each other and to the respective higher levels, be it the *Länder* as in Germany or the central states.

Society and economy are dynamic. Both require the state to promote and channel these dynamics. Democracy based on the rule of law is the central guarantee that social and economic dynamics will be reflected by the government and the administration. In a multi-level state, federalism and decentralization can act as the principal facilitators of such dynamics. As levels of democracy, they capture the needs for change – as well as for stability – precisely and finely differentiated.

The constitutional structures of political and administrative federalism have to take up these dynamics and translate them into policies that always constitute new compromises between often divergent demands and needs. Federalism and decentral democracy function well when this system works permanently in a way that is characterized by a basic spirit of partnership and the honest acceptance of – sometimes burdensome – federal compromises. In the eyes of the authors, this definition of a functioning federalism applies to today's Germany.

Here, the federal fiscal relations play a central role as this is the mechanism where all material conflicts are handled (or could be handled). By means of taxation and public expenses, the modern state has quite considerable opportunities to bring about substantive material convergences and deal constructively with remaining divergences. This also applies to the focus of the present paper, the horizontal relations among the *Länder* and their vertical ties to the central level. But financial resources and re-allocations can and should not regulate all kinds of federal disputes. In this respect, federal fiscal issues are only one dimension of complex federal dynamics.

In this paper, we explain the structures and mechanisms of federal public finances in Germany. Our main focus is not on the numerous technical peculiarities and oddities of the financial system. Many of them will be explained; some may also be inspiring beyond the specific German context. Our principal interest, however, is to appreciate the German fiscal equalization as a political system that generates at irregular intervals new compromises between the federal government and sixteen *Länder*.



We tell this as a reform story. Specifically, as the history of German federal fiscal relations and how these were reformed in 2017. A distinctly different story could be told about the multitude of conceivable and, in part, recommended reforms for federal finances. The discussion of the reform within Germany was also influenced by viable reform elements, which were not realized then. We revisit this other dimension in the last section IV of the paper. Most of all, however, we look at the actual fiscal federalism in Germany and its actual reform.

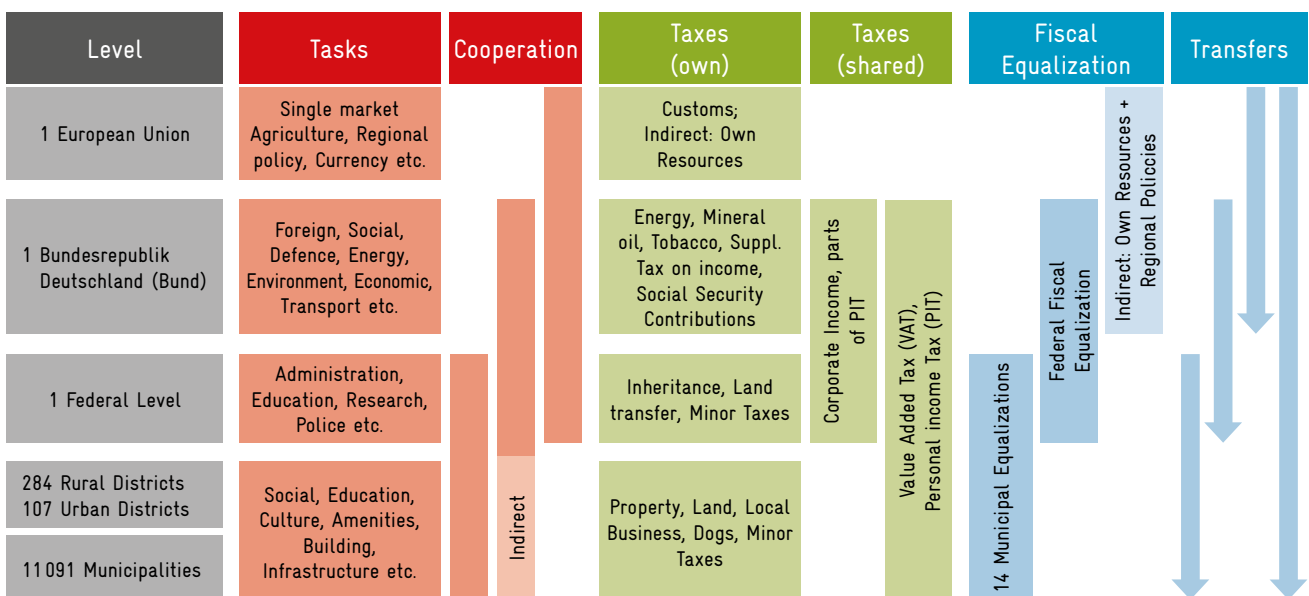
## II. ROLE AND MECHANISMS OF FISCAL EQUALIZATION IN GERMANY

### A. Basics

The spatial distribution of public funds, accomplished by vertical and horizontal fiscal equalization, shapes the distribution of political power by determining the distribution of resources. At the same time, the distribution of resources by way of an equalization law arises from a given distribution of political power. But it would be too easy to label finances and power just as the proverbial “both sides of a coin”. This image is too static. The interplay of political and financial power can be very dynamic: An equilibrium of money and competencies pushed off balance on either side will, as reforms become necessary, settle back to a new and markedly different balance. One noteworthy aspect of the federal dynamics in Germany is that the roles of the different players may change over time: For example, Bavaria, today the largest payer in the horizontal fiscal equalization between the *Länder* due to its economic strength, was a recipient of solidary transfers from then financially strong *Länder* for almost forty years until end of the 1980s.

In order to clarify the role of the fiscal equalization within this federal system, we first illustrate some basics. Figure 1 provides a simplified overview of the entire task and financial allocation in the effective four-level federalism of Germany.

FIGURE 1: THE GERMAN MULTI-LEVEL STATE AT A GLANCE



The Federal Republic of Germany comprises sixteen states (the *Länder*), of which three are city states and thirteen territorial states. Conversely Germany itself is, through its membership in the European Union, part of a community that, while not yet recognized as a full-fledged federation, is much more than a confederation. This federal entity *sui generis* with currently 28 member states constitutes the level above the German federal government. The foundation below federal and *Länder*-governments in Germany, as elsewhere, is formed by the local level – here with circa 12,000 cities, independent municipalities and districts.

In this four-tiered federalism, there is always an official or an effective fiscal equalization between two adjacent levels, which at the same time includes vertical financial flows and horizontal redistribution between the respective territorial communities:

- In the thirteen territorial states and in the city state of Bremen, the *Länder* level co-finances the local level through **municipal fiscal equalization** in a way that is meant to achieve a horizontal balance between financially strong and financially weak municipalities. Only the city states of Berlin and Hamburg do not use municipal fiscal equalization, since local and *Länder* level are legally integrated in both cities.
- On the surface, the **federal fiscal equalization** – the main subject of this paper – consists of transfers from relatively rich to relatively poor *Länder*. Inextricably linked to horizontal equalization, however, are extensive vertical transfers from the federal government to most of the *Länder*.
- Finally, judged by the budgetary results, the financial relationship between the European Union and its member states via so-called own resources and via the Union's expenses can be considered a **de facto EU fiscal equalization**, even if this term is officially avoided. In contrast to the fiscal equalization in Germany, the EU vertical transfers flow from bottom to top. In conjunction with the regional spread of EU spending, there is also a horizontal redistribution between the financially strong and the financially weaker Member States.<sup>1</sup>

For the further assessment of the federal fiscal relations between German *Länder* and the federal government, this constellation is of particular importance. Not only the equalization system is on a sort of “sandwich position” between the municipal fiscal equalizations on the one side and the EU funding on the other. This also holds true for the individual administrative actors: The *Länder* – even the relatively financially weak “recipient states” – are strong transfer donors when they face their municipalities. In turn, the federal government is not only a transfer donor to the *Länder*, but also to the European Union, and thus indirectly to many other EU members. No government negotiates only for itself. As a consequence, criteria for financial strength or weakness cannot be chosen simply according to opportunity in specific negotiations, as they may prove to be viable and credible in entirely different circumstances.

<sup>1</sup> See: M. Thöne (2017), EU-Regionalpolitik und europäischer Finanzausgleich, in: Deutsches Forschungsinstitut für die öffentliche Verwaltung/BMF (eds.), Reform der EU-Finzen, Speyer/Berlin, p. 69 82.

### Info box: The *Länder* and the financing of their municipalities

This paper looks at the reform of federal fiscal relations. But as an additional level, municipalities plus urban and rural districts are always aboard – sometimes explicitly, often unspoken. Correspondingly, in the 2017 reform of federal fiscal equalization the *Länder* were expected to speak and negotiate in the own name as well as in the name of their municipalities. In a way, the municipalities were indirectly at the table, but did not participate.

This ambivalent position is laid down in the German constitution. It also reflects the multi-layered and sometimes complex mechanics of financing municipal tasks and politics: On the one hand, the municipalities are constitutionally regarded as parts of the *Länder* which are obliged to fund their local level through equalization systems. On the other hand, the municipalities are independent democratic bodies whose self-government is protected by the German constitution (Article 28 of the Basic Law). The special protection of municipal autonomy in the constitution is, inter alia, expressed by the fact that they are guaranteed sizeable tax rights – significantly more than their superordinate *Länder* enjoy. The cities and municipalities have the guaranteed right to determine the tax rates of the real property tax and the local business tax themselves.

In practice, the ambivalent relationship of municipalities with the *Länder* comes in many different shapes due to the great diversity on the local level: The smallest independent community of Germany, the holm Gröde in the North Sea, has just nine inhabitants. Berlin, Germany's capital and by far biggest city with 3.5 million people is a municipality and a Land at the same time. In addition, we have municipal organizations as an additional layer of administrative players between the individual municipalities and the *Länder*. Beyond the big cities, which are usually urban districts at the same time, rural districts (counties) conduct common tasks for their villages and towns. But it also gets bigger: The most populous Land of North Rhine–Westphalia, for example, is additionally subdivided into two regional associations, which perform strongly centralized social and medical municipal tasks. The larger of them, the Rhineland Regional Association, comprises approximately 9.6 million inhabitants – almost 15 times as many people as the smallest Land, Bremen, consist of (which includes only two cities).

This great diversity is mirrored and deepened by very different degree of decentralization of tasks to the local level. The term “degree of communalization” describes the distribution of administrative responsibilities between the *Länder* and their municipalities. Both levels each have a number of fixed, inalienable tasks. But in many other public tasks, the individual *Länder* determine whether they perform the respective services by themselves, whether in cooperation with the local authorities or whether the municipalities must fulfill the tasks alone. Depending on the size of cities and local authorities, on the nature and capabilities of existing municipal associations and on historical developments, the degrees of communalization significantly differ among the *Länder*.

This factor – but not alone – already points to another, directly fiscal aspect of municipal diversity in Germany: The financing of the municipalities by their *Länder* is very heterogeneous. The basic elements are the same everywhere; but their composition and weighting very unique. In addition to the above-mentioned local business tax and real property tax, a municipality receives 15 percent of the income tax of its citizens as well as a small portion of VAT. The local level also levies charges for local services – for fresh water and sewage, waste disposal and street cleaning. These charges have to be calculated according to cost-pricing; they must not be used as cross-subsidies for the regular local budget. In certain high-tax cities and municipalities, these revenues are enough to meet the public expenditure needs. This kind of ‘abundance’ is not the case in most municipalities; their revenues are supplemented through a municipal fiscal equalization financed by the respective Land. These equalization laws vary from Land to Land; yet their basic features are roughly similar: For each municipality of a Land the fiscal capacity (relative revenue strength) is measured according to an artificial benchmark which in turn is based on a simplified notion of expenditure needs. If the abstract need is greater than the revenue strength, the difference is partly offset according to a fixed formula. Thus, the vertical supplementary financing also causes a horizontal compensation of financial differences. The exact mechanism to calculate and compensate fiscal needs differs widely from Land to Land. Some *Länder* use traditional mechanisms mainly based on political negotiation, others *Länder* try to make extensive use of scientific methods from econometrics and other fields of empirical public economics. Since municipal financing systems always affect a large number of players in different ways and often produce controversial distributive results, fiscal equalization laws are frequently legally challenged. Thus, their appropriateness and distributive fairness are then examined by the constitutional courts of the respective *Länder*.

A second strand of financing relationships between the municipalities and their *Länder* which is strongly influenced by the rulings of the courts follows from the so-called principle of connectivity. The municipal level – municipalities, cities, but even more districts and higher-level municipal associations – fulfills many tasks which are strongly determined by the decisions of the respective Land or of the federal government. Today, according to this principle of “who orders, pays”, it becomes increasingly difficult for higher levels to adopt laws which place the responsibility for implementing and financing them on the municipal level without compensation. Meanwhile, all *Länder* had to include such principle of connectivity in their fiscal constitutions. However, these new rules are not directly applicable to old benefit laws. As a result, many in-kind social services traditionally provided by local authorities, but regulated on the federal level, are a recurrent cause for financing disputes between municipal, *Länder* and federal level.

Against this background, it becomes clear that the municipalities are always tacitly at the table when the federal government and the *Länder* negotiate on federal finances. The fact that the *Länder* always have to negotiate federal finances for themselves and on behalf of their municipalities is important for additional reason: Direct financial links between the federal government and local government are outlawed. In this dimension, the Basic Law – the German constitution – bars cooperation. With few exceptions – the 2017 reform of the federal finances discussed in this paper has slightly broadened this short list – municipalities and the federal government are forbidden to interact directly with one another. As a rule, the *Länder* must act as brokers and mediators of their communities.

This ban on cooperation is very controversial – not least because many local and regional players deem the federal government structurally stronger in fiscal terms and also ‘more generous’ as many *Länder* may be. In this perspective, it might appear as a quick fix for some municipal financing problem to be allowed to ask the federal government for direct financial support. In all fairness, the federal government indeed is currently fiscally more capable than the other levels. Yet it is very doubtful whether the federal level, if it was made responsible for financing municipal tasks on a regular basis, would prove to be more willing in the exercise. Thus, the hope to provide a quick solution to municipal financial problems by eliminating the cooperation ban between federal and local level is, to some extent, wishful thinking. The grass is not necessarily greener on the federal side of the fence.

The purpose of the cooperation ban is first and foremost to create order and clear-cut responsibilities: On the linear chain “federation–Land–municipalities” there is always only one contact party in each direction. In contrast, a triangular constellation would be difficult, in which the municipalities would enter into one financial relationship with their Land and one with the federal government simultaneously, because a delicate delineation of responsibilities would be needed. This would leave plenty of scope for tactical maneuvering of all parties, possibly resulting in funding gaps or double financing.

However, the solution with cooperation ban is also far from perfect: Today, the *Länder* cannot straightforwardly represent their own interest and, at the same time, act as a neutral broker and mediator of municipal concerns. This seemingly unavoidable dual role of the *Länder* will always give reason to seek opportunities to improve for the relationship between federal, state and municipal finances in German system of multi-level governance. For all levels – in particular for the local level – it is essential that the important and politically beneficial modernization of public tasks is always mirrored by equally modern and well-manageable financing mechanisms. Creating and maintaining this connection is neither natural nor easy. This paper will reflect on this challenge especially for the relationship between federation and *Länder*. As we have seen, the municipalities are sitting always, at least indirectly, at this table.

The federal fiscal equalization system and the underlying tax system, which heavily relies on influenced by shared sources of revenue, have to be viewed against the background of the German fiscal constitution – i.e. the financial provisions in the Basic Law and adjoining legislation. In the decade before the recent reform, the fiscal constitution has undergone two profound changes that are critical for the further changes, the reforms of the “Federalism Commissions” I and II in 2006 and in 2009.

In international comparison, German federalism distinguishes itself by a high degree of vertical cooperation between the levels and also by plentiful horizontal coordination between the administrations of the sixteen *Länder*. First of all, the strong cooperation is necessary just because the central state itself has only a comparatively small administrative apparatus, so that the *Länder* are also responsible administrating and carrying out many federal tasks. For this reason, in all matters concerning their administrative competence, the *Länder* governments act as co-legislator on the federal level through the second chamber, the Federal Council.

The mission of the Federalism Commission I was to bring about some unbundling of the decades-old sharing of tasks and competences so that more political questions could be decided either by the federal or *Länder* governments alone. The partial unbundling was enacted with the reform of 2006; yet cooperative federalism continues to prevail in many public tasks. In addition, the reform has established a limited element of tax autonomy for the real estate transfer tax.

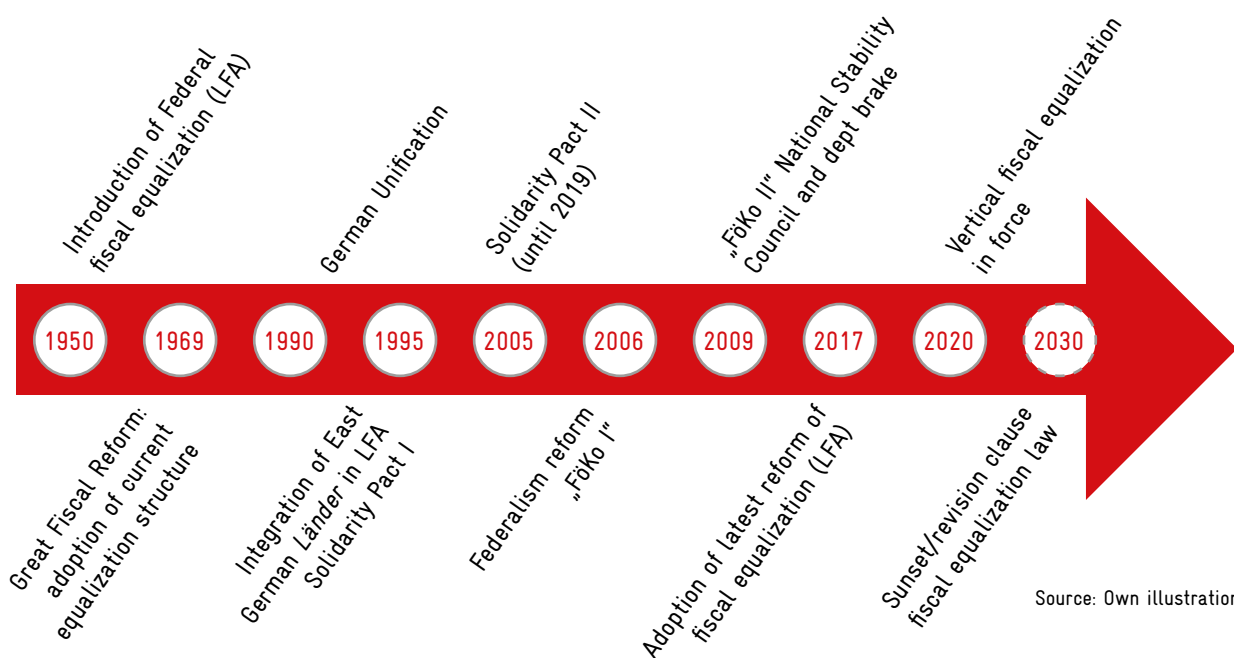
In response to the global economic and financial crisis of the years following 2008, a new constitutional restriction on public borrowing by the federal and *Länder* govern-

ments was established as a consequence of the proposal of the Federalism Commission II. The constitutional deficit restriction, based on the Swiss “debt brake”, allows the federal government from 2016 onwards only structural deficits in the amount of 0.35 percent of the gross domestic product. The *Länder* must abide by the ‘debt brake’ from 2020. From then on, each Land must produce structurally balanced budgets; permanent deficits are virtually outlawed. In the case of an economic downturn, deficits are allowed to stabilize public spending und thus the economy. But in the economic upswing these deficits must be offset by budget surpluses again. To ensure that all *Länder* are able to meet the requirements of the debt brake, federal financial aids have been used to assist consolidation programs in those states that have been classified as in need of assistance.

The Stability Council was established to oversee the budgets of the *Länder* in fiscal consolidation and to provide a precautionary observation of the fiscal stance of all *Länder*. Here, the Federal Government and the sixteen *Länder* come together on a half-yearly basis, evaluate the development of public finances with scientific help, and give early warnings in case of undesirable developments. This consultative body may temporarily cancel consolidation subsidies from *Länder* that do not comply with the terms of the agreed assistance programs. The importance of the debt brake and of the Stability Council for the 2017 reform of federal finances was very high – even if this may not become obvious in every single reform step.

Figure 2 gives an overview of important milestones in the development of federal finances from 1950 to 2030. It shows important decisions and the introduction of new procedures on the timeline.

FIGURE 2: MILESTONES OF FEDERAL FISCAL RELATIONS 1950–2030



Source: Own illustration.

## B. The current system of fiscal equalization

In the German system of federal finances, the horizontal fiscal equalization between the sixteen federal states, the *Länderfinanzausgleich* (LFA), is the – always controversial – heart, but neither the beginning nor the end of the multilevel financing system. Since the outcomes of this intermediate level of fiscal equalization are immensely being shaped by the preceding stages, a look at the overall system should be necessary. Starting with the tax revenues of the *Länder*, which are determined by the Basic Law and federal laws, five levels of actual fiscal equalization can be distinguished. The following sections 1 to 5 explain these stages.

### 1. Vertical distribution of separate and joint tax revenues

The tax system in Germany relies heavily on joint taxes of the different levels.<sup>2</sup> Separate taxes for the federal level, for each Land, and the local communities play no more than a complementary role. Personal income tax (PIT), corporation tax (CT), value added tax (VAT), and also – via a special sharing arrangement – the local business tax are joint taxes. Their revenues are shared either between the federal and the *Länder* level (CT), or between all three levels (PIT, VAT, and local Business tax). The individual sharing quotas for each tax differ. Traditionally, the vertical sharing of the revenues from value added tax is used as the flexible element of tax allocation whenever the need for a change vertical distribution is deemed necessary. All in all, 72 per cent of total German tax revenues in 2017 came from joint taxes.

Revenues from separate taxes accounted for the remaining 28 per cent of German tax revenue. The majority of these are federal taxes: revenues from energy taxes, tobacco taxes and other special goods and services amount to 13 per cent of total revenues. On the other side, separate taxes of the municipalities add up to eight per cent of total tax revenue. Here, the *Länder* clearly stand out, their separate taxes make up only 2.9 per cent of total tax revenues. The exceptional dependence of the *Länder* on joint tax revenues becomes more obvious when looking at level specific composition: In 2017, the *Länder* received 89 per cent of their revenues from joint taxes, whereas on the federal and the local level, joint taxes accrue to 75 or 42 per cent, respectively.

For the *Länder*, the whole story of their dependence in taxation matters is not yet told. Almost half of their remaining revenues from separate taxes come from inheritance tax

and gambling tax, i.e. taxes that accrue to the *Länder*, but which are regulated exclusively by the federation.

Prior to 2006, this was also true for the real estate transfer tax. But with the Federalism Reform I, the *Länder* were given the right to determine the rate of their tax by themselves (while tax base, exemptions etc. remain in the legislative realm of the federation). For the first time in decades the German *Länder* gained the competence to decide on one tax rate. Obviously, the granting of this little taxing right was welcome or, as one might say, overdue. In the twelve years since the decentralisation of the taxing right, only two of the 16 German *Länder* have not raised these taxes. At the same time, two *Länder* have raised their rate already for the third time. This has made the real estate transfer tax the fastest growing tax in Germany: From 2006 to 2017 the total revenue grew by 115 per cent. But still, this tax amounts to only 4.5 per cent of the average *Länder* tax revenues. So Germany's position as the federal Land with the lowest degree to tax autonomy for the state level worldwide remains unchanged.

### 2. Horizontal allocation of joint tax shares

Once the total tax revenue of all *Länder* is determined, the proceeds will be allocated to the individual *Länder* in the second step. This step, the *Zerlegung* (dissection) of the *Länder* shares in joint taxes, officially is not considered a distribution of common revenue but a 'correct' allocation of one's own revenues.

The revenues of the few pure state taxes, mostly the inheritance tax and the real estate transfer tax, are allocated according to their local revenue, i.e. the revenues mostly 'stay put' in the Land where they are collected. But for most shared taxes, this principle of locality would lead to distortions and thus deviations from the 'real' tax capacity. Although the *Länder* administer direct taxes, they are not allowed to keep the taxes as they collect them. Here, the *Länder*-shares of the revenues are dissected.

The corporation tax is dissected, because for companies with several operating sites in different *Länder* only the headquarters of each company pay the tax to their tax office. As a result of dissection, revenue is divided between the *Länder* in question and the various business premises of the company concerned. Personal income tax of dependent employees is paid by employers to their tax offices. However, the *Länder* where these employees live are entitled to these PIT revenues. Many commuters live and work in different *Länder*. This is particularly evident in the city-states, where a

<sup>2</sup> The depiction of the existing system roughly follows the own prior work: M. Thöne and C. Fuest (2012), Reform des Finanzföderalismus in Deutschland. In: I. Härtel (ed.), Handbuch Föderalismus, Vol. II, Springer, Berlin, p. 265-321. And M. Thöne (2015), An End of Federalism without Revenue-Autonomy? The Effects of Fiscal Equalization and the new Debt Brake for the German *Länder*. In: Giancarlo Pola (ed.), Principles and Practices of Fiscal Autonomy. Experiences, Debates and Prospects. Ashgate, Farnham, p. 135-151.



sizable part of the total labor force resides in the neighboring *Länder*. The PIT-dissection corrects the disparities on the basis of the wage tax statistics. The result is a 16x16 matrix that determines what percentage of their income tax revenue each Land has to transfer to each of the fifteen others.

Tax dissection serves the “allocation of one’s own”, not the redistribution of revenues. However, also elements of redistribution become evident here, especially in the dissection of personal income tax of dependent employees. The allocation of all revenues according to the place of residence intuitively is very reasonable; but on closer inspection not uncontroversial. Taxes serve to finance public services; these are used by citizens to a large extent at the places of their residence. However, other public services do not benefit citizens at their home places, but at their places of work. In addition to services such as public order, internal security and the judiciary, these are above all the business-related infrastructures. The city states of Hamburg, Bremen and Berlin, where many people commute from the surrounding *Länder*, have long and unsuccessfully demanded that PIT revenue allocation should, at least partially, follow jobs not homes in order to cover the public costs of job-related infrastructures and transport.

### 3. Allocation and pre-equalization of VAT

The horizontal distribution of VAT shares between *Länder* combines a tax dissection with a first, upstream horizontal redistribution. The *Länder*’s VAT share need to be dissected, since the local revenue cannot serve as a suitable allocation rule, because the value added tax is paid at the company headquarters.

However, the distribution of the VAT share among the individual *Länder* is not enacted according to a decomposition standard, which approximates consumed incomes. Instead, the VAT share of the *Länder* is largely distributed to the *Länder* according to the current population. Prior to this, allocation of VAT shares involves a more manifest element of redistribution over the so-called “supplementary shares”: Up to 25% of the *Länder*-share is not distributed on a per head basis, but according to tax capacity. For *Länder* whose receipts from income tax, corporation tax and other own taxes per capita are lower than the average this gap is closed with a linear-progressive topping-up schedule. For this up-front compensation, up to 25 percent of the *Länder*’s total VAT share may be spent. In 2017, 14.7 percent were enough for the supplements. The remaining 85.3 per cent were allocated on a per capita basis.

This ‘equalization ahead of equalization’ significantly reduces the gaps between the tax-strong *Länder* and the relatively tax-weak *Länder*. To all intents and purposes, it is a vertical fiscal equalization with horizontal redistributive effect. Compared to an allocation based purely on population figures, in 2017 already 8.4 billion euros were redistributed

between the *Länder* on this level. As a result of this this narrowing of the gaps, the volume of visible compensation in the ensuing actual horizontal fiscal equalization decreases significantly. In 2017, of EUR 11.2 billion of these direct LFA payments between the *Länder* were made.

This pre-equalization was introduced in the wake of the major fiscal reform in 1969 with the explicit goal to ‘unburden’ the core mechanism, i.e. to make it look smaller and thus, politically more tolerable. After the “supplementary shares” in VAT allocation had been granted for the first time in 1970, the volume of the subsequent *Länder*finanzausgleich was halved. This impression was substantiated by the fact that this VAT pre-equalization was de jure understood as a step in the original tax allocation. In this view, the official horizontal redistribution only then began with the actual *Länder*finanzausgleich. This long-upheld view was never accepted by economists and also has gradually dissolved over the years in the political realm. In the negotiations prior to the 2017 reform, the horizontally redistributive elements of VAT allocation were recognized as such by all parties involved.

### 4. Horizontal fiscal equalization (*Länder*finanzausgleich)

Officially, the core mechanisms of horizontal fiscal equalization, the *Länder*finanzausgleich (LFA), is the only step which generates explicit contributions from ‘payer-*Länder*’ whereas the preceding steps entail ‘only’ losses or gains relative to some abstract benchmark. After VAT supplementary shares were granted for the first time in 1970, the actual fiscal equalization gained the role of a “peak compensation” between *Länder* that were very similar in their tax capacity. This has changed again with the German unification and the integration of the East German *Länder* and Berlin into the regular LFA from 1995 onwards. Since then, even at this level, large differences in financial capacity are significantly reduced via redistribution.

The structure of the horizontal fiscal equalization has remained largely unchanged until today. In general, the system creates a contribution obligation if the revenue capacity of a Land – measured by the “fiscal strength index” – is greater than its generalized fiscal needs – expressed in terms of the “compensation index”. If, on the other hand, the compensation index is greater than the fiscal strength index, the Land concerned is entitled to horizontal transfers.

In the actual implementation of what constitutes the fiscal strength of a Land and what is accounted for in is fiscal needs, the resemblance of the LFA to the VAT pre-equalization wanes. While the VAT pre-equalization is based on pure tax revenues and population figures, the *Länder*finanzausgleich also takes into account some special needs elements. In addition, also the financial strength and the financial needs of the municipalities and associations of municipalities are partially included in LFA.

The financial strength is understood as the sum of the tax revenue of the Land including its VAT shares. Added to this are 64 percent of the municipal tax capacity in the Land concerned. This ‘odd’ value can be seen as a compromise between the 50 percent practiced until 2004 and the frequent demand to fully take include local taxation. Taxes with municipal tax rate autonomy (real estate tax and local trade tax) and the real estate transfer tax as the only *Länder* tax with autonomy are not included in the fiscal strength index with their actual revenues, but are recalculated as having been charged at a uniform, average tax rate. In this way, independent tax rate variations are isolated from fiscal equalization so that their impact cannot be neutralized in the compensation mechanism. This mechanism is necessary to protect the tax rate autonomy.

The lump sum fiscal need of each Land is represented by the compensation index. It represents fictitious average revenue for each Land, i.e. the current average per-capita tax revenue weighted by population. Technically, each Land’s compensation index figure is composed of two parts, the “compensation index Land” and the “compensation index municipalities”.

This separation is important in the further determination of financial needs, especially in the so-called “population ennoblement”. The compensation index is not determined on the basis of the actual population figures of all *Länder*. The population figures of the city states Berlin, Hamburg and Bremen are multiplied by the factor 135 percent (for both partial measurements). In addition, since 2005, the population for three sparsely populated *Länder* Brandenburg, Mecklenburg-Western Pomerania and Saxony-Anhalt are ennobled with factors between 102 and 105 percent, but limited to the municipal index. By artificially increasing the relevant population figures, payer *Länder* in the LFA are substantially unburdened, while recipient *Länder* receive higher compensation payments. This special compensation is financed by the non-ennobled *Länder*, because the artificial increase in total population figures decreases the average per capita fiscal need, which is relevant for them.

The population ennoblement for the city-states can be traced back to Brecht’s “Law of parallel progressivity of population concentration and public expenditure”, which is traditionally followed in Germany. In 1932, Arnold Brecht formulated the thesis that higher urban agglomeration increases public spending per capita. First, the demand is greater in cities. At that time, it was not common to have paved footpaths and street lighting in rural areas. Even today, cities provide central services which are also used by the inhabitants of rural regions (hospitals, schools, theaters, etc.). Nowadays, it is also stated that in larger cities the demand for welfare and in-kind-social services is above average. In addition, the production costs of public services in agglomerated areas are higher, which can be illustrated by higher property and rental costs.

However, the “population ennoblement” of the city-states has always been criticized. Today, above average need for public services in big cities is as doubted as the alleged cost disadvantages. Since the production of other goods and services is generally based on the notion of economies of scale, it is not intuitive for public services to accept the opposite. And indeed, the new 2005 rules in favor of the sparsely populated *Länder* recognize that also there can be above-average costs of providing public services (path maintenance, school trips, etc.). From a scientific perspective, the empirical justification of the population ennoblement is still not clearly understood due to a lack of undistorted data. Politically and constitutionally, however, the population ennoblement is widely accepted.

After these calculations have been made and both, the fiscal strength index and the compensation index, for each Land are fixed, the compensation tariff can be applied. If the fiscal strength is greater than the fiscal need indicator, the Land in question is liable to pay. In the reverse case, the Land receives LFA transfers. That is, payer *Länder* display a relative fiscal strength above 100 percent, recipient *Länder* below.

The compensation tariff determines how gaps are compensated and how much the financially strong *Länder* have to give. After an idiosyncratic and asymmetrical tariff had previously been rejected by the Federal Constitutional Court, since 2005 a symmetrical, partially linear tariff has been introduced for payers and receivers. Shortfalls in financial capacity of less than 80 percent of the *Länder* average are topped up to 75 percent. In the range between 80 and 93 per cent of the average fiscal strength the top-up tariff steadily falls from 75 to 70 per cent, in the range between 93 and 100 per cent finally the tariff falls again steadily, but steeper from 70 to 44 per cent. The tariff for payers with above average fiscal strength exactly mirrors this scale. However, their tariff is still adjusted with a multiplier, so that exactly the sum is collected from the financially strong *Länder*, which is needed for the financially weak ones.

## 5. Supplementary federal grants

The German system of federal finances close a circle: as it begins with the vertical distribution of revenue, it ends again with a vertical element. With supplementary grants, the federal government can provide additional non-earmarked funds to *Länder* due to remaining financial weakness or other needs. Currently, four different types of supplementary federal grants (*Bundesergänzungszuweisungen* = BEZ) are granted.

1. **General supplementary grants** are given to those states whose financial capacity per (ennobled) inhabitant after horizontal fiscal equalization lies below 99.5 percent of the average. The deficits are offset to 77.5 percent. In 2017, 4.5 billion euros were spent on these BEZs to twelve *Länder*.



2. **Special BEZ for above-average costs of political leadership:** The fixed costs of a state parliament, a government and an administration are disproportionately burdening small *Länder*. To compensate for these burdens, ten out of sixteen *Länder* receive special federal supplementary grants, which are fixed in the longer term but are reviewed by the federal government and the *Länder* every five years. In 2017, a total of 517 million euros was spent on this purpose.
3. **Special BEZ to cover division-related special burdens:** The East German *Länder* and Berlin receive these grants in order to build up public infrastructure comparable to West Germany and to compensate for the low financial capacity of their municipalities. These BEZ are the central grants of the Federal Government within the framework of the “Solidarity Pact II”. The new *Länder* and Berlin each receive a fixed percentage from the “Soli II” lump-sum, which is agreed for the years 2005 to 2019. The total funds in this budget gradually decrease during this time from 10.5 to 2.1 billion euros per year. In 2017, 3.6 billion euros were available here.
4. **Special BEZ for the compensation of special burdens due to structural unemployment:** Where structural unemployment is particularly high, *Länder* incur disproportionate burdens. Here, the new *Länder* (excluding Berlin) collectively receive EUR 0.5 billion a year, the distribution of which is regulated in fixed amounts. These supplementary grants are reviewed every three years by the federal and *Länder* governments and, if necessary, recalculated.

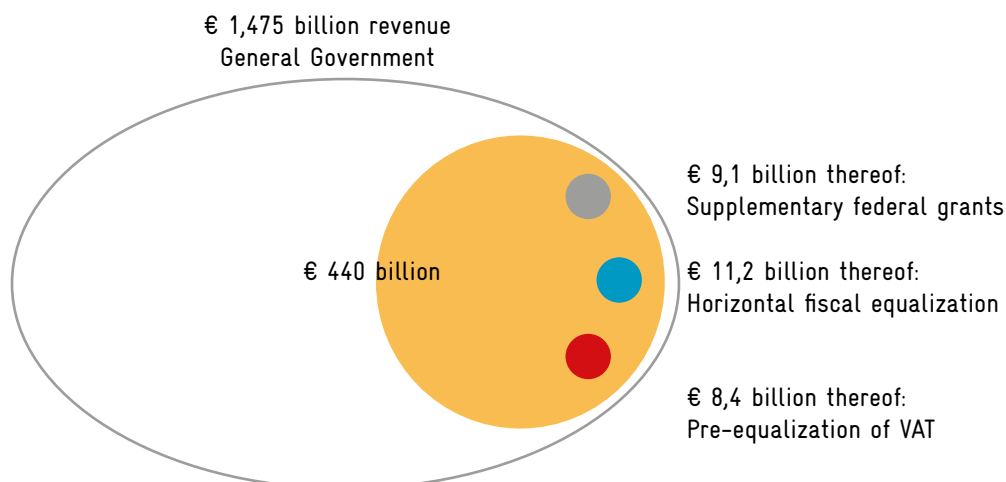
### C. Small equalization, great significance

In view of the small volume of the equalization elements in comparison to the total revenues, it is not yet plain why the federal fiscal equalization system plays such an important role in the financing of the *Länder* and in the public discussion. The federal fiscal equalization plays at the same time a small and a large role in the public finances of Germany. The quantitative meaning depends here, as so often, on the perspective. From a bird’s-eye view, the balance with its three elements is rather small. VAT equalization, core horizontal fiscal equalization and all federal supplementary grants add up to € 28.7 billion in 2017. If one compares this amount to the general government revenue of 1.475 billion euros (2017, national accounts), the circa two percent almost disappear.

Figure 3 also provides a comparison for the *Länder* level, the sum of the regular *Länder* revenue in 2017 was around 440 billion euros. Even in this perspective, it is not yet fully understandable why the federal fiscal relations plays such an important role in the *Länder*’s financing and also in public debate.

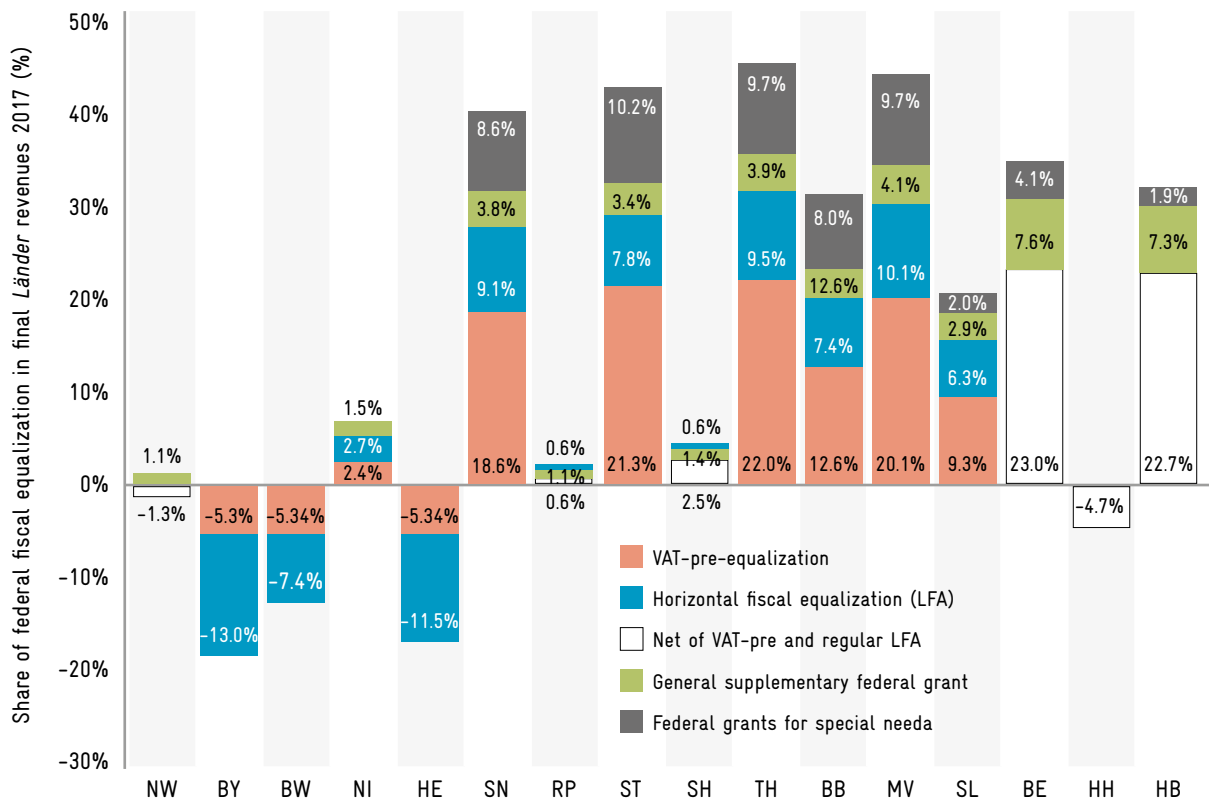
This judgement changes completely when one looks to the individual *Länder*. The seemingly small significance of the compensation elements follows only from the different Land sizes, the (fiscally) large *Länder* dominate the overall picture. Figure 4 shows the importance of all elements of federal finances as shares of the final Land revenues. For some *Länder*, we show a net of VAT pre- and national fiscal equalization if they have lost revenue in the upstream stage but then turned recipient *Länder* in the LFA. In this presentation, the differences between the *Länder* become very clear: In the exceptionally large North Rhine-Westphalia or in the very rich Hamburg, the federal fiscal equalization actually plays a relatively small role. For the other *Länder* the impression is the opposite. Berlin and Bremen receive the largest shares from the core

FIGURE 3: EQUALIZATIONS COMPARED TO TOTAL REVENUES (2017)



Sources: Own calculations, own representation. Data: BMF, Destatis (VGR).

FIGURE 4: SHARE OF FEDERAL FISCAL EQUALIZATION IN FINAL LÄNDER REVENUES (2017)



Source: Own calculations; own illustration. Basic data BMF; FAG.

fiscal equalization, whereas for the eastern German *L nder* VAT pre-equalization and federal supplementary grants are more important. For the four LFA payers in 2017, equalization transfers due are also significant compared to their final revenues.

As Figure 4 also shows the horizontal transfers of VAT supplementary shares, the picture is very unambiguous. On the one extreme, Bavaria loses more than 18 percent of its final revenue. For Thuringia, however, it is disclosed that in 2017, well over 45 percent of the revenue came from the various distribution mechanisms. In light of the figures shown in Figure 4, it becomes very clear that the system of federal finances substantially affects the vital interests of many *L nder*: the seemingly small amount of equalization is actually of great importance.

#### D. The new fiscal equalization from 2020

On June 1, 2017, the German Bundestag, in a third reading with the required two-thirds majority, adopted a bill amending the Basic Law (BT printed matter 18/11131), a simple majority bill reforming the federal equalization system from 2020 onwards (BT printed matter 18/11135). The approval of the *L nder* chamber, the Bundesrat, took place the following day.

The symbolic centerpiece of the reform is a double abolition: On first glance, the VAT pre-equalization and the horizontal *L nderfinanzausgleich* itself are abolished. In fact, other issues were in the foreground of the negotiations and of the outcome. The *L nder* had originally gone into the talks on reform under three premises, which were all implemented by the final decisions:

- All *L nder* should be able to meet the requirements of the ‘debt brake’ from 2020 onwards. This included the common willingness to provide Saarland and Bremen with consolidation assistance that would enable them to do so.

- No Land should be financially worse off after the reform. The payer *Länder*, of which Bavaria and Hesse had submitted constitutional complaints against the applicable current *Länderfinanzausgleich*, should be financially relieved; the recipient *Länder* saw no room to finance this at their own expense. Therefore, everyone negotiated from the outset on the premise that the federal level would shell out additional funds for the future fiscal equalization.
- Municipal tax capacity should be included to a greater extent than hitherto in calculating the financial strength of the *Länder* in the equalization.

In the course of the negotiations, another demand was added that initially threatened to make an agreement more difficult. The stumbling block was the VAT pre-equalization, the upstream mechanism prior to the actual LFA. Over the years, the two successive, but not harmonized equalizations had developed into a problem for the self-representation of the largest Land: North Rhine-Westphalia (NRW) is at the stage of the VAT pre-equalization one of the major payers. But these payments weaken it so far that the Land becomes a recipient Land in the subsequent fiscal equalization. This is true for several *Länder*, but North Rhine-Westphalia is the only one to lose significant net revenues – but earns the plus the image of a ‘pauper’. For obvious reasons, NRW wanted to see the VAT pre-equalization abolished. Honestly and transparently, the whole redistribution should take place only in the actual horizontal equalization.

This met the resolute opposition of the current LFA payer *Länder*. They already had large burdens anyway and could not support a reform resulting in an even larger LFA mechanism. Also, some of the governments of *Länder* which are recipients in both stages had no interest in abolishing the upstream and more obscure VAT mechanism. The controversy surrounding VAT equalization became highly symbolic for the *Länder* concerned because it was more about self-image and public communication than about the underlying financial issues.

Against this background, the compromise found is psychologically quite clever: it breaks through the Gordian knot by “eliminating” the entire old equalization and shifting all horizontal compensation entirely into the vertical distribution of VAT shares. The entangled ‘image problem’ of North Rhine-Westphalia and its counterparts had its roots in the frame of reference of the traditional system. The problem could not be solved within this frame. So the frame of reference was completely redefined – while the underlying finances did not change dramatically.

As a result, there will no longer be VAT pre-equalization from 2020 onwards. The VAT share of the *Länder* is allocated only according to current population figures. However, these shares are not yet paid out. Rather, surcharges and discounts are calculated according to the standards that have hitherto been used in a very similar way in the core horizontal fiscal equalization. Instead of horizontal compensations of the *Länder* among each other, in the future a correction calculation called “fiscal capacity equalization” will be made directly in the VAT allocation. Instead of horizontal fiscal equalization between *Länder*, vertical equalization with horizontal effects between the federal government and each of the sixteen *Länder* will take place.

As regards financial substance, the further elements of reform were partly more important. The changes in the horizontal sphere include:

- The municipal fiscal capacity is accounted for at 75 percent instead of 64 percent.
- The equalization between financially weak and financially strong *Länder* (which are no longer officially called ‘strong’ or ‘weak’) follows a symmetrical linear surcharge and discount rate of 63 percent instead of the similar, but linear-progressive tariff of today.
- The mining levy,<sup>3</sup> which is significant in terms of financial volume only for the *Länder* of Lower Saxony and Schleswig-Holstein, is only taken into account in the Land’s fiscal strength index by 33 percent instead of 100 percent.

There are a number of changes in the vertical relationship between the federal government and the *Länder*:

- The federation gives about four billion euros per year from its VAT share to the *Länder*. This additional replenishment of the equalization system is the first step in ensuring that all sixteen *Länder* are financially better off after the reform compared to the current system.
- The general supplementary grants which are given to those states whose financial capacity after fiscal equalization lies below average percent will be further increased: as of 2020, 80% of the funding gaps, leading to a fiscal capacity of 99.75% or less of the average, will be topped up by the federal government.

<sup>3</sup> The *Länder* levy a charge for certain mineral resources in the amount of 10% of the market value (§ 31 Federal Mining Act). Due to numerous old and persistent exemptions, only natural gas and oil production in Lower Saxony and Schleswig-Holstein generate a total of circa 100 million euros in annual revenues; while lignite and coal mining as well as salt mining do not lead to tax revenues.

- Supplementary federal grants for East German *Länder* with low-tax municipalities are replaced by generally available grants to *Länder* with low-tax communities. In fact, most of these municipalities are located predominantly in East Germany.
- A new allocation of federal grants creates a partial financial compensation for those *Länder* that have achieved below-average results in securing common research funds. These compensatory grants are not earmarked for research.
- The federal government will help with the financial restructuring of the Saarland and the Bremen with 400 million euros per year.
- Within the framework of the Municipal Traffic Financing Act, the federal government pays around 330 million euros more annually to the *Länder*.
- Bremen, Hamburg and the coastal states receive additional funds to cover port liabilities amounting to 39 million euros per year.
- Brandenburg receives eleven million euros per year additional special needs federal supplementary grants for above-average costs of political leadership. For the other nine recipient *Länder* of this allocation, the amounts remain unchanged.
- The federal government will be able to finance investments in municipal infrastructure more easily. Specifically, this refers to investments of financially weak municipalities in the educational infrastructure. This gives the federal level direct access rights for grants to the municipalities for the first time.
- The competencies of the federal government in tax administration are strengthened.
- Where financial assistance is provided, the Federation may, with the consent of the Bundesrat or an administrative agreement, regulate the principles of *Länder* programs.
- The control rights of the Federal Court of Audit are extended, where the use of federal funds in the states is affected.
- The Stability Council is strengthened in the monitoring of *Länder* budgets.

At the same time, the new fiscal equalization will eliminate other vertical payments from 2020 onwards. The gross amount of 9.5 billion euros, which the federal level additionally grants (4 billion euros additional VAT shares, 4.3 billion additional BEZs and 1.2 billion euros other federal funds), is to be confronted with federal savings amounting to 5.4 billion euros. As of 2020, the federation will pay an additional 4.1 billion euros per year for the *Länder*-level. Thus, the common reform premise of the *Länder* can be well met: each of the sixteen states will be better off financially compared to the current system.

To achieve this politically, the federal level had to win something in the compromise. As counter-trade to the 4.1 billion euro federal funds, the fiscal equalization reform is accompanied by the following measures in the vertical relationship, which promise in part an increase in competencies for the federal government:

- A new infrastructure company of the federal government can bundle the investments in the trunk road network and eliminate friction losses. In future, the federal government will be solely responsible for the planning, construction, operation, maintenance, and financing of the federal motorways. However, the administration of the infrastructure company is planned to remain regionalized.

### III. FINANCING OF THE LÄNDER AS AN ELEMENT OF COOPERATIVE FISCAL RELATIONS

#### A. The reform of federal fiscal relations – a successful compromise

The 2017 reform of the federal fiscal equalization system, of the vertical grants system and of the accompanying elements increasing central competencies were, after intensive negotiations between the *Länder*, reached with extraordinary unanimity: at the end of 2015, all sixteen *Länder* agreed on a jointly developed reform model. For the all of priority issues, compromises were found. In addition, the proposed financial package lead to all sixteen *Länder* being better off with the reform than with the status quo. The required additional funds will be raised by the federal government from 2020; in return, joint control of the states' budgets as strengthened. Here, too, the federal government – which had been informally involved in the *Länder* talks from the outset – agreed after a few adjustments, above all after the relocation of some powers to the central level.

Naturally, the result did not correspond to all the wishes and recommendations brought to the process from the outside. Some scholars, parts of the press and the parliamentary opposition at the federal level had made dissimilar, sometimes far-reaching and, of course, among each other not identical proposals for the reform of federal finances. But these players were also not obliged to agree on a viable solution. The agreement on the reform of federal finances was negotiated between those who had to take responsibility for the decisions and implement them. The federal government is supported by the parliamentary majority in the Bundestag, the first chamber of the federal legislature. The sixteen *Länder* governments form the second chamber of the federal legislature via the Bundesrat. Certainly, de jure a 16:0 unanimity among the states would not have required for this reform; for the necessary constitutional amendments a two-thirds majority in each chamber suffices. But in view of the constitutional framework, far-reaching majorities are desirable for this kind of financial reform. Otherwise, a compromise reached might be quickly called into question by the outvoted minority by bringing an action before the constitutional court.

Nonetheless, it is a noteworthy success that such a consensual reform has been adopted in a large and heterogeneous federal state, thus fixing the essential framework of the federal finances for the period from 2020 to 2030 well in advance. That is not a matter of course: Also in German federalism pressing reform questions, the necessity of which

is well understood, remain deadlocked in endless conflict between different *Länder* interests. Today, the overdue reform of the land property tax, which has been negotiated for decades to no avail, illustrates this very vividly. Agreement does not come about between the *Länder* even under extreme pressure to act: the current property tax has recently (and expectedly) been rejected as unconstitutional and will no longer apply after the end of 2019. Should the reform be decided upon, it won't happen sooner than the in the last minute.

Due to the 'sunset' clause of the Fiscal Equalization Act (Finanzausgleichsgesetz = FAG), there was also pressure on the federal and *Länder* governments to adopt a new system for the period from 2020 onwards. However, although the FAG, which expires at the end of 2019, regulates the distribution of VAT to the federal government and all *Länder*, the self-imposed phasing-out period did not guarantee a substantial reform. The federal government and all *Länder* are equally dependent on the revenues from this second largest tax. Correspondingly, a decision would always have been reached on a simple FAG renewal or on a repeal of the expiry period. But the 2017 reform of the federal finances goes much further; it solves important conflicts and regulates several urgent questions of the future. In the following section, we will examine which elements and conditions of the federal and *Länder* finances have facilitated these successes. Our special attention is given to structural factors, not to specific political and historical constellations in Germany.

It is these structural elements that are to be examined for their benefit from an international perspective. Such a benefit may be that certain elements of German federal finances can actually serve as a model. However, in the case of major differences from cooperative German federalism, the benefit can also come about that no transfer of success factors is reasonable, but the German model can be used as a counterpart in order to develop own expectations and options more clearly.

## B. Success factors

For the sake of clarity, the success factors are presented as individual modules. However, as it will become obvious, these different factors interact in practice and are, at least partly, mutually enhancing.

In the stock-taking of structural success factors for German-type cooperative federalism, two external circumstances should not be concealed which have assisted the realization of the 2017 reform notably. For one thing, Germany in phase of the decision-making was in a sustained upswing (and still is). The economic boom has had a very positive impact on tax revenues and public finances. Without the resulting consolidation, and without the prospect of continued growth in tax revenues, coming to the financial terms of the compromise probably would have been thornier. On the other hand, at the time of the decision in the summer of 2017, the governing coalition in the German Bundestag had a majority of 80 percent of the votes. This has facilitated the necessary constitutional amendment, which requires two-thirds of the votes in each of the two chambers.

Beyond these external conditions of the recent reform, the following factors contribute structurally and permanently to the progressive development of German federalism, so that all relevant actors recurrently come to compromises and actively support the new solutions after their implementation.

### 1. Equivalent living conditions via semi-determined norms

The federal fiscal equalization is not carried out solely on the basis of voluntary solidarity; the constitution calls for an adequate compensation of the financial strength of the *Länder* (Article 107 of the Basic Law). The claim behind this is further formulated in the Basic Law: A central task of the federation is to establish equivalent living conditions in the federal territory (Article 72 of the Basic Law).

Equivalence of living conditions is not a clearly tangible, operational goal, even if one only considers only the spheres of government influence on people's living conditions. During the first forty-five years of the (West-) German constitution, the Basic Law postulated the uniformity of living conditions as a criterion of government action. This high standard was abandoned with a change in the Basic Law in 1994 – but not as a reaction to the German unification four years earlier, even if that was sometimes claimed. However, the German unification has certainly emphasized the difficulties with this standard. Already from 1949 to 1994, the uniformity of living conditions was an impractical standard for the federal action and fiscal equalization. The goal is not attainable in a large and heterogeneous country. People who live in a mountain village

on the edge of the Alps or on Helgoland out in the North Sea cannot live in the same conditions as in the heart of big cities like Berlin or Hamburg. Most do not want that too. Federalism means to appreciate regional differences in accordance with the principle of subsidiarity and not to seek a regional balance through 'unification'.

A criterion for regional reconciliation that cannot be attained and, ultimately, must not be attained, cannot serve as a yardstick – neither in, nor beyond the constitution. Equivalence as a new benchmark has been much criticized since its introduction: the term is vague and open for different interpretations. What is the value of pursuing goals whose reachability cannot be determined?

We argue differently: The 'semi-determined' equivalency is a particularly good goal to base which federal and state finances and fiscal equalization on. The criterion must fulfill a double function in the federal process. First, there must be an approximate measure of which results the financial redistribution should bring about. Whoever claims that "approximately" does not give an accurate goal overlooks the crucial merit of the formula: equivalency says clearly enough that redistribution must go very far from initial inequality. The criterion promises constitutional protection against obvious inequalities stemming from different fiscal capabilities – not from geographical or other objective differences that cannot or should not be offset. But equivalence of living conditions is not only an important protection against arbitrary differentiation. Automatically, the goal legitimizes far-reaching redistribution of resources, where necessary.

In addition – and this is often underestimated – every federalism needs a redistribution formula which can upheld continually by all sides, by the federal government, by the financially weaker and also by the financially stronger *Länder*. The formula must allow common identification in and with federalism; it must function as a federal narrative. For this, it each side must be able to identify itself with the federal model and its role herein. When some appreciate the differentiation, brought about by the renunciation of the uniformity-goal, while others emphasize the implicitly high degree of equalization facilitated, the opacity of the equivalence-goal is a real advantage. In order to serve as a good basis for continuous compromise-seeking in federalism, it does not hurt if the common goal itself emanates some of the ambiguity of a good compromises.

### 2. Integrated legislation for federal finances

The provisions for distributing non-earmarked financial resources to the *Länder* in Germany are laid down in the regulations of the federal fiscal equalization system. All agreements are reflected in the Fiscal Equalization Act (Finanzausgleichsgesetz = FAG). This also applies to such provisions that do not belong to fiscal equalization in the strict sense:



- distribution of VAT between the federal government and the states,
- VAT distribution among the *Länder* (with VAT pre-equalization until 2019),
- general supplementary grants of the federal government to all recipients of the fiscal equalization system, and
- special federal supplementary grants that are allocated according to specific needs-criteria, deviating from the general equalization mechanism.

However, the law is not only changed in the major fiscal equalization reforms such as 2017 or before 2001. Regular changes in the distribution of funds between the federal government and the *Länder*, which have become necessary for specific events, are regularly included in the FAG. Such vertical adjustments are always made by changing the VAT shares the federal government and the states. The cause of such adjustments may include changes in child benefits, pension insurance subsidies, increases or decreases of shared taxes, refugee integration and many others. Only if the federation explicitly supports specific purposes with own ear-marked programs or if it reimburses the *Länder* for distinct costs, the payments are regulated outside the FAG.

The integrated consideration of all non-earmarked financial flows between the federal government and the *Länder* is beneficial in two ways:

- Automatically everything is always ‘in view’. Federal financial relations are observed by all players as a whole and in their total impact.
- The custom of regulating everything financial in the FAG (it is not an obligation) also exerts a degree of discipline on negotiations and the options considered there.

In ad-hoc negotiation situations, it might sometimes be more convenient to regulate current agreements separately from the system of fiscal equalization. Yet, such solitary commitments would gradually result in parallel and uncoordinated fiscal equalization structures. An example of this is provided by the regional financing system of Spain, where several subsystems of horizontal fiscal equalization have been created side by side over time. In sum, the distributional effects are not only very opaque; above all, they are also clearly unjust, since the interaction of several different sub-logics has created a kind of great illogicality. This is now a major obstacle to the further development of the Spanish regional financial relations.<sup>4</sup>

Such a situation cannot arise in Germany, as long as the integrated habit is continuously implemented.

### 3. Common data and accounting standards

The clear definition of the budget figures and economic data used is an essential prerequisite for the implementation of fiscal equalization and transfer solutions. You have to rely on the figures with respect to

- their volumes,
- their completeness and
- their comparability.

When doubts arise about these qualities of the data, the confidence in equalization systems built upon them dwindles. Where uncertainties and gaps in data standards leave room for ‘creative accounting’, also the confidence of the actors involved decreases. A loss of confidence does not only occur when there is evidence of tactical exploitation of such gaps. Even the possibility of interpreting common standards with selfish ends creates mistrust and thus markedly restricts the room for compromises on all sides.

Common data and accounting standards, which not only exist formally, but are also uniformly implemented in practice, seem like a matter of course at first sight – with no need be mentioned separately. But in historically grown federal countries such a practice is by no means warranted automatically. Also, establishing common accounting standards for complex public-sector tasks often creates significant costs; thus they cannot be considered ‘low-hanging fruits’.

In Germany, federal and state governments in their budgets work on the basis of common principles. At the federal level, they are laid down in the Budget Principles Act (Haushalts-grundsatzgesetz = HGrG) and in the Federal Budget Code (Bundeshaushaltsordnung = BHO). The states use Land Budget Codes (Landeshaushaltsordnungen = LHO) largely analogous to the BHO. On this, on financial accounts and national accounts coordinated between the Federal Statistical Office and *Länder* statistical offices as well as on each related rules and regulations, the essential elements of the German federal finances are based. Especially for joint data acquisition and validation, the states created the Central Data Center of the *Länder* (ZDL) in the early 1970s. It is jointly organized by the ministries of finance of the sixteen *Länder* and is based in the Federal Council in Berlin. The common standards were further boosted in 2009 by the adoption of the constitutional ‘debt brake’, as well as by the European Deficit

<sup>4</sup> See A. de la Fuente, C. Kastrop, M. Thöne (2016): Regional Financing in Germany and Spain: Comparative Reform Perspectives, BBVA Working Paper N° 16/04, Madrid.

Rules of the Maastricht Treaty (1992) and the European Fiscal Compact (2012).

Data quality and improvement is always a process of dialogue between practice and science,<sup>5</sup> and among practitioners through peer review. Usually, these processes make gradual progress.

But if the interests are clearly controversial or the concern of individual actors lies far beyond the average level, data disputes must be solved politically or even by supreme courts. In 2018, the Federal Constitutional Court in Karlsruhe has to decide on a key data question for federal, *Länder* and municipal finances: In 2011, the latest census in Germany was implemented as a sample survey with subsequent extrapolation. For statistical reasons, the extrapolations for municipalities under 10,000 inhabitants were implemented in a simpler way than the extrapolations for all larger municipalities. As a result of the census, the new calculation presented in 2013 led to a downward correction of the population of Germany by 1.5 million persons. The changes were distributed unevenly across Germany. For some regions, higher numbers of inhabitants were reported, others lost tremendously. Mathematically, Berlin shrank by 180,000 inhabitants. Since federal fiscal equalization relies on these population figures for the distribution of VAT receipts, fiscal needs and federal supplementary grants, this data issue had a significant impact on financial flows. According to FiFo-calculations, the changes added up to over 940 million euros a year, Berlin alone would lose 515 million euros a year.<sup>6</sup> Meanwhile, the changes in population figures have been put into effect with a transitional period of three years. Today the federal fiscal equalization and all municipal equalizations are implemented on the new basis. However, in view of their considerable losses, the city states of Berlin and Hamburg have the 2011 census reviewed by the Federal Constitutional Court. Because of the different extrapolation methods for small and larger communities, they conclude an unequal treatment that is unconstitutional. A verdict had not been made at the conclusion of this short study.<sup>7</sup> This example illustrates how serious the political and legal acceptance of data questions is for the success of fiscal equalization.

Obstacles also occur where improvements in data quality cannot be achieved by gradual improvements, but require a fundamental and costly system change. For example, Germany is one of only six OECD member states (out of a total of 35) that continue to use cash accounting in their public finances. All others use double-entry bookkeeping with accrual accounting or are in transition there.<sup>8</sup>

Accordingly, the federal fiscal relations finances are calculated on cash basis. The two *Länder* with accrual accounting (Hamburg and Hesse) present parallel calculations on a cash basis. The fact that Germany mainly uses traditional accounting at the federal and state level illustrates two other factors that are important for common accounting standards:

- Modernizations must create added value that, at least, matches the extra effort of in introduction and transition. The extra work involved in converting the entire accounting systems is huge. The Federal Court of Auditors expects that the introduction of the double-entry bookkeeping according to the EPSAS standard in Germany would cost considerably more than the 3.1 billion euro estimated by the European Commission.<sup>9</sup> Whether accrual accounting pays off this effort is often questioned in Germany.<sup>10</sup> In the long-term, however, this modernization would be a good starting point to anchor advanced governance systems as well as performance-informed accounting more consistently in the budget.
- In order to act not only as a basis for accounting but also as a joint basis for discussions and negotiations common budget standards should be as user-friendly as possible for non-experts. In this respect too, accrual accounting demands a great deal from all those involved in the political process, including the press and the interested public. The experience at the municipal level in Germany illustrates this vividly.

Whether sooner or later, whenever double-entry bookkeeping with accrual accounting is introduced for the federal government and the remaining *Länder*, a parallel system with cash accounting must be continued for a long

<sup>5</sup> See e.g. H.T. Burret and J. Schnellenbach (2013), Umsetzung des Fiskalpakts im Euro-Raum, SVR-Arbeitspapier 08/2013, Wiesbaden.

<sup>6</sup> The calculations were carried out for the equalization year 2012. See M. Thöne in M. Greive: Zensus stellt *Länderfinanzausgleich* auf den Kopf, Welt am Sonntag 02.06.2013.

<sup>7</sup> At the hearing of the proceedings (2 BvF 1/15, 2 BvF 2/1) it became clear that the court should at least not unconditionally accept the census method developed by the statistical authorities: "One has a bit of the impression of a Münchhausen construction," said Andreas Voßkuhle, the president of the constitutional court (See: Das geschätzte Volk, Frankfurter Allgemeine Zeitung of 24.10.2017).

<sup>8</sup> See OECD (2017), Accrual Practices and Reform Experiences in OECD Countries, Paris.

<sup>9</sup> Bundesrechnungshof: Bericht über die angestrebte Einführung harmonisierter Rechnungsführungsgrundsätze für den öffentlichen Sektor (EPSAS) in den Mitgliedstaaten der Europäischen Union, Bonn, 15.11.2017.

<sup>10</sup> However, at the local level, where the accrual budget is most urgently needed because of extensive investment activities, double-entry bookkeeping has now been introduced in the vast majority of the German *Länder*.



time in any case. Only in this way it can be guaranteed that there will be no interruption in the dual function of the common accounting standard essential for the federal finances, i.e. as a basis for communication and for trust.

#### 4. Some equalization through the central level

A functioning horizontal fiscal equalization between the *Länder* must not, according to the German experience, become too large. If, however, a relatively high degree of financial evening-out between stronger and weaker *Länder* is to be achieved, a sizable part of the horizontally effective equalization between ‘the poor’ and ‘the rich’ must be made through the central level. From a mathematical perspective, this statement cannot be substantiated. Rather, what is important here is the policy perspective – the federal psychology.

From a purely mathematical point of view, many different solutions would be equivalent. As noted above, in Germany the various shared taxes with different proportions are assigned to the federal government, the states and the municipalities as ‘their own’ revenues. This tax allocation is the result of a special historical process that, of course, could have been different. From the given initial distribution the federal fiscal equalization systems redistributes revenues until the politically agreed distribution of funds is reached at the end. With a different initial distribution and a correspondingly different equalization system, the same final result would be achieved mathematically.

Already in today’s federal fiscal relations, the central government plays an important role for the horizontal equalization between the *Länder* by means of the early and very effective VAT pre-equalization. After the core-LFA, the remaining differences in financial capacity are be further reduced by general supplementary grants to all recipient *Länder*. Once the 2017 reform enters into force from 2020, the core horizontal fiscal equalization will be transformed into a vertical mechanism via the federal government. From a mathematical point of view, this would not be necessary: With another initial equipment, the *Länder* could theoretically deliver the desired equalization horizontally. Also, the strong role of the federal government is not necessarily given, but the result of a long historical process – before 1920 the German Reich was considered as dependent of the *Länder*.

But this theoretical perspective is indeed unhistorical; it does not reflect the actual federal process and what we refer to as the ‘federal psychology’. As already emphasized, federalism has to balance the tense relationship between regional independence on the side and solidarity on the

other. Where fiscal equalization of regional disparities is necessary, this act of solidarity should not conflict with the self-perception of regional autonomy among the ‘payers’ and also among the beneficiaries. That is, ‘payers’ should not be burdened by fiscal equalization in a way that exceeds their readiness for solidarity. ‘Recipients’ should not have to be helped by legally equals in a way, that they must feel that they are petitioners. Both sides should be able to meet as equals on an equal footing. In addition, the role of horizontal redistribution between them should not become overly dominant.

However, there is no mechanism which automatically ensures that objective compensation needs and objective financial strengths are consistent with these subjective limits to redistribution. Ideally, both match – but there is no guarantee. Such a mismatch poses no problem if the subjective readiness for solidarity is bigger than the objective distributional requirements.

Yet, the German experience of the last decades points in the opposite direction: the subjective acceptance of solidarity for payers and recipients is often lower than the objective needs and the objective fiscal strengths. In such a situation, it is natural to shift part of the ‘objective’ redistributive need to the less salient zone of vertically-implemented federal transfers with horizontal effects. In this way, visible redistribution between *Länder* and the acceptance of direct horizontal redistribution are reconciled.

This psychological need is also recognized in other fiscal equalization systems. For example, in Switzerland – whose federal model in other aspects offers a diametrically opposed counterpart to the cooperative German model – the National Fiscal Equalization (NFA) among the cantons also is financially heavily supported by central level: In 2018, the three “equalization vessels” of the NFA, the resource equalization, the hardship equalization and the burden-sharing, are funded by the federal government with about 3.3 billion francs – that is 65 percent of the total volume.<sup>11</sup> In Germany, the creation of the VAT pre-equalization in 1969 followed this logic. The mechanism introduced by Federal Finance Minister Franz-Josef Strauß meant that the previously sharply increased, visible horizontal fiscal equalization was halved in the first year of its use 1970.

With the integration of the East German *Länder* in the regular fiscal equalization from 1995, the disparities in economic power and individual welfare that had to be overcome made a leap: the need for redistribution increased dramatically. VAT pre-equalization and federal supplementary grants helped to keep the actual horizontal Land fiscal

<sup>11</sup> See Schweizerische Eidgenossenschaft – Der Bundesrat (2018), Wirksamkeitsbericht 2016–2019 des Finanzausgleichs zwischen Bund und Kantonen. March 2018, Bern.

equalization looking smaller. However, the method chosen resulted in an equalization in which very few payers have to make up for a large number of recipients: In today's core horizontal fiscal equalization, four 'payer *Länder*' face twelve recipients in 2017. In contrast, the preceding VAT pre-equalization effectively has eight payers facing eight recipients. But with the system that seemingly concentrates the burden of redistribution on only the few payers of the salient *Länderfinanzausgleich*, a new seed was sown for a growing sense of overburdening by solidarity demands. Moreover, since Bavaria – due to its outstanding economic and tax revenue development – has to shoulder a growing share of the LFA payments, the feeling of imbalance has exacerbated even more: Today, about half of the payments in the horizontal equalization system are born by Bavaria. They spend more than ten percent of the Land's budget on the *Länderfinanzausgleich*.

With the reform effective as of 2020, it is achieved that this outward appearance of an overburdening of few payers disappears. By shifting the full horizontal equalization into a vertical mechanism, it would seem as if all payers and receivers disappear. Instead, all *Länder* now receive differentiated VAT shares from the federal government according to slightly modified, yet by and large upheld LFA standards. From 2020, no Land will have to provide for equalization expenditures in its state budget anymore.

It certainly is not true that the subjective readiness for solidarity had fallen so far that the equalization had to be completely shifted to the vertical mechanism. Also, the perception of a horizontally effective redistribution will not completely disappear, even if it is less visible. The fact that in this reform a seemingly complete 'verticalization' came out as a solution was also due to the specific negotiating constellation, where a 'Gordian knot' had to be penetrated (see section II.D).

However, it remains true that at least partial verticalization – a strengthening of the central government's role – has repeatedly been very helpful in achieving horizontal acceptance of the necessity to balance regional disparities. Since it mathematically does not make a difference whether the necessary equalization is settled by means of horizontal or vertical mechanisms, actually nothing is lost. In this perspective, taking the federal psychology into consideration and thus choosing of a high degree of verticalization to produce effective acceptance of solidarity can be seen as a kind of practiced statecraft in federalism.

## 5. Homogeneous taxes of the *Länder*

The German tax system is very homogeneous. With the exception of a few small levies, all taxes are decided and changed uniformly by the federal legislator. Here, only the taxes, which the federal government alone is entitled to and which it levies itself, are the sole responsibility of the first chamber, the Bundestag. These are mainly large excise duties, such as fuel and energy taxes and tobacco tax. All other notable taxes are governed uniformly and jointly by the Bundestag and the Bundesrat, the *Länder* chamber: shared Saxen, *Länder* taxes, local taxes and central taxes administered by the *Länder*. Legislative power regularly includes the determination of the tax bases and the exceptions thereto, the tax expenditures. Also allowances, exemptions and tariff structures – proportional, indirectly or directly progressive – are determined by the federal legislator.

The federal government has its own discretionary powers with regard to the mentioned central taxes; together they make up about 30 percent of its tax revenues. Since 2006, the individual *Länder* have the right to change the applicable rate of the real estate transfer tax independently. Thus, their influence is restricted one single tax that accounts to less than five percent of their total revenues. The individual municipalities have the right guaranteed by the constitution to determine the tariffs of the land property taxes and the trade tax on their own. On average, they can exercise their autonomous influence on almost 60 percent of their tax revenues.<sup>12</sup>

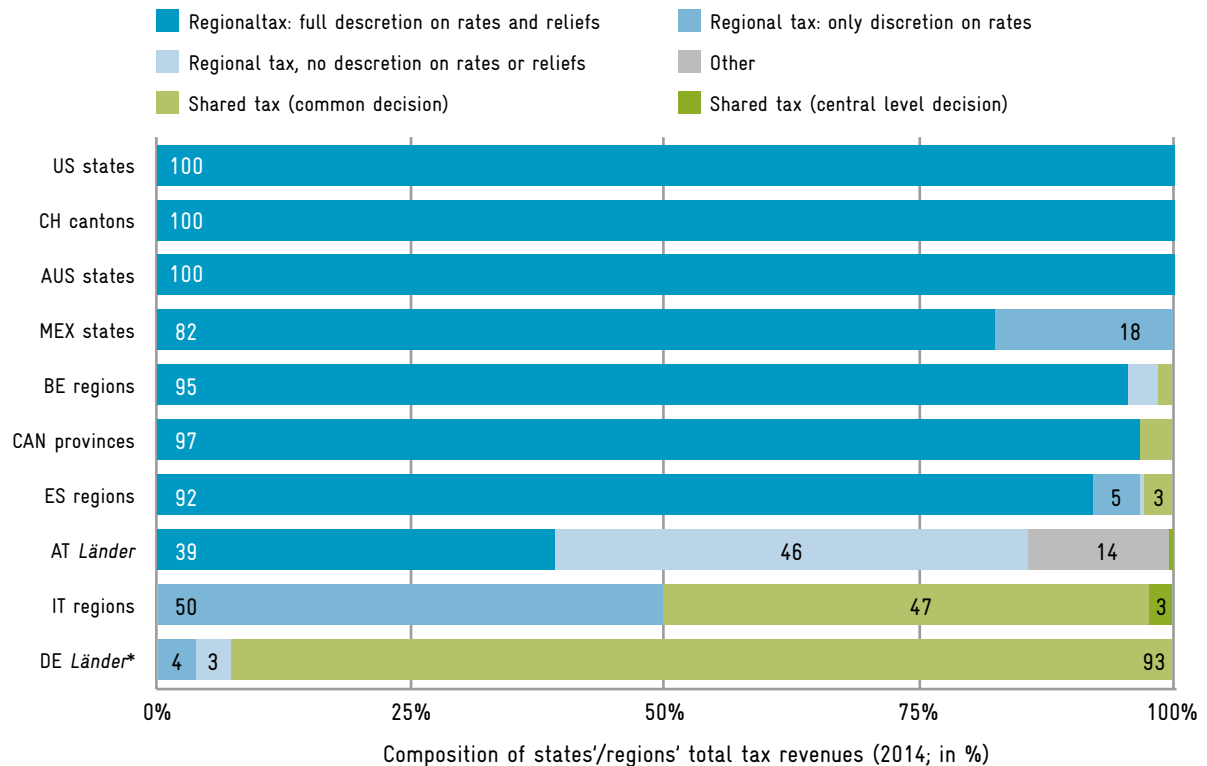
Thus, the tax revenues of the *Länder*, which are relevant for the federal fiscal equalization, are very uniform. Figure 5 illustrates this idiosyncrasy of the German *Länder* compared to the states and regions in other federal OECD countries.

In international comparison, this does not suggest that taxation, on the German example, should be standardized as far as possible. In Germany too, the introduction of tax autonomy in the small real estate transfer tax was understood by many as a first step towards more regional independence on the revenue side. On the other hand, there is no doubt that something like the total tax autonomy of the US states, whose already low degree of coordination was further limited by the 2018 tax reform implemented by the federal government,<sup>13</sup> would be completely incompatible with a successful horizontal fiscal equalization system

<sup>12</sup> See. C.A. Hummel, M. Thöne (2017), *Wachstumsgerechte Reform der Bund-Länder-Finanzbeziehungen*, München.

<sup>13</sup> With the reduction the tax rates at the US federal level also the deductibility of state income taxes has been severely limited. This eliminates an element of indirect and ex-post tax coordination via the federal tax code.

FIGURE 5: REVENUE STRUCTURE OF THE REGIONAL LEVEL IN OECD FEDERAL COUNTRIES



Data: OECD (2017). Own illustration. [\* For Germany an error was corrected.]

like the German one. Efficient fiscal equalization requires a high degree of tax coordination; a certain degree of tax standardization is also helpful.

Undoubtedly advantageous is the uniform taxation for the communication and the compromise finding in the federal finances: The fiscal equalization between the *Länder* is understood, despite some abstract needs elements, primarily as a balancing of fiscal strength. The philosophy behind this is closely related to the federal idea: where equalization is primarily geared to revenue performance, differences on the expenditure side should remain in the Land's self-determination, so that regional differences and different political preferences can be realized.

This idealistic picture does not always match the complex and often restricted reality of federal politics. But it plays an important role in the self-perception of the *Länder* governments and the recognition of each other in all federal discourses. In the early stages of the recent reform negotiations, the debate was occasionally fueled with public questions, why individual recipient *Länder* could "afford" public services such as free kindergarten years, if not all payer *Länder* offered such services. These arguments were used to strengthen negotiation positions and to influence public opinion. In the actual negotiations, however, differences in expenditures and different political programs behind them barely played a role. As long as a Land 'does

its homework' in the Stability Council (see III.B.6 below), differences in levels and types of performance between *Länder* are not discussed.

In order to be able to 'ignore' the differences on the expenditure side, the compensation on the revenue side has to be efficient. This, in turn, requires a sustainable common understanding of what constitutes financial strength:

- Due to the extensive uniformity of the German tax system, no doubts arise for the bulk of the *Länder's* tax revenues that the same standards are being used everywhere. Theoretically, differences in the enforcement of tax collection are still thinkable, since the administration of the large shared taxes lies with the *Länder*. However, since the Federal Ministry of Finance coordinates the tax collection through numerous administrative regulations, significant differences could only occur in a gray area of semi-legality or where the tax administrations of individual *Länder* reach the limits of the capabilities in complex cases. With the 2017 reform of the federal fiscal relations, the federal government's competences in revenue service were strengthened in order to further unify the administrative conduct.
- With a uniform tax system is also and easy and uncontroversial to implement a measure of fiscal strength that includes revenue from all taxes to full extent. The only

substantive exception concerns the Inclusion of municipal taxation in the financial strength of *Länder*. This is a systematic special case, which is also dealt with separately: As stated in the above infobox on the municipalities, the local level constitutionally is regarded as part of the *Länder*. The states are regularly obliged to co-finance the municipalities through vertical fiscal equalization systems. This speaks in favor of a completely integrated consideration of a state and its municipalities when calculating the Land's financial strength for federal fiscal equalization. At the same time, the municipalities are independent democratic bodies whose self-government is protected by the Basic Law. This speaks against the full inclusion of municipal taxes as equivalent to Land revenue. Thus, a compromise must be found here. The 2017 reform has increased the share of municipal revenue accounted for in the fiscal strength of its LFA from 64 to 75 percent. This further strengthened the idea of standardizing the revenue base of the fiscal equalization.

- Taxes with the right to set local rates independently cannot be included with their actual revenue in a fiscal equalization because this would neutralize the tax rate autonomy. Instead of the actual one, a standard tax rate will be used to normalize the actual revenue to a fictitious amount covered by the fiscal strength indicator. The obvious and plausible solution, it seems, would be to use an average tax rate instead of the individual rates to recalculate the relevant revenue. This is the legal practice for the *Länder's* real estate transfer tax in federal fiscal relation. However, the average tax rate as an indicator not neutral with respect decision-making: if one Land raises its tax rate, the average rate at which any other Land's real estate transfer tax revenue is accounted for also changes.. In Germany, fourteen of the sixteen *Länder* have raised their real estate transfer tax one or several times since 2006.<sup>14</sup> under circumstances like these, the standardization with the up-to-date average tax rate easily sets off a 'spiral' – the increases of one cause may the others to offset their own resulting increases in relative fiscal strength, which cause actual revenue from equalization, by own tax rate increases.<sup>15</sup> In such a situation, an exogenously fixed standardization rate slows down the spiral effect. Even better, however, would be sufficient funding for the *Länder* in federal fiscal relations. Then, with tax-rate autonomy, there are no spiral effects, and the average tax rate can be used for standardization straightaway.
- One fundamental problem of standardization with decentralized tax-rate autonomy does not occur in German federal fiscal equalization, because the weight of these revenues is so small. The problem can be partly observed in the municipal fiscal equalization systems in Germany, since here the revenues the land property tax and local business tax have a much larger share in total municipal receipts. Here local authorities rely to a greater extent on such taxes and, also to a good extent, on municipal equalization transfers. Sooner or later the question of the relationship between these two pillars of funding will be raised. This quickly culminates in the question of how much tax increases can be expected or even demanded of local authorities on average.<sup>16</sup> Without guidance from a robust (constitutional) rule, such an argument can easily erode the basis for constructive negotiations of fiscal equalization or disproportionately overburden ongoing negotiations.
- The most difficult combination of fiscal equalization and tax autonomy does not have to be dealt with in Germany today: implementing efficient fiscal equalization for a state with full regional tax autonomy over tariffs and tax bases is a demanding task. Here, not only standardization of tax rates is needed; in addition, fictitious benchmark taxes or even a whole benchmark tax systems are needed to determine fiscal strength. It is obvious that, with well-founded regional tax autonomy, the agreement on a common and uniform reference tax system, which then makes the difference in the financial equalization, must be a very laborious undertaking. Here it makes sense to reduce the complexity and thus the number of contentious issues to a manageable number of indicators to be used permanently.<sup>17</sup> Yet, because of its overarching importance, the act of simplification should also be very challenging to negotiate.

It becomes clear that efficient fiscal equalization is compatible with different degrees of tax unification or autonomy. However, the more heterogeneous the revenue side is, the more energy will probably go into the agreement on the common understanding of revenue performance in fiscal equalization negotiations. That would be one of the 'prices' to be paid for more tax self-determination. As shown, Germany can concentrate on other issues in the federal fiscal equalization system – currently, the revenue side is well-defined.

<sup>14</sup>This is a clear indication that the limited tax autonomy has been implemented in a situation of structural underfunding of the *Länder*.

<sup>15</sup>See Hummel/Thöne (2017), Wachstumsgerechte Reform der Bund-Länder-Finanzbeziehungen, a.a.O., S. 26 ff.

<sup>16</sup>A current example in Germany is provided by the state of Rhineland-Palatinate, where the question of whether the 2,300 towns and municipalities use too low tax rates is being dealt with in the context of a vertical distribution confrontation (see. T. Döring (2018): Unzureichende Ausschöpfung der Realsteuern – das Beispiel Rheinland-Pfalz, in: Wirtschaftsdienst 201, H. 1, S. 42-49). Objectively, such a question is difficult to answer.

<sup>17</sup>In Switzerland, the "resource equalization" is based on an index of cantonal potential tax resources. In turn, the resource potential consists of: (1) the taxable income of the natural persons, (2) the assets of the natural persons and (3) the taxable profits of the legal persons with and without special tax status (article 3 FiLaG). Thus, the equalization is based on three large taxes bases; all other questions are set aside.

## 6. Stability Council: Common commission as soft law instruments

In the negotiations on new federal fiscal relations from 2020, one institution played a key role, which has hardly ever officially occurred in this context: the Stability Council.

To serve as debt brake-institution, the Stability Council was established in 2010 as an early warning system for emerging fiscal crises. According to the debt brake – a common zero-deficit rule – from 2020 onward, *Länder* will not be allowed to raise new loans in economically normal times. The Stability Council regularly reviews the budgets of the federation, THE state and local governments. It can oblige them to work out recovery programs. For that, it is assisted by an independent scientific advisory board for consultation and critical reflection.

The members of the Stability Council are the Ministers of Finance of the *Länder* as well as the Federal Minister of Finance and the Federal Minister of Economics. The joint chairmanship is held by the Federal Minister of Finance and the respective chairmen of the *Länder* Finance Ministers. The Council meets on a half-yearly basis and reports publicly on its findings and resolutions.

Hence, the Stability Council is still a comparatively new body created to review the debt rules, not fiscal equalization. Nevertheless, the Council played a major role in the course and subject matter of the 2017 fiscal equalization reform, although not explicitly as an institution. But in the Stability Council as well as in the direct negotiations on the fiscal equalization reform, the same persons meet in the same roles. And the decisions on federal fiscal equalization have a very significant impact on how easily or how difficult it will be for *Länder* to reach the balanced budgets required by the debt brake in each year from 2020 onwards. In addition to the expectation that the *Länder* represented in the Stability Council and the federal government will adhere to the debt brake, there is a second, potentially stronger motive for cooperation: Governments in Germany – federal, state or local level – do not let one another go bankrupt. The above-mentioned federal narrative finds its echo in the principle of covenant loyalty. In practice, this means inter alia that in each Land, the state level and the local level take collective responsibility for the debts of each municipality. This bail-out-pledge finds its equivalent in the covenant loyalty that the *Länder* and the Federal Republic of Germany provide each other in practice.

The multilateral bailout expectation for all German local authorities is one of the central signals that justifies the high creditworthiness of Germany and its federal states and

municipalities and the ensuing low-interest rates. On the international financial markets, the comprehensive bailout obligation is virtually considered one of the ‘trademarks’ of Germany as a public borrower. At the same time, the obligation to bailouts is rarely discussed explicitly by the actors involved. A certain degree of residual uncertainty as to whether the willingness to comply is really taken seriously by all those who are potentially called upon has a disciplining effect in view of the potential moral hazard of a bailout promise.

Additional discipline is to be provided by the Stability Council. Because of its limited sanction possibilities, it is sometimes accused of being a ‘paper tiger’. In the event of a threatening budget crisis in one Land or at the federal level, a restructuring program must be agreed with the Stability Council. Restructuring aid can only be granted if the affected Land (or the federal government) strives for suitable remedial measures that are the sole competence of that authority. If these measures are not sufficient or are not implemented adequately, the Stability Council Act provides for a procedure which, above all, provides for the disclosure geared towards the media and a multi-stage warning without any further sanctions being available (§ 5 para. 2-4 StabiRatG). Yet, this notion of weakness is deceptive. The administrative arrangements for consolidation programs regularly stipulate that a Land loses the financial assistance for the following year if the agreed measures are implemented insufficiently. In principle, this mechanism also applies if the mechanism would have to be applied to the federal government. As a result, the Stability Council has more extensive degrees of escalation available that can already discipline ex ante. Nevertheless, it is true that, so far, the Stability Council did not have to stand a really hard test – such as the effects of a major economic crisis or a permanently uncooperative policy by one state government.

However, the early experiences with the Stability Council give reason for optimism. For what is often overlooked in the Council, are its qualities as a so-called soft law instrument. ‘Hard law’, i.e. a Stability Council that relies primarily on sanctions, would have meant a significant boost in centralization. Such an instrument would not have been implemented in the first place. The risk is much lower with soft law. Here, the Stability Council acts in a ‘textbook manner’:<sup>18</sup> its activities include benchmarking, peer review and an exchange of good practice; funding and sanctions are added only when needed.

To dismiss these measures as noncommittal appeals fails to recognize the functioning of the Stability Council, as it emerges after only a few years. As a peer-review between the finance ministers, which takes place behind closed doors, the Council is already doing very well today. Here, the closed

<sup>18</sup> See e.g. David Trubek et al., *Soft Law, Hard Law, and European Integration: Toward a Theory of Hybridity*, in: Joanne Scott & Gráinne de Búrca eds., 2006, *New Governance and Constitutionalism in Europe and the US*. Oxford.



doors play a very central role, even if they foster a lack of transparency at first glance. Without the public, finance ministers speak with finance ministers as peers, not as the representatives of certain governments or political parties. This round co-ordinates more powerfully and convincingly than you would expect by traditional hard law standards.

The Stability Council clearly reverberates in the negotiation results on the fiscal equalization. Not only has the aid for Bremen and Saarland explicitly ensured that these *Länder* will be able to meet the debt brake. All the results of the negotiations reflect the knowledge of the participants that they will meet regularly in the Council where they will be confronted with their respective performance. This has prevented the negotiators from considering compromises that may have been politically opportune in 2017, but could not be sustained for the years up to 2030.

### C. Benefits for the development cooperation

The inspection of German federal finances and their reform shows that many elements of the system are closely intertwined. Also the features that have been particularly emphasized as success factors initially work especially well in Germany. Nevertheless, these factors are not specifically German. They are listed here in the conviction that the fiscal equalization elements themselves or the mechanisms behind them can also be interesting and sometimes exemplary from an international perspective.

Of course, this is not about the full and direct transfer of elements of the German fiscal equalization. Rather, it is important to distinguish the structural aspects of a success factor from – sometimes specifically German – ‘environmental effects’: Germany is a mature federal state with an efficient economy and high national income. Even in its federal relations, a country of this kind can enable high levels of administrative quality and far-reaching redistribution. However, the good economic environment and the ensuing great governmental abilities are also faced with large – often dynamically increasing – demands on fiscal policy. If one abstracts from this environment of a country, which is undeniably rich in international comparison, the structural strengths that can also be exploited internationally come into view much better.

The following overview recapitulates the most important success factors in a short form.

German success factor...	...in international perspective
<p><b>Equivalent living conditions: Semi-determined norms...</b></p>	<p>...as a 'federal narrative' strengthen the integrative power of an equalization system, as they help to bridge the inherent tension between equalization and autonomy.</p> <p>In dynamic federalism, narrowly defined goals quickly become an obstacle or must be revised perpetually. On the opposite, indefinite goals cannot bring any binding force into the political process as they are empty formulas. A semi-definite goal offers all sides a chance to identify the federal model, but creates, at the same time, a corridor of commitment. This creates an understanding of where in the federal constitution the limits of autonomy lie, on the one hand, and on equalization, on the other.</p>
<p><b>Integrated legislation for federal finances...</b></p>	<p>...ensures that the overall impact of adjustments is always taken into account. Because all central financing issues of fiscal federalism are governed by one law.</p> <p>In ad-hoc negotiation situations, it might sometimes be more convenient to regulate current agreements separately from the system of fiscal equalization. Yet, such solitary commitments would gradually result in parallel and uncoordinated fiscal equalization structures. Thus, in the medium and long term, integrated legislation prevents potential obstacles to negotiations. If ad-hoc decisions cannot be settled directly in financial equalization, they should be included in the next revision.</p>
<p><b>Common data and accounting standards...</b></p>	<p>...significantly reduce the number of potentially contentious issues in negotiations. Because you do not have to question facts, you can trust in them.</p> <p>Accepted data is created via accepted institutions. This creates trust and also provides a reliable basis for legal disputes. The political independence of statisticians, accountants and auditors is crucial. If in doubt, this will be facilitated by international standards and peer review.</p> <p>As long as acceptance among the political actors is guaranteed, common data do not have to follow the highest standards down to the last detail; most important are reliable and fully accepted basic data.</p>
<p><b>Some equalization through the central level...</b></p>	<p>...creates the political conditions for a fair and accepted balance between financially strong and financially weak partners, when starting conditions are difficult.</p> <p>The equalization of regional disparities should not conflict with the perceived independence of the financially strong and weak states. In the case of large initial differences, it may happen that the objective equalization requirements (and also objective capacity to compensate) are greater than the subjective, politically accepted limits of mutual help. In such constellations, the partial shift of the redistribution between the strong and the weaker to the central level offers a way to avoid mutual blockade in negotiations.</p>

German success factor...	...in international perspective
<p><b>Homogeneous taxes of the states ...</b></p>	<p>...make it much easier to measure the financial strength, which is decisive for fiscal equalization. Everyone automatically knows the revenue of each other in amount and composition.</p> <p>With extensive tax autonomy, benchmarks of revenue performance that are accepted from all sides are not totally unachievable; but they take up a lot of space in reform compromises. They also need very good comparative data.</p> <p>Also, with homogeneous taxes tax competition cannot be a source of political controversy over the 'right' tax rates.</p>
<p><b>E.g. the Stability Council: Common commission as soft law instruments...</b></p>	<p>...ensure the permanent dialogue of finance and departmental politicians in the federation by organizing a monitoring of basic governmental decisions.</p> <p>Federal constellations are characterized by their political dynamics through acting persons. Hard sanctions seem broad and unspecific, they ignore the inner structures of governments. Soft-law can bring together the right people with individual political responsibility more precisely and less invasively and united them through team spirit and peer pressure. In a small circle and behind closed doors, decisions are made that would rarely be reached in open political discussions.</p> <p>The use of hard sanctions to secure the conditions of common assistance is thus less often necessary, which in turn strengthens the federal team spirit. Soft law committees are also useful for integrating the local level in political processes of their respective regional state.</p>
<p><b>'After the reform is before the reform'...</b></p>	<p>...helps as a guiding principle to arrive at joint compromises among many reform actors. From the outset, it is clear to all involved that even major reform projects can only answer a limited number of questions when many actors have to be involved. This constellation is typical in the federal context.</p> <p>'After the reform is before the reform' means that questions which were tackled by a reform, should be 'checked off' for a longer period. In return, however, the reform issues that have not yet been dealt with are not finished; they can and should be brought back on the agenda as soon as possible.</p>

With the last factor on the nature of finding federal compromises, we already anticipate the following agenda section IV. Representative of the open questions and challenges addressed there, the factor points out that the

naming of success factors of federal progress cannot aim at reaching a desired status or equilibrium. Success factors can help formulate and achieve realistic milestones. After each small step comes the next, probably also small step.



## IV. AFTER THE REFORM IS BEFORE THE REFORM – A FEDERAL AGENDA

### A. The nature of federal compromises

The decisions on the federal fiscal relations of summer 2017 are meant to apply for the period from 2020 to 2030. According to current understanding, they are designed in such a way that they can actually last that long. Today, nobody can say whether that will be the case at the end. This depends on the development of numerous political and economic factors in Germany and globally, which cannot be foreseen.

But already today it is obvious that some aspects of federal finances will be back on the agenda before 2030. The assessment that this new fiscal equalization can be used up to 2030 does not preclude its being supplemented with elements that address budding problems.

Some questions for the near future are already evident. This is due not least to the established procedure of recent and previous reforms of competences, debt rules and fiscal equalization. The federalism in practice of a country such as Germany requires a continuous balancing of competencies, responsibilities and funding. Many financial demands are made on this general system and often reform wishes are formulated. The system is analyzed and evaluated by science with numerous criteria. From this background grows a steady stream of suggestions and burgeoning expectations.<sup>19</sup>

The federal and *Länder* governments deal with the large number of these recommendations. Of course, they do not follow all the suggestions. The scientific discourse, by its very nature, formulates recommendations that are oriented towards optimality and which go far and wide beyond what a compromise-driven political process can at best do. Without doubt, as a benchmark as well as a pool of knowledge and ideas, the scientific discourse makes an important contribution to the reform processes in federalism and in federal and *Länder* finances.

This remains true, even if every reform process can always only work off a part of the issues originally put on the agenda by politics and science. That also applies to the 2017 reform we are studying here. Federal compromises in Germany have to be found between many players with sometimes very different intentions – sixteen self-confident *Länder* and a federal government with an own agenda. This multiplicity of actors almost automatically lead to limit the number of issues that can be considered in a compromise: A multitude of actors and a multitude of issues would render it extremely difficult to come to substantive compromises.

However, the reform adopted in 2017 on federal and *Länder* finances is anything but one-dimensional. It covers all topics that were a priority for the political leaders in the *Länder*. In addition, some elements have been added that have had a high – sometimes symbolic – value for some actors. Without success in these symbolically charged dimensions these actors would not have been able to sign the deal. Then there are decisions that represent the offset-deals in favor of the federal government that have become necessary. After all, there are a few small aspects that are neither particularly important nor harmful to the big picture, but were helpful in completing the compromise and making it mutually acceptable. So, in the end, a multi-layered reform compromise came about.

<sup>19</sup> Also, one of the authors of this paper participated in this process, formulated criteria and recommendations from the point of view of public economics. See for example: M. Thöne and C. Fuest (2012), Reform des Finanzföderalismus in Deutschland, in: Handbuch Föderalismus, ed. by I. Härtel, Bd. II, Springer, Berlin, S. 265-321. M. Thöne (2014), Vertikaler, Transparenter, Aufgabengerechter: Agenda für einen Bund-Länder-Finanzausgleich für das 21. Jahrhundert, in: ifo Schnelldienst 01/2014, S. 26-31. De la Fuente, A., C. Kastrop, M. Thöne (2016), Regional Financing in Germany and Spain: Comparative Reform Perspectives, BBVA Working Paper N° 16/04, Madrid.

## B. Elements of a federal agenda

*After the reform is before the reform.* The new federal fiscal equalization will come into force in 2020 and should be used until at least 2030. This reform is accomplished. Yet, a number of other federal issues, as mentioned above, are already lurking today and will enter the agenda in the coming years. In the final section, we discuss some of the most significant additional questions.

Some of the coming reforms will need to improve the distribution of tasks among the levels, and in part will affect fiscal issues. It's not about the *Länderfinanzausgleich* itself, but it's about questions with so much financial weight that they cannot be answered without reference to federal and *Länder* finances. From today's perspective, the following topics will have to play important roles in the future development of federalism in Germany:

### 1. Social benefits and the principle of connectivity.

Even in the developed welfare state, more and better high-quality social benefits and social equality do not play a decreasing political role. At present, their importance is persistently increasing in Germany. This concerns, in addition to the major tasks of central government social security with regard to age, illness, unemployment and care, more and more social services and in-kind transfers of municipalities and *Länder*.

Parallel to the discussions about federal and *Länder* finances described here, in recent years a discussion has arisen in Germany about the lack of financial relations between the federal government and the municipalities. It builds on numerous social benefits that the federal legislature regulates in the Social Security Code (especially SGB books II, VIII and XII), but which are implemented and financed at the local level by the municipalities and partly by the *Länder*. In terms of matter, this is primarily about the so-called basic provision for jobseekers, child and youth welfare, social assistance and integration assistance for disabled people. With the large influx of refugees in 2015 and 2016, another transfer law suddenly became very relevant for *Länder* and municipal budgets. For the moment, the federal government is providing the *Länder* with financial means for many of the affected social services, which in turn are passed on to the local authorities via different mechanisms. This follows the demand for more connectivity, i.e. the principle 'who orders, pays'.

In practice, however, it is becoming increasingly clear that lump-sum money to the *Länder* and the subsequent transfer of funds to the municipalities bring no solution to the governance problems of this intertwined arrangement. At the same time, as the expenses involved are rising rapidly, more and more demands

will be made to involve the federal government in the organization and institutions 'its own' social benefits so that responsibilities for provision and financing better aligned. More 'verticalization' of this kind does not necessarily have to result in centralization. For any conceivable more vertical solution, however, the federal, *Länder* and local governments must definitely come together.

### 2. Demographic change and domestic migration:

Germany is a country undergoing demographic change. Indeed, refugee-related immigration peaks have temporarily masked the underlying trends in the years since 2015. Nevertheless, Germany is aging more than many of its neighboring countries. In addition to the improvement in average life expectancy, birth rates have been far below levels for decades that could guarantee an age balance. Recently, German birth have rising gradually for several years; but far from the level necessary to curtail structural aging in the foreseeable future.

The non-city states – initially in eastern Germany, and increasingly in West German regions – are affected to an above-average extent by demographic change. In addition to the low fertility rates and the aging population, in many regions the exodus of young people is exacerbating the shrinkage trends. With the population decline economic power and thus tax revenues also are lost. On the other hand, the fiscal equalization implies, through its extensive population orientation, that the supply of public services of the *Länder* and their municipalities can be reduced proportionally and just as quickly as inhabitants are lost. Empirically, this is often impossible, we encounter 'cost stickiness' – the costs are falling more slowly than the population – and also economies of scale become relevant: The fixed costs of government services per capita increase with declining population.

These two 'demographic deltas' between rapidly declining revenues and slower spending are just one dimension in which federal finances will be affected by regionally disparate demographic change. The principle of equivalence of living conditions will fuel the discussions here as well. Again, no solution can be foreseen without joint actions on the federal and *Länder* level.

### 3. Investive Modernisation.

For decades, Germany has neglected the preservation and renewal of public infrastructures. For a modern industrialized country in increasing competition with dynamic emerging economies, this finding is alarming.

The central reforms in German fiscal federalism, the creation of the debt brake plus the Stability Council

and the 2017 reform of federal finances had little bearing on the issue of public investment. In the political process, this dimension was treated largely separately. The background to this is the negative net investment in public infrastructure, which has been identified since 2003 for the country as a whole, and for the municipalities in particular. By comparison, the federal and the state governments are neither very good nor very bad; their net investment has not deteriorated over the last 25 years. But even at these stable, but low levels, infrastructures were primarily maintained and managed. With regard to the responsibility of the *Länder* vis-à-vis their municipalities and the continuing large backlog of investments at the local level, special efforts are required at the federal, state and local level, since the infrastructures must not only be preserved but also substantially modernized in the course of digitization.

Currently, the federal government is already providing assistance in the form of individual grants within the Municipal Investment Promotion Act. However, if public investment is to be strengthened on a sustained basis, even if the general conditions are less favorable for the economy and if the debt brake is universally adhered to, then a structural solution initiated by the federal government and the *Länder* will be needed, leaving behind short-lived, 'quick-fix' funding programs. It remains to be seen what approaches will be brought to life of the coalition agreement of the current federal government.

- 4. Debt management for bad times.** The repercussions of the economic and debt crisis of the years after 2008 brought an unusual combination of extremely favorable macroeconomic conditions: an (from a German perspective) undervalued common currency and historically unprecedented low interest rates fuel a sustained growth in the economy. The concomitants of public finances are also very favorable; low interest rates and fiscal boom produce full coffers and enable the budget balance and debt reduction. But this untypical economic environment will not last forever.

The road to implementing the debt brake at the federal level from 2016 and from 2020 onwards at the *Länder* level has been taken. The federal fiscal equalization system, which will apply from 2020, will enable all *Länder* to comply with the debt brake. This starting point is essential for the sustainable success of this rule in all *Länder*. It will be equally important to prepare the debt management of the *Länder* – and also of the municipalities – for bad times. Sooner or later, interest rates in Germany and Europe will rise again. The economy will not remain on an upswing forever. In order to also adhere to the debt brake under unfavorable conditions, precaution must be

taken by preparing the debt management and the rules on economically acceptable deficits for coming 'rainy days'. Provision must also be made through more financial reserves. Some *Länder* need to start with it, others should step up their efforts. The precautionary measures should include the municipal level; especially in the case of the particularly sensitive local trade tax, a large revenue boom often leads to a sharp drop in revenue.

- 5. Pension and pension costs.** The long-term sustainability of public finances in a demographic aging country like Germany is also significantly influenced by the age profiles of public servants and the financing of their pensions and healthcare.

In Germany, civil servants of the federal government, the federal states and municipalities and judges are traditionally do not participate in social security; they stay in their government jobs for a lifetime. After retirement, wages will continue to be paid at a reduced level; sickness costs are also covered lifelong to 70 percent at the quality level of privileged privately insured patients. This also applies to the widows and widowers of civil servants and judges. This very attractive system of high pensions and top-quality health-care is an important factor in recruitment for the public sector. Traditionally, the system has always been funded from current budgets. In the civil service, pension funds or a separate social insurance were and are not provided for.

The budgetary financing of pensions and health care for the 1.7 million German officials and judges and for the current 1.6 million pensioners will pose major financial challenges for the *Länder* in particular. The *Länder* employ more than 75 percent of German public servants. They are responsible for the particularly personnel-intensive public services like schools, colleges and universities, the police and the judiciary, as well as the tax authorities. In the coming dynamic and in view of the current rise in public service recruitment, it is above all the *Länder* – not the federal government, and less the municipalities – that are confronted with increasing pension burdens; here especially the West German *Länder*.

In recent decades, most *Länder* have begun to accumulate reserves for newly hired public servants. But that is far from enough to refinance the wave of retirement that is currently beginning in West Germany. The officials hired there in the course of the great educational expansion in the 1970s and 1980s are currently retiring. In combination with demographic growth in life expectancy, pension spending in many Land budgets is already rising by five percent or more from year to year.

For this large and further increasing financing task, there is no sufficient refinancing foreseeable in the affected *Länder* budgets. As a counterpart to the predominantly East German tax weakness arises a predominantly West German financial problem concerning above all the *Länder* of the 'old' Federal Republic. At the same time, there is currently no politically achievable way to cut or even circumvent these pension commitments. Thus, even though it is actually not a federal financial problem, there is no serious chance for a comprehensive solution without a joint effort of the federal government and the federal states.

To sum up, two elements must play a more important role in the further development of fiscal federalism in Germany: the principle of long-term sustainability must permeate more and more sectors of public finances in this changing and demographically aging country. And quantitative improvements need more qualitative innovation. Modern governance of public finance does not 'just care about the money', it also incorporates the performance side into consideration and strives for accountability structures that are compatible with the financial flows. There is still a lot to be done in the implementation of results-oriented governance in Germany. Both principles are also laid out in the coalition agreement of the new federal government – and urge further development and dissemination throughout German politics, at all levels.

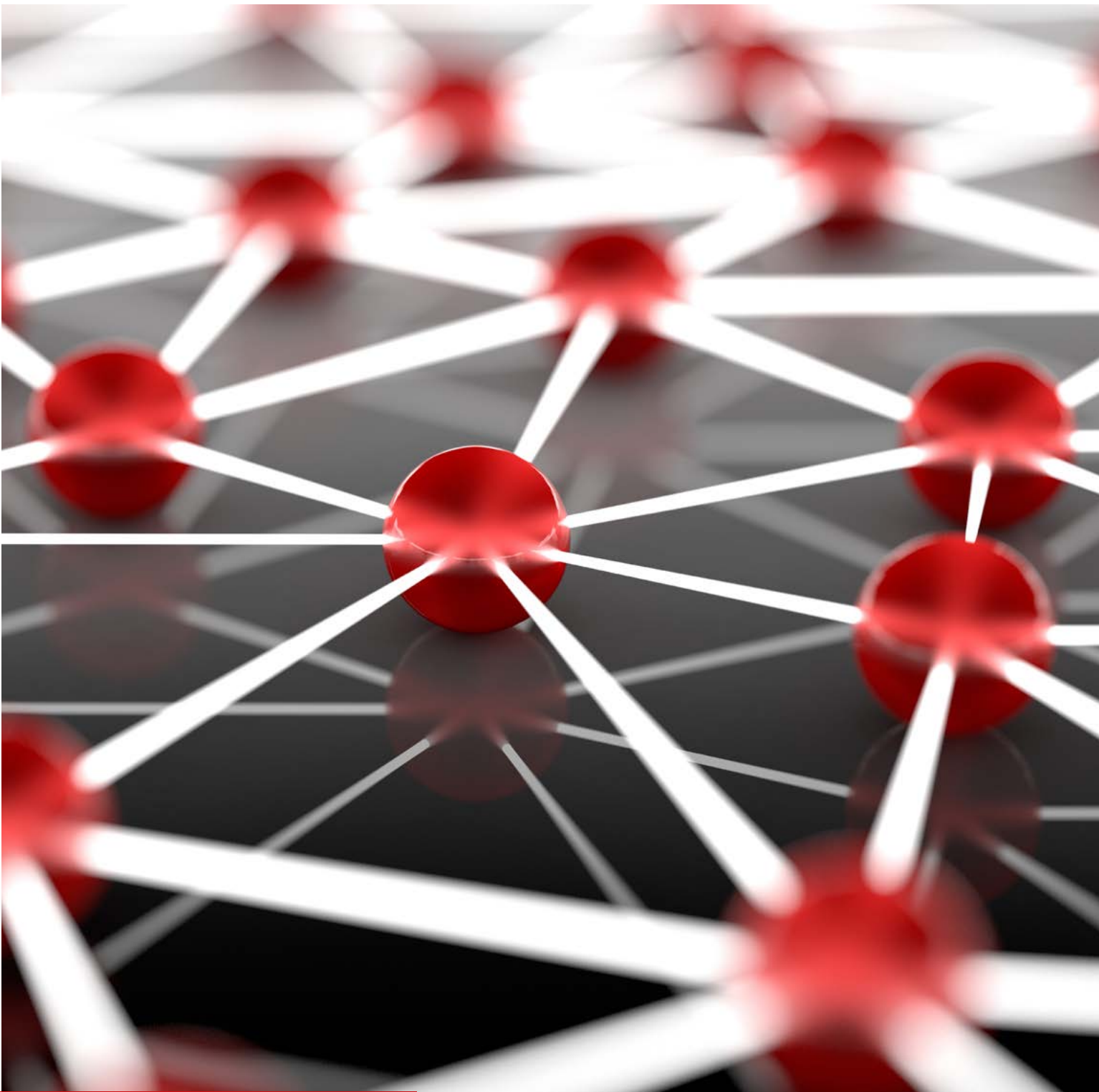
The federal process in Germany is not moving towards a specific stable state or even equilibrium, as is likely in most states around the world. The constant effort to adapt the distribution of tasks in the federation to changing demands and, at the same time, to balance public finances accordingly results in a kind of long amplitude. The 2017 reforms of the federal finances were regarded by many observers as a strengthening of the central government. Many of the above five agenda objectives for the further development of German federalism also require greater involvement of the federation.

But what may appear to some as increasing centralization may only be the return to a balance: the central level, which currently can bear loads easier, will be left with some additional burdens. *Länder* and municipalities are financially strengthened and structurally relieved. This enables them to move upwards on the 'federal amplitude'. The supposed centralization can thus become a harbinger of a strengthening of the *Länder*. Once social in-kind and cash transfers are financed and co-organized by the federal level (where they belong), the *Länder* may once again make greater use of their core competences in education over the next few years. For example, it could become possible to unburden the municipalities and the federal government from their partial responsibility for early childhood care and replaced that by a clear 'pre-school' competency for the *Länder*. It would also be conceivable that structurally disburdened *Länder* become well-funded enough that they can engage in more elements of fiscal autonomy. This can be accomplished undertaken, when even the financially weaker *Länder* can be sure that they do not have to increase their own taxes as a substitute for shrinking solidarity. Instead, they should become acquainted with tax autonomy as an element of flexible responsibility, in which even financially weaker *Länder* can benefit from tax cuts if their own citizens demand them in the democratic process and in return also want to forego certain public benefits.

These are just two examples of how *Länder* might act on the 'federal amplitude'. They might also be strengthened in other ways, according to the emerging needs of the population and also according to the self-image of the political actors in the multi-level state.

Whatever happens, no matter what the challenges facing people and their elected representatives, the very fact that several levels can take care of it and that these may even compete politically to offer solutions is real democratic value added. In this sense, federalism always makes sense, always is valuable – no matter where the federal amplitude stands.





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