



# MUNICIPAL FINANCES AND MUNICIPAL FINANCIAL EQUALISATION IN GERMANY

Benefits for development cooperation

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## Benefits for development cooperation

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## OVERVIEW OF THE REPORT

The German municipal finances and the municipal fiscal equalisations form the outermost branches of a financing system which, in federal Germany, links and binds together the three state levels of federal government, Länder and municipalities. The levels are linked via many mechanisms in the fulfilment of state tasks and their financing, not least via a joint tax system in which all three participate. Nevertheless, in this dense network, which characterizes the cooperative federalism of the German type, two regulatory circuits can be clearly distinguished.

The regulatory circuit at the upper level is constituted by the Federal-Länder fiscal equalisation system, which links the central state with the 16 Länder – three city states and 13 territorial states. This system and its changes were examined by the authors of the present study in 2018 in a first GIZ study with regard to its suitability for providing impetus and instruments for the work of the development cooperation partners.<sup>1</sup>

With the same focus on impulses for development cooperation, the present study examines the second regulatory circuit of the federal and decentralised financing system in Germany, the financing of the 11,000 independent municipalities and community associations in and through the 13 territorial states.

In principle, German mechanisms and instruments of public finance are not directly presented as functional and worthy of imitation in this report either. The German municipal financing system has been shaped by developments and political needs over the past 150 years. Many instruments are, first and foremost, answers to concrete questions that have been raised in individual German Länder or throughout Germany. Hardly any of these questions can be answered in the same way in a partner country of development cooperation today. Accordingly, we do not present the components of municipal finances as “solutions”, but as the results of political processes in which, at best, the efficient decentralised fulfilment of public tasks and their financing are sought. This process approach provides a number of starting points for international cooperation and for the adaptation of solutions.

The study talks about the public finances of municipalities but does not start with money. Revenues serve tasks. Whoever talks about municipal finances has to start with the distribution of tasks and their financing. Important principles of the municipal system must already be implemented when public tasks are being carried out: Subsidiarity, connexity, equivalence, solidarity, equivalence of living

conditions and loyalty to the alliance. These principles resonate in municipal finances.

The first pillar of the municipal finances are their own tax revenues, such as property and trade tax, rates and contributions. We discuss their origin, development and future in detail. The main focus is placed on the interplay between municipal autonomy and integration, which is expressed in the fact that each municipality determines the tax rates of its own property and trade tax itself, while the federal government and the Länder decide on these in their legislation.

At the same time, it has long been clear that the traditional municipal taxes are not sufficient to ensure adequate funding everywhere. This is why municipalities have long been involved in the important joint taxes, income tax and VAT. For many municipalities, this second pillar, their participation in the German tax association, has now become their true basic funding.

Finally, the third pillar of municipal financing in Germany is the municipal financial equalisation scheme in the 13 territorial states. Even the differentiated and adaptable municipal tax system offers only few municipalities funding that allows them to fulfil their legal obligations and fulfil their democratic self-government. For this purpose, municipal financial equalisation is needed. It is these financial and equalisation instruments with which the intention to think municipal services from the perspective of the task and not from the perspective of money can be redeemed.

In the beginning, there is always the “vertical financial equalization” between the state and the entirety of its municipalities. Here, the financial portion is taken from the tax revenues of a Land state, and used later for distribution to the individual municipalities. This distribution of funds determines the political scope of both levels: The gains of one level are the losses of the other. Because of that, vertical financial equalisation is often very controversial. Since the Federal states act as legislators, the legal protection of the local level by the constitutional courts is of particular importance.

The pinnacle and conclusion of municipal financing in Germany is the horizontal municipal financial equalisation in each territorial state. In some countries, so-called “abundance allocations” are actually used to redistribute funds from rich to poor. In all countries, however, the transfer system is primarily designed as a vertical compensation with a horizontal effect: From the very start, allocations are

1 J. Bullerjahn and M. Thöne, Reform and Future of Federal Fiscal Relations in Germany. Benefits for Development Cooperation. Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ), Bonn/Eschborn 2018.

made on the basis of municipal revenue power. The relatively poor municipalities receive a lot, the relatively rich receive little or no allocations at all. This means that the final horizontal financial equalisation is the final decisive phase in German municipal financing. At this point it is decided whether the municipalities have sufficient funds to fulfil their tasks adequately and evenly.

If these mechanisms and the underlying principles of German local politics and local financing can be used as suggestions or examples in development policy - in whatever intention and complexity - this short study will serve its purpose. In our view, the issues of decentralisation of political and administrative structures, the establishment and expansion of infrastructure, the economy, education, the welfare state and the rule of law on the basis of growing, stable public revenues are more acute than ever in developing countries.

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## I. INTRODUCTION: GERMAN MUNICIPAL FINANCES IN THE CONTEXT OF DEVELOPMENT COOPERATION

Germany's experience with municipal finances and its municipal financial equalisation system may be of great benefit for development cooperation, though this theory is far from obvious given the complexity of some parts of the German municipal financing system. In this study we intend to show that this complexity is mainly down to the large number of institutions and processes involved. The multiple forms of municipal financing in Germany's federalist system offer a wealth of ideas on how different policy solutions have arisen, often under highly divergent conditions. We present German municipal finances as a process of ongoing dynamic interaction between established principles and current political solutions to new challenges. The benefits of the German municipal financing system for development cooperation lie in the fact that the system can also be understood as a policy approach in conjunction with a practical toolbox.

In Germany, many aspects of municipal tasks and finances are currently high on the political agenda of the country as a whole. The high level of attention that the German federal government, i.e. the central-state or national level of the Federal Republic of Germany, devotes to municipal issues is particularly noteworthy and by no means a matter of course. A major committee installed at national level to examine 'equal living conditions', part of a plan to combat regional inequality, completed its work in 2019. It focused on the disparity between municipal living environments and the various problems confronted in carrying out municipal tasks.

Over and beyond this specific topical issue, the question of where key state tasks should be located within the federal system always first involves deciding, from a political and social perspective, which level – national or sub-national – should carry out which tasks? How, and to what quality standard, should sub-national entities be provided with funding for that purpose? Germany views this question from the perspective of a traditionally decentralised state. At international level, many countries are aiming for greater decentralisation. In these, wider and deeper decentralisation is a key element of modernisation and democratisation strategies. In this context, it should be pointed out that greater decentralisation must always be intended and driven at the central level too. In the best-case scenario, voters will share the wish for decentralisation with the politicians who represent them. Without such a shared and central will,

measures to achieve decentralisation always risk remaining nothing more than well-meaning administrative exercises.

Although this study of German municipal policy and municipal finances outlines the status quo of decentralisation rather than the decentralisation process itself, in Germany too, the performance of state tasks at local level and their financing, i.e. the degree of decentralisation, is far from static. Our study will make clear that constant pressure is brought to bear to adjust the local performance of tasks, whether due to the changing needs of people and companies or to political competition. In consequence, there is substantial, and very healthy, pressure to justify the high degree to which tasks are performed locally and to ascertain whether this degree of local performance continues to meet the goals of efficient decentralisation. It goes without saying that German policy with regard to municipalities is not always that systematic. Here too, there is often no master plan, and developments follow the political needs of the day.

Nor need there always be a master plan. At international level, it is, however, important to remember that German experience, whether good or bad, and elements of German municipal financing, may offer useful guidance provided it is generally clear how decentralisation in a given country should develop the national system. This paper will show that the experience, instruments and approaches of German municipal financing are not in themselves either valid or invalid. Municipal taxes, financial equalisation and the other components of municipal financing are always a means to an end, in Germany as elsewhere. Different municipal financing models are suitable for achieving different decentralisation objectives. Depending on the particular decentralisation agenda, different ideas taken from the German context concerning the broad range of municipal tasks to be performed, municipal taxes and municipal financial equalisation may offer helpful guidance.

Looking at Germany from the outside, we see a country that not only has a federal structure consisting of 16 federal states – 13 non-city state and three city states – but is very highly decentralised with 11,000 cities and large towns, independent municipalities and rural districts plus other local authority associations. From outside, we see a country with traditionally strong and efficient local policy-making and administrative structures that are able to offer citizens and



the local business community a broad range of high-quality public services.

The fiscal backbone for the municipal autonomy guaranteed in the German constitution is a municipal financing system that provided municipalities in the 13 non-city states with a positive financing balance of roughly EUR 14 billion in 2018, against overall expenditure of EUR 272 billion. This is a new record following three years with an equally positive balance.<sup>2</sup> Seen from outside, therefore, Germany's municipal financing system appears very successful and indeed exemplary.

This impression can also be confirmed from an internal perspective for many elements of municipal financing in Germany. Nevertheless, the point here is not to assert that benefits exist for development cooperation merely by stating that Germany is a model. German municipal financing cannot be presented as an export model if only for the simple reason that there is not just one model, but 13 different models in the 13 non-city states. Although they share some characteristics, they also leave scope for many individual solutions. And they also leave scope for very different results: the good results on average conceal major disparities between very rich cities and large towns, and those that are close to bankruptcy, between heavily indebted municipalities and those with enormous assets, as well as between municipalities with excellent infrastructure and those whose infrastructure is in great need of renovation. Some of these disparities have even increased in recent years. The view from inside thus reveals aspects of German municipal financing that do not necessarily invite emulation. These financial disparities are only one dimension of municipal variance. There are major geographical, economic, social, demographic, environmental and cultural differences in the local governance of the 13 non-city states and of the three city states.

Handling this diversity makes municipal politics, federal state politics and the politics of the German federal government vis-à-vis the municipalities a highly dynamic task. The same is true of municipal financing. In a constantly changing social and economic environment, the aim is to preserve and appreciate the advantages of diversity in the regions and localities while simultaneously curbing or neutralising the negative aspects.

At first glance this statement might seem paradoxical. To protect municipal autonomy in diversity, in Germany we

speak primarily of equal living conditions, financial redistribution and financial equalisations, as well as key national legal frameworks that are intended to apply equally and to everyone. What it really comes down to, though, is the simple experience that municipal diversity cannot be an end in itself. Nor is it accepted in Germany as an excuse for substantial differences in municipal services. All citizens in Germany want to receive high-quality services. Whether in villages or cities, on the coast or in the mountains, the social consensus that has emerged over many decades is that streets should be safe and well lit, schools and hospitals should be nearby, the sewage system should be reliable and building authorities should make their decisions rapidly and incorruptibly. Given Germany's size and diversity, people's living conditions cannot be uniform. Policy-makers do, however, have the constitutional mandate formulated in Article 72 of the Basic Law of the Federal Republic of Germany to ensure equivalent living conditions for all of the country's citizens. Equality amid diversity – this difficult mandate that frequently involves contradictory action in practice is a characteristic feature of German municipal policy and of German policy vis-à-vis its municipalities. It shapes the shifting and sometimes even fluctuating relationship between centralisation and decentralisation in Germany.

These processes of adjustment and constant renegotiation are what characterise Germany as a federal and decentralised country. Municipal finances and the municipal financial equalisation systems that are used to manage disparities play a key role in this context. A funding level that is adequate for fulfilling the given tasks and providing the requisite services is more than half the battle when it comes to ensuring municipal autonomy in line with the tenet of equality amid diversity. The authors of this study firmly believe that this is where key benefits for development cooperation lie. Parts of the German municipal finance system may appear worthy of emulation. We shall go on to present such 'exemplary' modules.<sup>3</sup> However, the political, administrative and often also judicial and scientific processes that lead to the system are just as important as its structural elements.

We do not understand the German system of municipal financing primarily as the complex construct it appears to be at first sight. Municipal financing in all its elements and ramifications can better be understood as the result of historical processes that called for constant reaction to new requirements, or in which newly emerging possibil-

2 Data taken from the national accounts of the German Federal Statistical Office. The city states of Berlin and Hamburg are not normally included in such comparisons because they integrate the municipal level with the federal state level, i.e. they are both at the same time municipalities and federal states. The third city state, the comparatively small Bremen, is not included in such comparisons either, although it would in principle be possible to distinguish between the federal state level and the municipal level because the federal state of Bremen consists of two municipalities, the city of Bremen and the city of Bremerhaven.

3 Naturally, the authors cannot predict which element might be worthy of emulation from which perspective.

ities were grasped. We will therefore endeavour to present municipal financing and municipal financial equalisation as a toolkit that contains modular financing solutions. These can be used to fashion individual solutions in a wide range of different local contexts.

As with every good toolkit, our presentation will make clear that not every piece will fit together with another in all situations. Apart from the interactions between individual components that must be borne in mind, we will also outline elementary prerequisites. In doing so, we will draw not only on one German model, but on the 13 different municipal financing equalisation systems in the German non-city states, without making any claim to be exhaustive.

## II. FINANCING OF THE MUNICIPAL LEVEL IN THE GERMAN FINANCIAL SYSTEM

### A. Income for the tasks to be performed: finances in the federal four-level model

This brief study focuses on municipal finances. Particularly in view of the relationship between the national and sub-national levels, the financial aspect is very important also in Germany and is never easy to regulate. Money is not our starting point, however. To talk about municipal finances in Germany, one must always start by looking at the structures and how tasks are distributed in the country as a whole.

Figure 1 offers an initial simplified overview of the complex distribution of tasks and funding in the four-level federalist system. Germany is a federal republic that consists of 16 federal states, three of them city states and 13 non-city states.

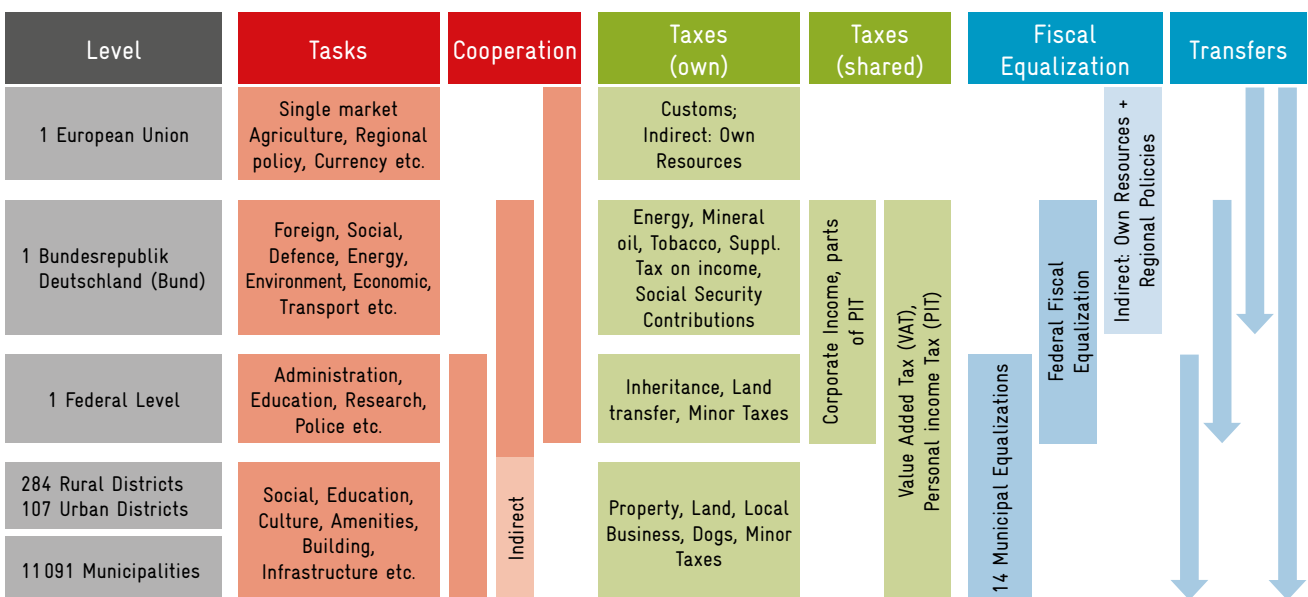
Beyond this, as a member state of the European Union, Germany is part of another community that cannot be considered a federal state but is far more than just a confederation of states. From a German perspective the EU – a federal structure sui generis, consisting of 27 member states after ‘Brexit’ – is located vertically above the federal government. The European Union already plays a key role in terms of providing state services, and this role may in-

crease in future. Reform debates on further development of the EU regularly address the question of which of the tasks that are currently mainly borne by the nation states can be jointly provided at an integrated European level in future. Such discussions of ‘European public goods’ and ‘European value added’ centre on tasks such as defence, internal security, migration and asylum, and climate protection. Developments like these also have repercussions on the other levels. In Germany, this would primarily affect the federal government, and indirectly also the federal states.

The local level at the other end of the federal spectrum would be least affected by such changes. Nevertheless, a gradual change in the federal distribution of tasks and finances that might become significant over the course of time would of course end up affecting the German municipalities too.

In terms of the main structures that are in place, the municipal tasks and their financing in Germany and its federal states will nonetheless remain very stable for a long period of time. The further development of municipal finances is frequently a response to changes in the nature of the tasks to be performed by the municipalities, whether these are triggered from the ‘top down’ by legislation, or are due to changes in the demand for municipal services on the part

FIGURE 1: OVERVIEW OF THE GERMAN MULTI-LEVEL STATE



Authors' own presentation. © Michael Thöne (2018).

of citizens, i.e. are driven from the 'bottom up'. Political adjustments in the relationship between the federal government and the federal states may also have repercussions on municipal finances. The efficiency of a municipal financing system depends not least on how well and how quickly it can adjust to such changes.

The municipalities presented at the first and lowest level in Figure 1 form the foundation of public administration. The federal states and the federal government stand above these. Nevertheless, in Germany strictly speaking there are only two state levels: from a constitutional standpoint, the municipalities are parts of the federal states. In many respects, the federal states are the crucial political and financial 'central level' for the municipalities, as this study will show. The local level consists of some 11,000 municipalities of various kinds (cities and large towns, independent municipalities and rural districts). There are enormous differences between these. Germany's largest municipality is Berlin, a city state that is also a federal state and has 3.5 million inhabitants. Germany's smallest independent local authority, the small island (Hallig) of Gröde, has only seven inhabitants at present.

Between these two extremes there is a broad range of very small to very large local entities. Many different organisational forms are used to take account of the different sizes and situations. Most of the small villages and hamlets in Germany are no longer independent municipalities but are part of larger ones. In most of the federal states, small villages and towns were formerly grouped together to form larger, more functional units in the course of local government reforms. North Rhine-Westphalia, for instance, Germany's largest federal state with a population of 17.9 million, now consists of 396 independent cities/large towns and municipalities following two local government reforms in the 1960s and 1970s. Its neighbouring federal state to the south, Rhineland-Palatinate, has some 2,300 cities/large towns and municipalities with a population of only four million. Instead of local government reforms, here so-called combined municipalities have been formed there that perform higher-level tasks together on behalf of their members. Cooperative solutions of this type also exist in some other federal states.

All of the non-city states (the city states of Bremen, Hamburg and Berlin always play a special role) use rural districts as their own municipal level, which are placed above the respective small municipalities that belong to a rural district. These assume more regional tasks and also have their own democratic organs in the form of the rural district councils. A large part of Germany's territory is spread across 284 rural districts. In addition to these there are 107 'independent' cities and small towns with district status. In this case, the city or town performs both municipal and district tasks.<sup>4</sup>

The next-highest administrative level above the rural districts and the 'independent' towns or cities with district status is frequently that of the federal states. In many of the federal states, though, there are other administrative units in between. Some federal states combine specific tasks above the rural districts, and the cities or towns with district status, to form so-called 'higher-level associations of municipalities'. These entities carry out special social or cultural tasks on behalf of the municipalities assigned to them. The justification mainly given for such mergers is that higher efficiency is expected due to the benefits of specialisation and economies of scale.<sup>5</sup> In contrast to this 'upscaling' of municipal tasks, some federal state-related tasks are 'downscaled' in eight of the 13 non-city states, i.e. they are transferred to administrative regions (Regierungsbezirke). The purpose of these intermediate authorities is to anchor federal state administration at a more decentralised level.<sup>6</sup> Administrative regions do not generally offer their own public services to citizens and companies. Their key role lies in coordinating and monitoring the municipalities, cities/large towns and rural districts in line with the policy of the respective federal state.

These multi-tiered organisational forms in Germany's municipal administration are not the result of planning, as is immediately obvious. Municipal structures have evolved over time. Even where they have been changed, what usually happened was that additional elements were added to historical structures instead of choosing new solutions that might have been more rational from a planning point of view. The dominance of such an organic development rather than a consciously planned design also becomes clear when we look at the federal distribution of tasks

4 Added to these are four municipalities with a special hybrid status. These are the regions of Hanover, Göttingen, Aachen and the regional association of Saarbrücken.

5 The higher-level associations of local authorities may divide a federal state up into several regions, for example the regions of Bavaria or the regional local authorities in North Rhine-Westphalia. They may also, however, take the form of a single association of municipalities that covers the entire federal state, e.g. the Associations of Municipal Social Welfare Providers in Mecklenburg-West Pomerania and Saxony, the Municipal Association for Youth and Social Affairs in Baden-Württemberg or Hesse's state welfare association.

6 The commingling of the municipal and federal state levels sometimes has the effect that the higher-level associations of municipalities comprise a larger population and cover a larger territory than the decentralised elements of the federal state administrations. This overlap between the two levels culminates in the district commissioner. In most federal states this person is the supreme (elected) municipal officer and is simultaneously the head of the lower state administrative authority, which is an institution at federal state level.

between the (central) federal government, federal states and municipalities (Figure 2).

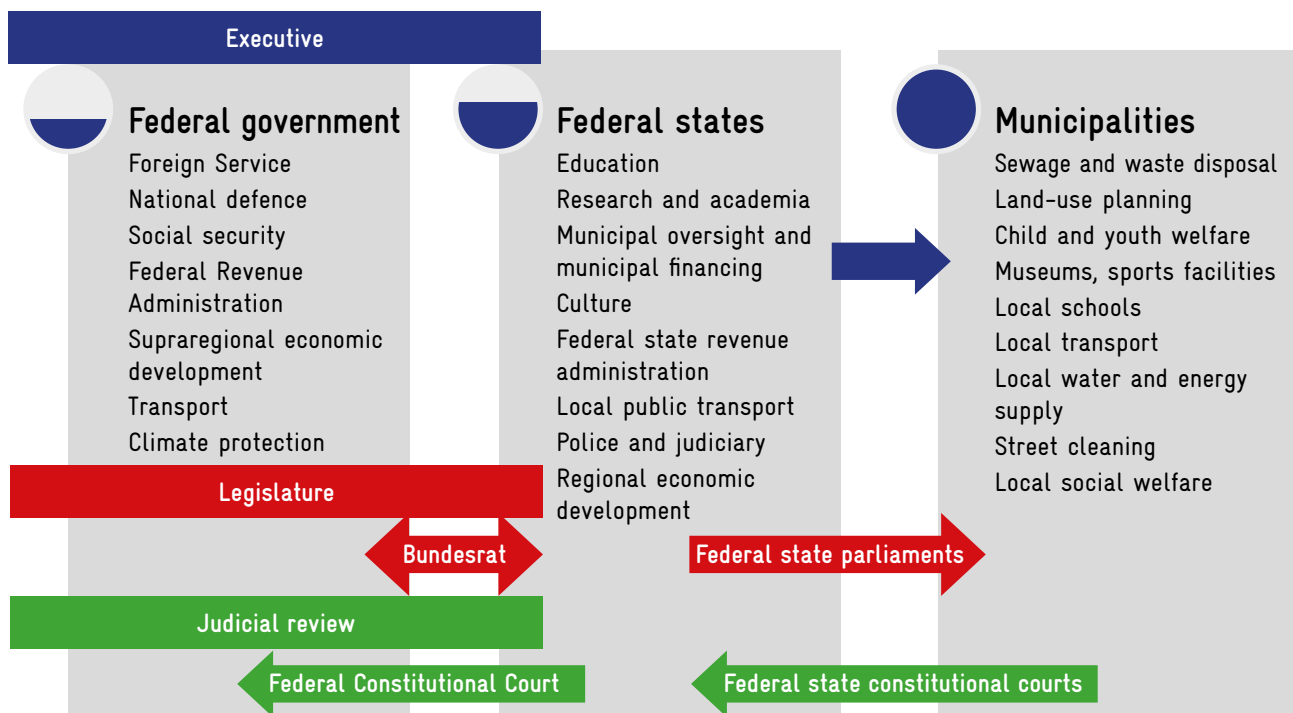
The distribution of tasks between the three levels (here without the EU) shown in Figure 2 is roughly guided by public services that have a local, regional or national/international impact. At the same time, this way of showing tasks broken down by level distorts how public services are actually provided. What is typical of Germany is the close 'vertical' collaboration between the levels that is not made clear in this visualisation. The fields named here in which the federal government, federal states and municipalities have their own executive administration should not be equated with autonomy at the given level for being able to regulate these task areas autonomously and on their own.

As far as regulatory or in the stricter sense legislative competencies are concerned, German federalism is much more densely woven than in other federal countries such as Switzerland or the USA. On the one hand, the German municipalities and also the federal states carry out many tasks under central framework legislation. On the other, the federal government has little administration of its own, which means the federal states and municipalities

regularly carry out its tasks locally together with their own. Germany's special type of federal statehood is thus also termed executive or 'administrative' federalism. The federal government tends to carry most weight when it comes to the distribution of power between the three levels.

The way in which legislation is fleshed out plays a major role as regards the vertical distribution of power between the federal government and the federal states. Regarding the relationship between the central state and the 16 federal states, this task falls to the second chamber of parliament, the Bundesrat. The Bundesrat represents the federal state governments.<sup>7</sup> In all issues that concern the performance of tasks by the federal states or their administrative competence, German federal laws require the explicit approval of the second chamber. This also applies to federal law that has an effect on federal state finances and to changes to the constitution. Such changes in the Basic Law must be adopted with a two-thirds majority in both chambers, the Bundestag and the Bundesrat. The second chamber only has a suspensive veto with regard to all other federal laws. Although the Bundesrat can force the Bundestag to engage in mediation and post-consultations, in the final analysis the first chamber can always override the

FIGURE 2: DIVISION OF TASKS FEDERAL GOVERNMENT – FEDERAL STATES – MUNICIPALITIES



Authors' own graphic.

<sup>7</sup> The German federal state does not, therefore, have a traditional two-chamber system in which both chambers are directly elected by the people. Nor do the 16 German federal states all have the same voting rights in the Bundesrat. While the voting rights in the Bundesrat are staggered slightly according to the number of inhabitants, they are consciously not proportional to population size.

### The partner country perspective: South Africa

In the quasi-federal state of South Africa, fiscal relationships between the three government levels (national, provincial and municipal) were reorganised in 1997. The nine provinces were mandated to perform key tasks especially in the fields of environmental protection, education and health care. The 257 municipalities are entrusted with local tasks such as maintaining local facilities, preventive health care and pre-school education. In order to perform these tasks, the provinces in particular depend to over 90% on transfer payments from the central level. Local governments are provided with approx. 50.2% of South Africa's public funds, of which 70% are again made up of transfer payments from the central level, and are largely used to cover ongoing costs. Local governments, especially the municipalities, generate less than 20% of national income from local taxes, contributions and public levies.

The Equitable Share Grant was set up to ensure the provision of local services. This is a formula-based subsidy that gives consideration to demographic and development-policy factors. Each year, the Budget Council comprising the Minister of Finance and the provincial Members of the Executive Council (MECs) for Finance prepares legislation on local government financing. This draft bill is discussed and revised during a Budget Forum consisting of the Budget Council and representatives of the South African Local Government Association (SALGA). It is finally passed by parliament, thus ensuring that allocations to the municipalities and provinces are binding and have full legitimacy. In addition to the equalisation mechanism, there are conditional subsidies for specific, usually sector-policy development goals. These subsidies support the provinces in building roads and housing, and in tasks related to health and education. However, the cross-departmental Municipal Infrastructure Grant (MIG) has become established as the most important mechanism. It was set up in 2004 to support the municipalities in the maintenance and development of public infrastructure.

South Africa's fiscal system has a functional legal and institutional framework that provides local governments with stable and predictable income for the provision of clearly defined and essential local services and infrastructure.

Since 2014, good local governance has become one of the priorities of the South African Government. The intention is to strengthen implementation of the guiding principles of transparent, accountable, effective and efficient service delivery at local level ('back to basics'). The Good Financial Governance in Africa Programme that GIZ is implementing in South Africa together with its partners supports precisely these guiding principles in a number of ways. In this context, reform of the fiscal architecture continues to enjoy high priority. In June 2019, a delegation trip to Germany took place at the request of the South African Government on the subject of municipal finance. Members of the delegation met representatives of the academic community, the Association of German Cities and the town council of Burg in Saxony-Anhalt to gain insight into how Germany meets the challenges related to the cost-covering financing of municipalities. The independence of municipalities within the German multilevel system met with particular interest.

objections of the second chamber. Given these prospects, the Bundesrat seldom makes use of its suspensive veto.

There is no such participation by the municipal level in the legislation of the federal states. The division of legal and thus also political power between a federal state and its municipalities is deliberately asymmetrical. According to the German Basic Law, municipalities are an independent federal level whose existence and liberty are constitutionally guaranteed, but the municipalities also count as part of the federal states from a constitutional perspective. This means the municipalities are partly independent and partly subordinate to their federal state.

The greater power given to the federal state also entails responsibility, however. Thus, the federal states are obliged among other things to ensure adequate financing of the municipal level in line with the principle of subsidiarity. The role of the federal state in supervising the municipalities also stems from this obligation. Apart from legal oversight, financial oversight is also intended to ensure that municipal budgets have a solid foundation and do not lead to the given municipality putting itself in economic danger. In the event of financial difficulties, for example, municipal budgets democratically adopted by the municipal council must be approved by the federal state oversight body before they can enter into force. Since the federal states are ultimately the ones who have to answer for debt in their municipalities, a federal state can prevent grave financial imbalances in towns, cities and municipalities by placing them under closer municipal oversight. In extreme cases, this may go as far as a federal state withdrawing budget sovereignty from a municipal council until the 'state commissioner'<sup>8</sup> delegated for this purpose has consolidated the municipal finances to a point where autonomy for financial management can be handed back to the municipality.

Because power is distributed very asymmetrically between the federal states and their municipalities in favour of the federal state level, legal protection against the disproportionate use of power plays a major role for the municipalities and rural districts. Control and oversight of municipalities by the federal states inevitably involves a risk of excessive intervention in the formers' guaranteed rights to self-determination.

Legal protection also serves as an additional corrective for the vertical balance of power in the relationship between the federal states and the federal government that is outlined above. Federal states can only influence legisla-

tion through participation via the Bundesrat in matters for which a majority can be organised in the second chamber. But the Bundesrat as a collective organ does not protect the interests of individual federal states or small groups of federal states. If a federal law intervenes in the constitutional rights of a federal state, bringing a lawsuit before the Federal Constitutional Court offers protection against disproportionate pressure or claims by the central level.

At the next level down, in the relationship between the municipalities and their federal state, legal disputes before the constitutional court at federal state level (each federal state has its own) play an even greater role. That does not mean there are regular disputes between the federal state and the municipalities in all non-city states, but the tendency towards legal disputes between the levels, especially in financial questions, is all the greater, the worse the financial situation as a whole is in the given federal state. Although exceptions frequently confirm the proverbial rule, it is often easier to reach a political compromise if the financial position is good, or in federal states with a strong financial status. Financial arrangements can then be made which satisfy all the parties involved so that legal disputes can be avoided. Conversely, the worse the financial situation, the more each individual actor must take care to robustly assert their own interests when it comes to the distribution of funds. The more problematic the financial situation is at the outset, the more important legal control is for the de facto balance of power between the municipal and the federal state level.

These aspects of formal and de facto distribution of power in the vertical state hierarchy are naturally of great importance if, unlike in Germany, decentralisation is effected without the intermediate level of the federal states. Effective legal protection of municipal interests not only shapes the existing distribution of power and funding between the national and sub-national levels. In the decentralisation process, a well-functioning legal control mechanism plays a role that should not be underestimated when it comes to allocating appropriate tasks to the municipalities and ensuring that they have fair and adequate funding for that purpose. In our following presentations of German municipal financing, we do not always explicitly refer to the option of a municipality lodging a constitutional complaint, but awareness of this option has a strong influence on the specific design of financial systems.

<sup>8</sup> A state commissioner is an officer appointed by the federal state who temporarily manages a supervised corporation, in this case a municipality. A state commissioner is usually appointed if the municipality has severely breached its duties or no longer has the capacity to act. The state commissioner is considered the federal state's last resort of municipal oversight over the municipalities and districts. (Outside the field of municipal oversight, the federal states may also appoint state commissioners at universities that are in a similar situation).

Against this backdrop, it is clear that one cannot take money as the starting point for discussing the question of municipal finances in Germany. As already shown in Figure 1 and Figure 2, the first priority must be given to the tasks that are allocated to a state level such as the municipalities. In a system that is divided into national, regional and local activities, the tasks should not be allocated according to where the sources of finance are located. It is not the level that 'has' the money that should perform a specific task, but the level that is best suited based on technical criteria. Even if this principle is not always applied in its pure form in Germany, the financial constitution is clearly based on the expectation that there is a need to first establish who is to fulfil which tasks.

The first obligation of the municipalities is to provide 'local public goods'. The Basic Law (GG) regulates this range of tasks also with a spatial reference as '(...) all local affairs on their own responsibility within the limits prescribed by the laws' (Article 28 GG). In addition, many tasks are transferred to the municipalities which, by their very nature, should not be determined at local policy level, but for which cities, large towns and rural districts are often the most efficient executive body and the one that is closest to citizens. Defining municipal tasks is therefore the first step in the process of allocating funds to the municipalities, as Figure 3 shows in a simple schematic diagram.

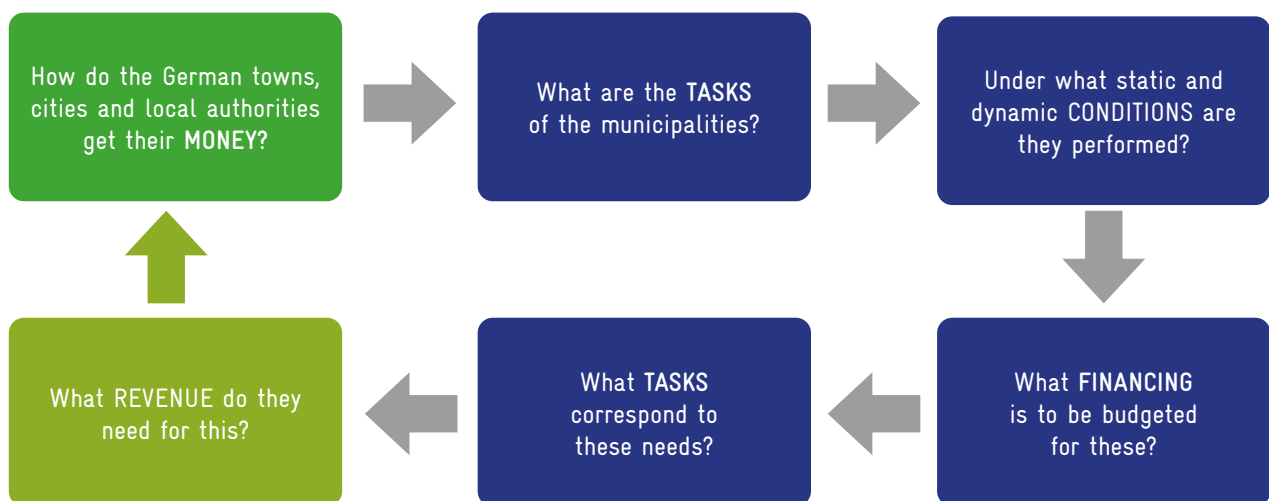
Municipal tasks must be carried out under a range of locally and regionally specific conditions. Key frame

work conditions, apart from the geographic location, are the settlement and transport structures that have evolved and been shaped over the course of time. Alongside these, the focus is on demographic factors: size of population, number of people moving to or from the location, age groups and ageing. The changing claims on the quality of specific local services may also have an enormous influence on the required funding in the long run.

The financial requirements for these services are determined based on the defined task and the local conditions under which it is performed. The expenditure, in turn, should match the financial requirements if the task is carried out in line with the budget principles of value for money and economy. From the planning perspective, the financial requirement should match the 'required' expenditure in advance. In practice, this does not always apply because 'objective' requirements are hard to measure and the actual expenditure may over time diverge from the financial requirement for performing a task<sup>9</sup>. Nevertheless, at this point it is easier to take the planning perspective in order to answer the question, based on the required expenditure, of how adequate income can be ensured so that the portfolio of tasks of each individual municipality, including its voluntary self-government, can be efficiently performed.

Besides this compliance with needs, other principles of the municipal system and its financing must be kept in mind. These are summarised in the graphic below.

FIGURE 3: FROM THE MUNICIPAL TASK TO INCOME



Authors' own graphic.

<sup>9</sup> See Gerhards et. al. (2019) on a new approach for capturing the actual needs for financial equalisation.



These principles also form the framework and reflect the characteristics of the German municipal financing system. As the basis for equitable, constitutional and efficient municipal (financial) policy, they should be applied both during the design process and examination in court. That does not mean, though, that these were pre-existing principles on which design of the German municipal financing system was actually based. On the contrary, these principles evolved over time in conjunction with political practice. This type of constitutional evolution is an ongoing process that carries on to the present day.

Thus, for example, the Basic Law and the constitutions of the federal states only gradually incorporated the principle of connexity named in Fig. 4 following fundamental judgements by the constitutional court. This process was concluded in 2008 when Baden-Württemberg incorporated the principle. Further development of the financial constitution is far from complete, though. With regard to the principle of connexity, there is a lively debate concerning the remaining 'gaps in connexity' in the many previous laws that were passed before the connexity laws were introduced, and the gap in connexity in the relationship between the federal government and the municipalities. It cannot be foreseen at present how and when the gradual evolution of the financial constitution will have

reached a point where the principle of connexity will have been completely and consistently applied. Since the precise definition of this principle is attended in practice by growing financing obligations of the central levels (federal government or federal state) towards the decentralised levels (federal states or municipalities), fiscally motivated opposition against further implementation of the connexity principle is frequently encountered.

Our comments here regarding the principle of connexity also apply to the other principles we have referred to: these principles grow and evolve during practical application and in response to current trends. This does not always mean that the principles (such as the principle of connexity) become hard and fast in the process. As a rule, though, the principles are updated whenever they are applied to specific controversial issues since they must be formulated in a practical and appropriate manner in each case. This prevents the principles of the municipal system and its finances from becoming too rigid and ensures that they remain relevant. At the same time, the recurring and often comparative review of municipal financing systems by the respective constitutional courts of the federal states ensures that the principles are successively applied across all the federal states, and in particular that the principles cannot be abolished when there is a change of government.

FIGURE 4: PRINCIPLES OF THE MUNICIPAL SYSTEM AND ITS FINANCES

'Municipalities must be guaranteed the right to regulate all local affairs on their own responsibility within the limits prescribed by the laws.' (Article 28 II GG). The following principles must be borne in mind:

- |                                     |   |
|-------------------------------------|---|
| • Principle of subsidiarity         | • Decisions to be as decentralised as possible. The higher level only intervenes if a uniform regulation is clearly advantageous. |
| • Principle of connexity            | • 'He who orders, pays': centrally established tasks call for adequate central financing.   |
| • Principle of equivalence          | • Revenues must correspond to the locally provided services.  |
| • Principle of solidarity           | • Redistribution from financially strong to financially weak municipalities   |
| • Uniformity of living standards    | • Constitutional standard that justifies a centrally organised regional equalisation.   |
| • Loyalty to the federal government | • Reciprocal commitment (in the last resort)  |

### The partner country perspective: Burkina Faso

The decentralisation process in Burkina Faso was launched by the new constitution of 1991. Eleven areas of responsibility were successively identified that could be transferred to municipalities, and were assigned to the relevant policy areas by a statutory decree. The new municipal tasks were mainly intended to include the policy areas of education, health, water and wastewater as well as culture and sport. In line with the principle of connexity, the municipalities were to be increasingly equipped with the required funds to provide services effectively at local level.

In actual fact, only four of the eleven areas of responsibility were transferred to the local level. The budget share spent at local level has remained stuck for years at 4.9% instead of the 10% for the 2018 budget year and 15% for 2020 envisaged in the national development plan. This corresponds to a municipal financial framework consisting of transfers of one dollar per inhabitant. Transfer payments to the municipalities tripled from 2016 to 2017, but this was a one-off occurrence that could not be maintained. The transfers fell again in the 2018 budget year. Apart from failing to comply with the principle of connexity, the transfers to which the municipalities are entitled also arrive unreliably and frequently too late. Resistance on the part of line ministries and general financial bottlenecks owing to the security situation are seen as possible reasons for the inadequate and unpredictable transfer payment situation.

In Burkina Faso, German development cooperation actors are working to increase local government income from transfers in two GIZ measures financed by BMZ (Decentralisation and Municipal Development Programme and Strengthening Good Financial Governance project). Both measures play an advisory role in consultation processes to improve fiscal architecture. The decentralisation programme supports the Ministry of the Economy, Finance and Development (MINEFID), the Ministry of Territorial Administration and Decentralisation and selected line ministries in effectively implementing and monitoring the action plan for the transfer of responsibilities and resources by providing technical and procedural advice and through capacity development. Parliamentarians are also supported in terms of presenting their arguments to the line ministries.

The Strengthening Good Financial Governance project, in turn, was tasked with enabling the Ministry of the Economy, Finance and Development (MINEFID) to provide better information and coordination concerning the envisaged funding of municipalities. The starting point for this improvement is an account structure that is used consistently by all the government bodies under the responsibility of the General Directorate of the Treasury and Public Accounts (DGTCP), as a condition for the reliable provision of funds in line with the needs of the local governments. The cash management system is being further developed by means of software solutions to improve coordination of the provision and monitoring of funds for the municipalities. Platforms for exchanges between the central and sub-national level are also being tested or strengthened for this purpose. Exchanges at international level are also meeting with great interest. In June 2019, a delegation of representatives from the Ministry of the Economy, Finance and Development (MINEFID), the Ministry of Territorial Administration and Decentralisation, local governments and non-governmental organisations and a parliamentarian undertook a study trip to Germany at the invitation of the Governance Fund. Key topics of the visit to Berlin, Brandenburg and Saxony-Anhalt were the German tax and financial system, especially tax allocations and the horizontal and vertical financial and fiscal equalisation system. This exchange will be deepened over the coming three years.

## B. Overview of municipal finances

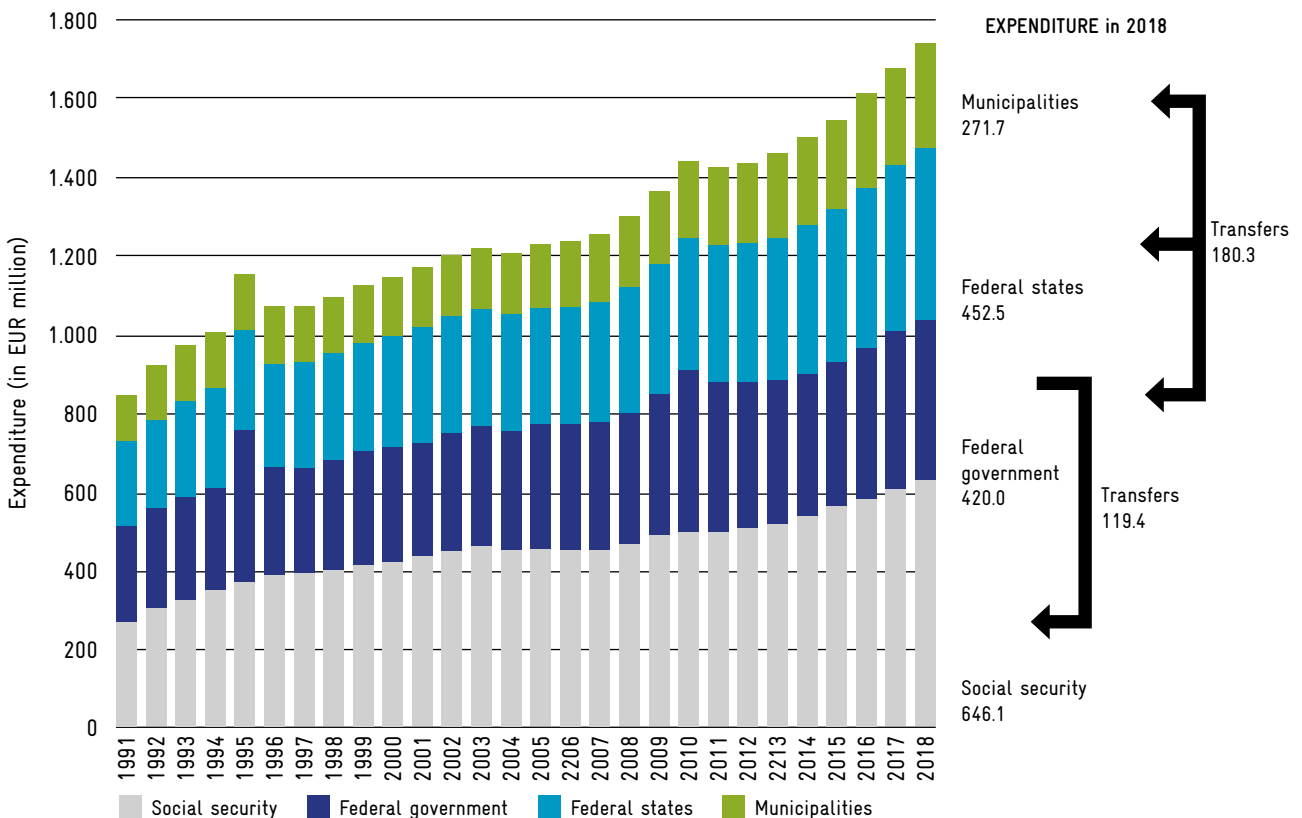
Looking at the finances of the multi-level German state as a whole (and disregarding the comparatively low contributions at European level for simplicity's sake), developments since German reunification reveal two key findings (Figure 5). On the one hand, state expenditure at all levels including social insurance is slowly but steadily increasing. State expenditure has more than doubled since German unification in 1990. It should be said, though, that the nominal values shown here exaggerate the real increase. Inflation-adjusted German state expenditure shows very moderate growth in most years. In addition, this type of presentation disaggregated by level is not consolidated, i.e. payments between the levels are not deducted. The non-consolidated data reflect the perspective of the respective public budgets, in which expenditure should always be posted as gross amounts.

However, payments between the levels do play a major role, as becomes clear when we look at 2018: the non-consolidated expenditure presented here amounts to EUR 1,790 billion, whereas the consolidated expenditure of Germany as a whole was EUR 1,490 billion. That means EUR 300 billion was counted twice or even several times over as transfers within the public sector. EUR 119.4 billion of the central

expenditures are subsidies to the statutory social security schemes and are paid out by these to insured parties. Vertical payments between the three levels of the federal government, federal states and municipalities, and horizontal payments between entities at the same level account for the remaining EUR 180.3 billion. Apart from subsidies, allocations and financial equalisations, remuneration and the reimbursement of costs are also paid by one municipality for the services of the other. In some cases, payments are made twice or even three times over, for example if the federal government pays capital investment subsidies to the federal states that are earmarked for the municipalities, the federal states then pass these funds on to the individual municipalities (possibly topped up with their own subsidies), and the municipalities then spend the funds for the actual investment purpose. These dense links between the municipalities are a key characteristic of German fiscal federalism.

The other main finding also relates to a stable development. The distribution of expenditures via the federal government (plus social security), the federal states and the municipal level is very stable over the course of time. The municipal level is the smallest of the three federal levels. The slightly different dynamics show that social security expenditure has grown most strongly (2018: 233% since 1991); the municipi-

FIGURE 5: EXPENDITURES OF THE LEVELS 1991-2018



Authors' own graphic. Data: destatis (2019).

palties (216%) and federal states (211%) account for almost the same amount. The federal government shows the lowest growth, with a nominal increase of only 164% as against 1991. This reflects in particular the drop in defence expenditure after the end of the East-West conflict. Following many years of decline, in 2017/18 the military budget nominally returned to the 1991/92 level.

Against this backdrop, Figure 6 gives an overview of the structure of municipal expenditures and the sources of income that are used to finance them.<sup>10</sup>

The foremost task of the municipal financial system is to safeguard the sustainable supply of local public goods to local citizens and to ensure the required long-term financing. On the expenditure side, three categories stand out: HR expenditure, expenditure on social services and operating expenditure. Seen over a long period, municipal social services have constantly increased. Municipal investments in infrastructure, schools and health institutions, by contrast, continue to be rather low and should be raised in the long term. Municipalities had traditionally provided roughly 50% of total public investment in Germany. This level has not been reached again since the turn of the

millennium. For many years, municipal investments have fallen far short of a level that even then would only have been sufficient for maintaining the value of existing infrastructure. A heated political debate has emerged in Germany since 2015 concerning this inadequate public investment level that is also damaging to the national economy. Meanwhile, all three levels are making efforts to once again close the existing investment gaps step by step.

Municipal expenditure is financed by municipal taxes and proportions of joint taxes (i.e. taxes that are raised partly by the municipalities and partly by the federal government and the federal states) as well as by rates, charges and contributions and the municipal financial equalisations that the respective federal states organise for their cities and large towns, independent municipalities and rural districts. Added to this is the (currently very low) net borrowing as a possible source of financing for municipal investment measures. As Figure 6 shows, the aggregated municipal financing balance is positive at present. However, there are substantial differences between the municipalities, as is the case with the other forms of income too. Despite excellent tax levels and correspondingly surging revenues, between

FIGURE 6: KEY DATA ON MUNICIPAL FINANCES 2016-2021

EUR million	2016	2017	2018*	2019*	2020*	2021*
<b>Expenditure</b>	<b>230</b>	<b>234</b>	<b>246</b>	<b>258</b>	<b>270</b>	<b>283</b>
Personnel	57	59	62	65	68	71
Operating expenses	49	50	52	55	57	59
Social services	59	59	61	64	67	71
Interest	3	3	3	3	3	3
Capital investments	24	24	26	28	30	32
Other expenditure	38	40	42	43	46	48
<b>Revenues</b>	<b>236</b>	<b>243</b>	<b>254</b>	<b>263</b>	<b>276</b>	<b>288</b>
Taxes	90	96	101	105	112	118
Rates	19	19	20	20	20	21
Ongoing grants from fed. state/ fed. govt	87	88	92	96	100	105
Investment grants from fed. state/ fed. govt	7	7	8	9	11	11
Other revenues	33	33	33	33	33	33
<b>Balance of financing</b>	<b>6</b>	<b>9</b>	<b>8</b>	<b>5</b>	<b>6</b>	<b>5</b>

\* Projections

Authors' own graphic. Data: Association of German Cities (2018).

<sup>10</sup> The aggregates of the municipal expenditures do not tally entirely because in Figure 5 the data used are distinguished from the national accounts, whereas in Figure 6 the data are distinguished from the financial statistics (in part as projections by the Association of German Cities).

2017 and 2019 far from all German municipalities managed to balance their budgets.

We will go on to examine the three major sources of municipal income: taxes (Section II.C), rates, charges and contributions (Section II.D) and the municipal financial equalisation as the key instrument for grants by the federal states to the municipal and rural district level (Section III).

### C. Municipal tax revenues

To explain the sources and structure of municipal tax revenues, we must first take a quick look at the German tax system as a whole. The German tax system is strongly integrated, even more so than the distribution of revenue

from the joint system and the separate system in Fig. 7 suggests.

#### Structure of tax revenue in Germany

Fig. 7 shows that roughly three quarters of overall German tax revenue comes from the central joint taxes. The current focus is clearly on the taxation of macroeconomic income flows, primarily via income tax supplemented by corporation tax as a levy on corporate income. The overall revenue from value-added tax is roughly the same as that from income tax. In economically favourable years, such as 2018, income tax still merits its old epithet as the ‘queen’ of the German tax system. In economically weaker years, however, VAT and income tax provide roughly the same revenues because consumption is less sensitive than income to the economic climate.

FIGURE 7: STRUCTURE OF TAX REVENUES (2018)

2018 (EUR million)	Fed. govt	Fed. states	Municipalities	Totals	Share
<b>Joint taxes</b>	262 022	256 350	48 666	567 038	74 %
Income tax (incl. wage tax)	117 208	117 208	41 182	275 598	36 %
VAT	116 513	110 841	7 484	234 838	30 %
Corporation and withholding tax	28 301	28 301		56 602	7 %
<b>Federal taxes</b>	108 586			108 586	14 %
Energy tax	40 882			40 882	5 %
Vehicle tax	9 047			9 047	1 %
Tobacco tax	14 339			14 339	2 %
Electricity tax	6 858			6 858	1 %
Insurance tax	13 779			13 779	2 %
Solidarity surcharge	18 327			18 327	2 %
Others	5 354			5 354	1 %
<b>Fed. state taxes</b>		23 913		23 913	3 %
Real estate transfer tax		14 084		14 084	2 %
Inheritance tax	9 047	6 813		6 813	1 %
Beer tax	14 339	655		655	0 %
Others	6 858	2 361		2 361	0 %
<b>Joint taxes</b>	2 058	7 020	62 707	71 785	9 %
Property tax			14 202	14 202	2 %
Local business tax	2 058	7 020	46 795	55 873	7 %
Others			1 710	1 710	0 %
<b>Totals by level</b>	<b>372 666</b>	<b>287 283</b>	<b>111 373</b>	<b>771 322</b>	<b>100 %</b>

(without customs duties to EU: EUR 5,057 million)

Authors' own graphic. Data: BMF (2019).

The figure also shows that a good quarter of German tax revenues come from the so-called separate taxes to which only a single municipality is entitled.<sup>11</sup> Income from the respective separate taxes plays a key role for the federal government, but especially for the municipalities.

The initial statement that integration into the German tax system continues to exceed the proportion of joint tax, which is dominant in any case, is based on the nature of the 'tax separation' system practiced here. The individual taxes listed here for the federal states and municipalities<sup>12</sup> are in fact all so-called 'bound separate taxes'. Although the local tax revenue is exclusively due to the individual federal states or municipalities ('income competence'), tax legislation is the prerogative of the federal legislature with the involvement of the Bundesrat (legislative competence). This bound status goes furthest in connection with inheritance tax, which is due exclusively to the federal state in which an heir liable to pay tax, or a donee during the deceased's lifetime, has their place of residence. At the same time, though, the individual federal state has no legislative influence on the taxation structure or tax rate. Inheritance tax is therefore considered a false separate tax. The same applies to beer tax, which must be uniformly regulated in each EU member state as a consumption tax on alcoholic beverages in line with European tax harmonisation.

For the other separate taxes that provide significant revenues, the real estate transfer tax of the federal states and the so-called 'impersonal taxes' of the municipalities (real estate transfer tax and business tax), the practiced<sup>13</sup> legislative competence also lies with the federal legislature. However the local authorities with the respective income competence can establish the applicable tax rates (real estate transfer tax) or collection rates (impersonal taxes) themselves.

Overall, German municipalities receive 9% of annual tax revenue. That is slightly above average in comparison with similar countries at international level. In the OECD fed-

eral states with three levels, the local levels have a share of roughly 8% of overall tax revenue.<sup>14</sup> By global comparison, the tax revenues of municipalities in Germany (as in most OECD states) are clearly above average, even if they cannot be precisely quantified due to a lack of reliable data.<sup>15</sup>

### Minor municipal taxes

Before we go into the impersonal taxes that are extremely important for municipal income, we should briefly mention the few completely separate taxes levied by the large towns, cities and municipalities. Part of financial sovereignty includes a certain level of municipal fiscal sovereignty based on the municipalities' fundamental guarantee of self-government (Article 28 GG). This gives rise to a municipal right to determine taxes that is, however, restricted to 'local expenditure and consumption taxes'. The so-called minor municipal taxes bear little financial weight as a whole, and their revenue is only included under 'miscellaneous' in Fig. 7. In individual cases, though, the small amounts of revenue earned from these minor taxes may make a crucial difference for a city/town or municipality as to whether it can stay within its budget constraints or not. The minor municipal taxes most often levied are:

- Dog tax. The history of this luxury tax reaches back into 15th century Germany. Today, high mark-ups are often charged for specific dog breeds (fighting dogs), and tax exemption is granted for guide dogs for the blind, herding dogs and other types of working dogs.
- Entertainment tax (on dances, legal gambling, prostitution).
- Beverage tax/liquor licence tax (for serving non-alcoholic and alcoholic drinks).
- Secondary residence tax. These taxes supplement the municipal revenue system to the extent that inhab-

11 Since the introduction of the apportionment of local business tax to the federal government and the respective federal state in 1969, municipal business tax has become a false joint tax but continues to be traditionally allocated to municipal taxes.

12 The federal legislature bears sole responsibility for the federal government's separate taxes. No further integration takes place here.

13 At the time this study was being completed, property tax was being reformed in Germany. By the end of 2019, a new constitutional model must be enacted in law following a resolution by the Federal Constitutional Court. In the course of the long-standing discussions on property tax reform, the question of whether the federal government does indeed have legislative competence for property tax has been discussed on many occasions, also at supreme court level. This question has not yet been finally resolved. In the final analysis, though, there can be no doubt that regulation of property tax by the federal legislature does not violate the constitution and will therefore claim validity.

14 See OECD (2019), Revenue Statistics 2019, Table 3. This group comprises eight countries; the municipal share of overall tax revenue varies widely from 3% (Austria) to 15% (Switzerland). In the OECD states without an intermediate federal state level, the average municipal share of overall tax revenue is somewhat higher (11%). Here the variance is bigger still; in Estonia, municipalities only receive 0.9% of overall taxes, but in Sweden the figure is 35%. Apart from the different degree of decentralisation of state tasks to municipal level, these figures also reflect the fact that central allocation systems may vary widely in their significance for municipal income.

15 The International Monetary Fund provides no data on municipal income in its established Government Finance Statistics (GFS) for most developing countries. See <http://data.imf.org/>.

itants whose main home is in the municipality determine the local allocation of the revenue for income tax and municipal financial equalisation. Without tax on secondary residences, municipalities with a large number of them (e.g. holiday homes) would otherwise provide many municipal services to residents who pay no taxes apart from local property tax. The tax on secondary residences also acts as an incentive for people to register their main residence at the place that is really their home. This is important in university cities and large towns, for instance, which are not interested in levying substantial revenue from secondary residence taxes. Their aim is rather to prompt as many people as possible to register their main residences there in order to avoid paying secondary residence tax. Re-registration then has the desired effect of increasing the basis for grants in the municipal financial equalisation system, which is usually more lucrative than the secondary residence tax.

Rural municipalities in some federal states are also increasingly levying hunting and fishing taxes and as of late also taxes for horses that are kept for leisure purposes. This rectifies a paradoxical situation that has arisen because dogs have long since ceased to be a luxury today, but were often subject to the correspondingly named local luxury tax. On the other hand, horses that were kept for leisure activities and continue to be classed as a luxury were (and are) untaxed in most places.

Cities and large towns that receive many tourists are increasingly charging a 'culture and tourism fee' for tourists who stay overnight at hotels. This tax, which is often called 'bed capacity tax' is the modern equivalent of the similarly designed 'spa tax', which has been established in traditional tourism destinations since the 19th century, in some cases.

But the municipal right to determine taxes is closely restricted. The limits are usually defined by the municipal tax law in the respective federal state. This becomes clear from the long list of tax ideas that municipalities have actually presented but have been unable to push through. Attempts by some municipalities or groups of municipalities to introduce solarium taxes, taxes on mobile phone masts, queues, packaging waste, or cats, are among those that failed.

### Traditional impersonal taxes

The two major traditional municipal taxes that are much more important than these small expenditure and consumption taxes are local business tax and property tax. Both are so-called impersonal taxes and are solely related to

the object of taxation (commercial activity, plots of land), without taking into account the personal circumstances of the individual taxpayer. These two impersonal taxes, as object-related income taxes, were not abolished with the introduction of modern, personal income taxation through Miquel's tax reforms (1891/93) in Prussia. They were allocated to the municipal level. Subsequently, the renaissance of these old forms of income tax as a source of municipal income spread to more and more German federal states and culminated in the impersonal tax reform of 1936, which allocated income sovereignty to the municipalities for the local business and property taxes that were only standardised throughout the German Reich from that time on.

In the Federal Republic of Germany from 1949, the federal government was given competitive legislative sovereignty over the impersonal taxes, whereas income sovereignty and the right to assess tax rates was again allocated to the municipalities. Since then at the latest, the two major impersonal taxes may be considered 'traditionally worthy of reform', because as object-related taxes on non-income values, they increasingly became foreign bodies in the German tax system as compared with the more modern personal tax system. For a good 50 years now, the impersonal taxes have been the target of regular demands for reform. The mere fact that they have been discussed for so long without satisfactory results illustrates their special status as the key taxes in the municipalities. The reform discussions naturally take into account the different interests and in part very heterogeneous income profiles of more than 11,000 cities/large towns and municipalities. Since tax reforms that do not also produce losers as well as winners are virtually inconceivable, firm opposition can always be expected from parts of the municipal 'family'. All efforts to modernise the historical impersonal taxes have been correspondingly laborious.

### Local business tax

Disputes over local business tax, for instance, are a 'never-ending story'.<sup>16</sup> , as Karl-Heinrich Hansmeyer said looking back in 1997. It is true that local business tax is an illustrative example of how the intensity of reform efforts is negatively correlated with the actual income they provide. As long as this tax, which depends heavily on the economic cycle, is abundant, no objections concerning the tax system, however profound they may be, can trigger a politically viable reform discussion. Demands for reforms only flare up (again) when the economy takes a downturn and income from local business tax drops to a disproportionate extent. Large commissions have repeatedly been set up on such occasions to further develop or replace traditional business tax. So far, the economic situation

16 See. K.-H. Hansmeyer (1997), Der Streit um die Gewerbesteuer, eine unendliche Geschichte, in: Gelebte Demokratie, Festschrift for Manfred Rommel, Stuttgart 1997, pp. 159-178

quickly recovered each time, faster than reform efforts could be put into practice. At the latest when income from local business tax pours into the kitties of the large and economically powerful cities/large towns and municipalities again, the old tax is rehabilitated in the eyes of a sufficient number of veto players and the reform debate dies down again (for the time being).

However, given these circumstances, it would be wrong to say that local business tax as a whole cannot be reformed. It has in fact undergone several changes in the past 50 years, which add up to a substantial change in its character as an ‘impersonal tax’. Traditionally, local business tax was interpreted as a form of business tax that is directly related to the object of a commercial operation that does not, unlike modern corporate income taxes, take into consideration the economic performance or even the existence of an individual behind the company. Businesses – the liberal professions, agriculture and forestry excepted – are seen as the recipients of municipal services, in proportion to their size, which are roughly offset by payment of this tax. This postulated understanding of performance and consideration that underpins local business tax does not depend on whether a business actually makes a profit or not. A business that is making a loss uses the services of a municipality and its infrastructures just like one that is making a profit does. In line with this design principle, local business tax was originally based on three pillars, only one of which concerned performance-based income. Apart from the business income, the tax originally took into account the company’s total payroll costs and its assets – its trading capital.

These two components of taxes unrelated to income were precisely the reason why local business tax was thought to negatively affect employment in economically difficult times. The local business tax reforms therefore consisted in consecutively abolishing the two elements unrelated to income; first payroll tax in 1980, then the tax on business capital in 1998. Prior to this, from 1970 onwards, the regional distribution effect of local business tax to the detriment of industry had been neutralised. In exchange for the apportionment of part of local business tax income to the federal government and the respective federal state, a 15% share of the wage and income tax of its inhabitants was allocated to the municipalities. This exchange was intended to simultaneously stabilise somewhat the income base of municipalities in the course of the economic cycle, since income from local business tax, as outlined above,

fluctuates strongly in conjunction with economic upturns and downturns.

To the extent that the most problematic elements were abolished and only the income-related and most productive pillar, that of business income tax, was retained, income tax proved not entirely resistant to reform. All more ambitious attempts to modernise or replace this object-related and impersonal tax that was alien to a modern tax system failed, however, or ended up being more or less cosmetic adjustments. There has never been a lack of reform proposals. The last major reform debate envisaged a ‘municipal economy tax’ and a local value-added tax as systematically superior alternatives to local business tax.<sup>17</sup>

Against this backdrop, the technical diagnosis of today’s local business tax is clear: hardly any tax is less suitable than local business tax as a municipal tax whose assessment rate can be established by each municipality itself. By its very nature, it depends heavily on economic trends, and not just since the components unrelated to income were abolished. Local business tax is also designed as a tax on business profit, which is confined to larger companies and leaves out the so-called liberal professions (lawyers, doctors, architects and many others). That makes the basis for calculating the tax extremely dependent on the state of the economy. Frequently it experiences more pronounced upturns and downturns than the company profits themselves.

Such taxes should only be levied at national level, because sub-national entities need reliable income in order to perform their ongoing tasks.<sup>18</sup> Income from local business tax is very unevenly distributed across regions and between municipalities (once again; such taxes should only be levied at central level). Finally, by its very starting point, local business tax inclines heavily towards harmful tax competition (the levying of such taxes today should always be coordinated at the European level. The lower the level they start at, the worse their effect). The literature on public finance is full of proofs that local income taxes in particular generate potentially high, damaging tax competition that is clearly to the detriment of locations with higher tax rates. Currently, Fuest, Peichl and Siegloch show in their in-depth study of econometric panel data that German business tax is on average borne to 50% as an economic burden (especially a loss of income) by the working population. Female, young and unskilled workers are particularly hard-hit<sup>19</sup>. Summing up, local business tax is

17 For an overview, see C. Fuest and M. Thöne (2005).

18 It goes without saying that the higher federal levels must also perform their tasks on an ongoing basis, independently of economic developments. However, in contrast to the municipalities, the federal government and the federal states are allowed to run on a deficit during economic downturns, which means these budgets can work as ‘automatic economic stabilisers’.

19 See Fuest/Peichl/Siegloch (2017), Do Higher Corporate Taxes Reduce Wages? Micro Evidence from Germany, ifo Working Paper No. 241.



problematic in itself from a public finance viewpoint, but it is utterly unsuitable as a municipal tax in principle. This does nothing to change its enormous resilience in practice, as demonstrated above.

The urgent need to rethink the local business tax is exemplified by the map showing the tax rates levied by individual municipalities in the whole of Germany in 2017 (Figure 8). The figure shows how strongly the finances of the federal states influence the collection rates:

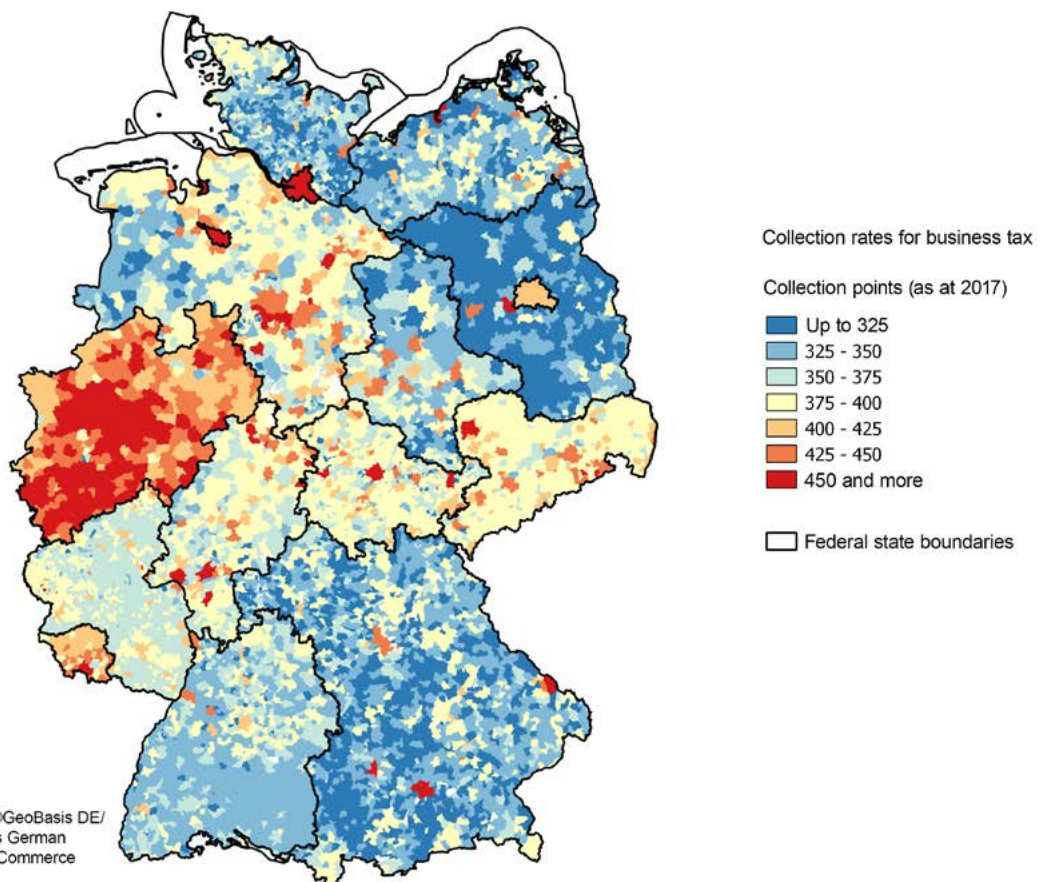
- Municipalities in economically powerful federal states (Bavaria, Baden-Württemberg) do not need high collection rates.
- Economically weak municipalities cannot allow themselves to charge high tax rates (Mecklenburg-West Pomerania, Brandenburg, Saxony-Anhalt, etc.).
- Inadequate financing via grants and municipal financial equalisation necessitate high collection rates for local business tax (North Rhine-Westphalia).

That is bad news for a municipal tax system in which municipal finances are not meant to simply reflect federal state finances. Putting it more positively, the continued existence of local business tax shows that it is possible to live with a problematic but resilient municipal tax if an instrument exists to curb its impact: an effective municipal financial equalisation system.

### Property tax

Unlike local business tax, the second impersonal tax, property tax, has led a fairly peaceful existence for many decades, at least from the point of view of the legislature. Following a brief episode in 1961 and 1962, when a tax on building land was introduced ('property tax C') to mobilise additional land for building on, in addition to property tax A (real estate in the form of agricultural and forestry land) and the dominant property tax B (other real estate), nothing much has changed in this municipal tax for over 40 years in structural and formal terms.

FIGURE 8: COLLECTION RATES FOR LOCAL BUSINESS TAX – MUNICIPAL DISTRIBUTION IN 2017



Even German unification in 1990 did not lead to changes in the old property tax, although it was clear by this time at the latest that the traditional model could not be applied in the long term. This is because property tax, which is aligned with the principle of the value of land and real estate, rests on a premise that cannot be implemented: all real estate would need to be revalued at seven to ten-year intervals. That has never been done. In Western Germany, the 'unitary values' of 1964 are still used today (for recent buildings using an administrative construct that can only hope to reflect the true values by the greatest of coincidences). In Eastern Germany, the planned economy was in force in 1964, and it set little store by capitalist 'unitary values'. Correspondingly, the Eastern German federal states have not made use of new unitary values since reunification in 1990. Instead, the unitary values actually determined in 1935 have been reinstated and still apply today, despite a plethora of reform initiatives.

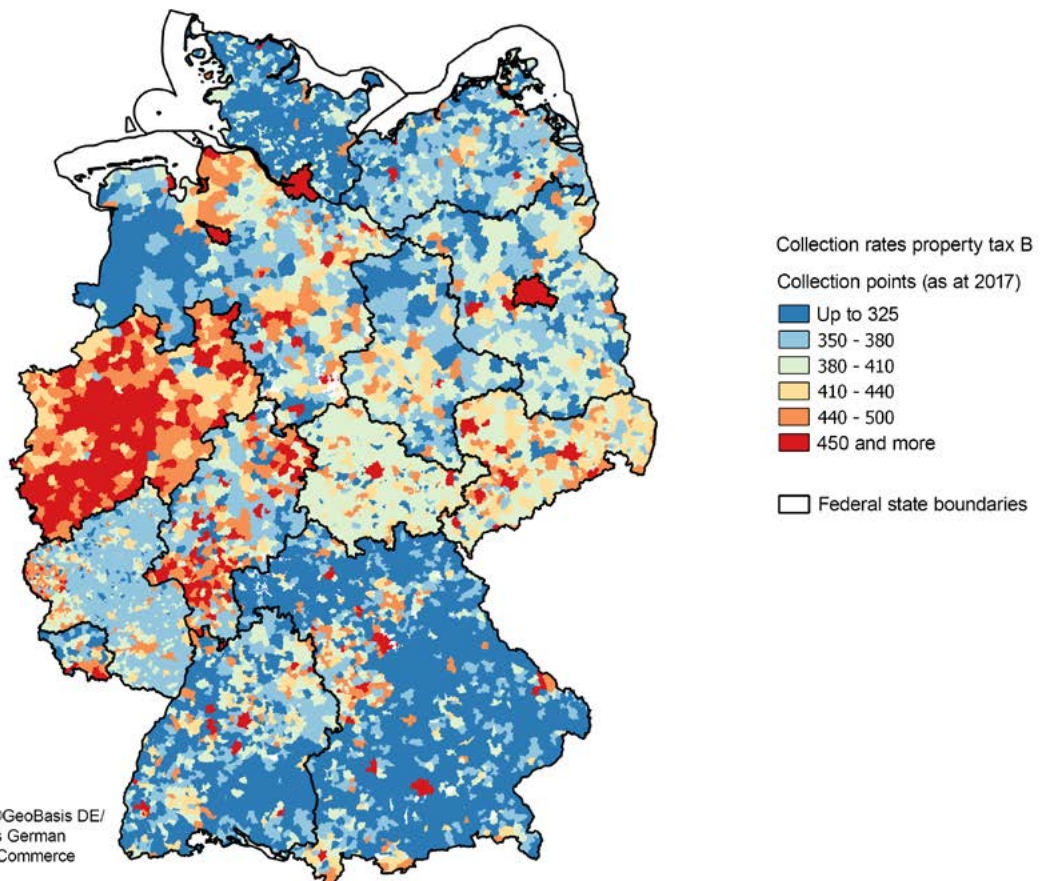
There was no lack of reform initiatives in this regard. The major reform discussion on property tax from 1998 to 2001 was far from being the first high-level attempt to

fundamentally reorganise this municipal tax. The fact that property tax was indeed fundamentally reformed in 2019 can be seen as a huge success. But this was only enabled by external pressure: in the first quarter of 2018, the Federal Constitutional Court ruled that the different application of the traditional property tax in Eastern and Western Germany (i.e. the unequal treatment before the law of objectively identical circumstances) was unconstitutional, and set a deadline for reorganisation in compliance with the constitution by the end of 2019.

As guaranteed by the Basic Law, the new property tax will indisputably grant the individual municipalities the right to determine the tax rates that are effectively applied by determining the collection rates themselves. Figure 9 illustrates the distribution of these collection rates for the existing property tax.

Here too, the figure shows how strongly the finances of the federal states influence the tax rates. The pattern is similar to that of the local business tax:

FIGURE 9: COLLECTION RATES FOR PROPERTY TAX B – MUNICIPAL DISTRIBUTION IN 2017



- Municipalities in economically powerful federal states (Bavaria, Baden-Württemberg) do not need high collection rates.
- Economically weak municipalities cannot allow themselves to apply high assessment rates (Mecklenburg-West Pomerania, Brandenburg, Saxony-Anhalt, etc.).
- Inadequate financing via grants and municipal financial equalisation necessitate high collection rates for property tax (North Rhine-Westphalia).

It also becomes clear that the range of collection rates is much greater in some federal states than in others. A wide variance in the map of collection rates may well signify that the respective federal state is also very heterogeneous. The spatial proximity of rural and urban areas, followed in turn by rural areas, is a characteristic feature of some federal states. Other federal states have large expanses of rural areas, where the collection rates are often similar as well. In part, though, it cannot be ruled out that decisions by individual municipalities to apply specific collection rates may not be entirely independent of the municipal financial equalisation system in the respective federal state. Such interactions are undesirable because they may undermine the autonomy of the individual municipalities to determine their own tax rates<sup>20</sup>. At the same time, Section III below will show that the tax revenues of the municipalities are so interwoven with the supplementary financial equalisation grants that it would appear difficult to completely avoid reciprocal influences. Protecting the tax revenue autonomy of each individual municipality while including it in a just and balanced distribution system in line with its entitlements is a constant balancing act between two rather discordant objectives.

The property tax reform adopted in 2019 constitutes a new challenge to this balance, indeed the greatest challenge to date. This is despite the fact that the first major step has already been achieved: agreement on a new property tax act has been reached (just in the nick of time). This agreement was made possible by creating a right of derogation for individual federal states. The aspiration to agree on a standard property tax for the whole of Germany for many years prevented a true compromise. Although there will indeed be a standard property tax model for the whole of Germany in future, the so-called joint model, each federal state will have the right to implement a divergent model for its own property tax. The new joint model will be designed as a property tax that is aligned with the value of the land and of the buildings that stand on it. The aspiration to reassess the actual economic value of

each individual plot of land at regular intervals has been abandoned. This aspiration was finally the reason why the current property tax also failed. Instead, simple lump sums will be selected that are geared to statistically determined values that are typical for the given location, or basic rent excluding ancillary costs. The basic right of each municipality to select the collection rates itself remains unaffected.

That must also apply to all models that may now be implemented at variance to the joint model. If one federal state or several federal states make use of their right of derogation, their models will presumably be geared to the sizes of plots of land and physical characteristics of the buildings on them. Area-based property taxes had already been proposed in the reform debate as alternatives to the property tax models based on asset value. The dispute over the advantage of a property tax based on value and thus on assets as compared with a simple tax related to characteristics flared up in particular due to obvious doubts as to the administrative feasibility of a model based on asset value.

From an international perspective, this must appear confusing, given that many countries have long and successfully levied property taxes based on property value – property taxes in the true sense of the word. The fact that the German tax administration, of all systems, should fail to comply with this aim and instead make do with a simple tax related to the characteristics of the object in question, as might have been expected in the 18th rather than the 21st century, is hard to explain. The fear of not being able to cope with the administrative demands of a value-based model is somewhat easier to understand, given the long and obvious failure of the old value-based model. But it remains unconvincing in the final analysis: the property tax model currently in use did not fail because the required regular revaluation of all land subject to taxation would have been objectively impossible. Redetermining the so-called unitary values every seven to ten years is time-consuming, but not impossible. The real reason why regular reassessment was abandoned is an (unspoken) cost-benefit calculation. This also explains the differences from an international perspective: in countries where value-based property taxes have been applied without any problems in the long term, these taxes frequently form the largest or even sole significant source of income at municipal level. That is not the case in Germany. Property tax accounts for roughly 12.5% of municipal tax income on average, and only for 6% of all municipal income<sup>21</sup>. Obviously, the proportionate effort of collecting data for an important but fairly middle-level source of income is assigned a different level of importance than the central source of income.

20 See Section II.C, especially footnote 37.

21 These percentages are calculated based on the revenue data in Figures 6 and 7.

It would be misleading to maintain, however, that the major disputes over the right property tax model in Germany were solely based on different judgements of their administrative feasibility. A value-based property tax is used differently to an area-based property tax. Area-based models have so far always been supported by federal states whose inhabitants have high income as compared with the national level, and where real estate values are above average or far above average. The rejection of value-based property taxes thus has the external effect of ‘sparing’ the federal state’s own population from higher taxation. However, such a ratio is not viable upon closer consideration because the final tax burden is not determined by the decision in favour of a specific tax model at federal state level, but by the assessment rate applied by the individual municipality. Here, considerations within the given federal state on the distribution of property tax burdens between different municipalities – wealthy and less wealthy on the one hand, urban and rural on the other – play a crucial role.

The second major challenge for the delicate balance between protecting the income autonomy of the municipalities, and the aim of integrating property tax into a balanced municipal financing system that performs its requisite tasks, will not be resolved by deciding in favour of one or other of these property tax models. This is because in practice, whatever the model, a new property tax needs to be introduced that is income-neutral. In terms of policy communication, there is a clear need to get the message across that an ‘enforced’ tax reform is meant to change the tax and not to increase it.

It remains to be seen how this aim can be put into practice, because the municipalities set the collection rates in line with their own needs. The wish on the part of the federal legislature to carry out an income-neutral tax reform probably carries little weight in this context. In view of the very heterogeneous starting situation outlined in Figure 9, it is hard to estimate in advance which individual calculations will be made by each individual German municipality to determine the collection rates for the new, significantly modified property tax. Given this uncertainty, for the reliable financing of municipal tasks it is good and to a certain extent reassuring to know that an instrument exists for curbing local income uncertainties with regard to this impersonal tax: an effective municipal financial equalisation system.

### Yardsticks for municipal taxes

Even if experience has shown that the two major municipal taxes in Germany are difficult to reform, the long debate over the reforms does have a positive aspect – it has established a long tradition of systematically discussing the yardsticks for better municipal taxes. A good municipal tax system should be able to meet the following criteria:<sup>22</sup>

- **Fiscal objective:** The primary objective of a municipal tax is to ensure that the municipalities have long-term, constant revenues to finance their tasks. Various sub-targets can be identified on this basis. The demand for constancy translates into a low level of economic reactivity, a key weakness of the local business tax. In addition, tax revenue should increase positively, ideally proportionally to economic growth (revenue elasticity should be at least 1). A tax of this nature offers stable real income over the course of time. Local population development must also be kept in mind as one of the key determinants of municipal growth potential today. For many municipalities in Germany, demographic change – due partly to ageing and partly to migration – is becoming the dominant structural factor. The demographic sensitivity of the basis for calculating tax revenue must therefore be kept in mind, even though it is clear that population trends and tax income cannot really be dissociated in the long run.
- **Financial autonomy:** Municipalities should be able to make independent decisions regarding a significant share of their income. Income autonomy is not only designed to ensure that municipalities have adequate tax income; it is also about strengthening the responsibility of municipal policy-makers toward citizens and tax payers. This is achieved by means of rights to fix collection rates or surcharges on the key municipal sources of taxation.
- **Reconciliation of interests:** The Advisory Board to the Federal Ministry of Finance (1982) formulated the principle of the reconciliation of interests for municipal tax systems as a pragmatic version of the principle of fiscal equivalence<sup>23</sup>. In the sense of ‘group equivalence’, the aim is to reconcile the interests of different groups within a municipality. The key groups to be considered here are local residents, the local business community and house and property owners. Services that are primarily provided to one group should also be mainly financed by that group. The burden of

22 Vgl. C. Fuest und M. Thöne, M. (2005): Gemeindefinanzreform - Hintergründe, Defizite, Alternativen, FiFo-Berichte Nr. 1; sowie grundlegend H. Zimmermann und T. Döring (2019): Kommunal финанzen, 4. Aufl., Berlin.

23 See Advisory Board to the Federal Ministry of Finance (1982): expert report on municipal tax reform, Bonn.

financing for jointly used public services should be shared correspondingly.

- **Harnessing the power of the local economy:** It is also important to maintain clear fiscal links with local businesses to ensure that the municipalities have a vested interest in companies settling there. This is by no means obvious, especially if the location of companies causes burdens for the local residents, for example higher traffic levels. Without financial incentives for the location of businesses, there is a risk of municipalities trying to function as residential and leisure locations, and of relying on other municipalities to encourage businesses to settle.
- **Other criteria:** Apart from these specific municipal aspects, a municipal income system must of course also meet the general requirements for a sensible tax system. Distribution effects must be considered and efficiency losses avoided. Beyond this, practical feasibility aspects must also be considered. With regard to local business tax, the main point is being able to incorporate any new taxes into the existing business taxation system.

It is clear from the above that Germany can offer a good normative basis for discussions related to reforming municipal taxes.

#### **Municipal share of value-added tax (VAT)**

When examining in detail a municipality's own tax situation, we should not forget the fact that income from joint taxes may also play a major role for the municipal level. More than 40% of municipal tax revenue stems from their share of income tax and VAT (see Fig. 7).

The municipal share of VAT is historically more recent and smaller. As outlined above, the tax on business capital was abolished with effect from 1998. To replace that, the municipalities were accorded a share of VAT revenue amounting to 2.2% of overall VAT. Replacing the form in which local business tax was collected (which had an adverse effect on employment and in the final analysis on the business location itself) with VAT, provided a reliable and steadily growing source of income that is relatively insensitive to the economic climate. These attributes are highly appreciated by the vast majority of municipalities. That said, in the long term the municipal share of VAT remains a peculiar source of income that is not really related to taxation, even though this peculiarity goes unnoticed. When establishing the shares of this VAT income received

### **The partner country perspective: Georgia**

The decentralisation reforms in Georgia can be termed relatively dynamic. Initially, the transfer system was only geared to closing the gap between the income and necessary expenditures of the municipalities. However, this had a counterproductive effect on the decentralisation process because the system offered no incentives for municipalities to do more to mobilise their own local income. This was not conducive to achieving the Georgian Government's goal of spending at least 7% of gross domestic product at local level. As the sole external supporter of the Ministry of Finance, GIZ provided information on the disadvantages of the existing system and outlined various scenarios for reforming the local financial system. This was discussed in the working group to implement fiscal decentralisation composed of representatives from municipalities, ministries and universities. Tax distribution models were simulated, for example. On this basis, value-added tax was chosen as a tax that is divided between the central level and local governments, and criteria were selected for distributing revenues from this shared tax to the municipalities. Following the reform, since 2019 municipalities have been legally entitled to 19% of VAT revenues. The amount is fixed based on five weighted criteria: population size, proportion of children of pre-school age, proportion of the population living in mountainous areas and proportion of socially disadvantaged people. Great importance was attached to ensuring that the reform does not put any municipalities in a worse position than before. On average, the municipalities were able to increase their income by 13% within a given budget cycle.

In addition, GIZ is supporting the expansion of sectoral transfers, particularly the Regional Development Fund that operates via project applications and has become the major instrument for building and maintaining local infrastructure. Georgia has meanwhile become a pioneer in the region and handles enquiries, for example from Armenia, on the reorientation of fiscal architecture within GIZ's regional project Public Finance Management in the South Caucasus.

by the individual cities/large towns and municipalities, it was initially important to be guided by the ratio of income from the 'lost' tax on business capital, in order to ensure a smooth transition for all concerned.

But of course, such revenue cannot be durably distributed on the basis of a tax that was abolished in the increasingly dim and distant past. Nor was it an option to distribute shares of VAT according to the number of inhabitants, as would normally be done and is practised in connection with the federal states' share of this joint tax. In accordance with the constitution, the character of VAT as an approximate substitute for part of the local business tax had to be retained (Article 106 para. 5a GG). Following this principle, there is a need to establish a durable local and economic link. After lengthy negotiations and several transition phases, a final allocation formula was put in place in 2018 and has been used ever since: 25% is distributed according to the ratio of local business tax revenue over the past six years, 50% according to the number of employees liable to pay social security contributions (excepting the civil service) and 25% according to the total of local income from labour by people liable to pay social security contributions. This allocation formula that is alien to VAT itself means that these municipal revenues are allocations from VAT revenues rather than a dedicated proportion of taxes.

The fixed allocation formula does, however, constitute a restriction of the allocation character that brings it close to taxation. The Federal Ministry of Finance states as one of the advantages of the VAT share: The municipal share of VAT has increasingly been used for a number of years as a means of making financial transfers from the federal government to the municipalities. This also ensures that federal government funding is received directly by the municipalities<sup>24</sup>. However, this only works with transfers that are intended to grow in tandem with the increasing economic power of the municipalities. This is seldom the case, though. Using VAT as a means of transfer also increases the need to make subsequent corrective adjustments via the municipal financial equalisations to ensure that VAT funds too are ultimately used to perform municipal tasks, even though their primary distribution was not originally designed to achieve this. However, this is not really a major problem provided an efficient financial equalisation system is in place.

With the exception of the fiscal objective, the municipal share of VAT meets none of the yardsticks for a good municipal tax system listed above. Nonetheless, VAT remains a comparatively popular source of income in policy reform

discussions. Increasing the share it contributes to financing should never be given high priority, in view of the outlined attributes of municipal VAT. In practice, though, the municipal VAT share in Germany shows that sources of income which are not really very suitable for the municipalities can also be used. This is made possible by the municipal financial equalisations that can be used to adjust the final distribution of income.

### Share of income tax

After local business tax, the municipal share of income tax is the second-largest source of income for German municipalities. For federal states that have comparatively few businesses, including all of the Eastern German federal states, municipal income tax is by far the largest source of their own income.

Similarly to VAT, the municipal share of income tax was created to replace the loss of revenue from tax on business capital (in this case, the revenue from the allocation of business tax to the federal government and federal states, see above). But there the parallel to the VAT share ends. The municipal share of income tax has nothing to do with an allocation. It is directly linked to the local income of the municipality's own residents (and of partnerships that are liable to pay income tax). The municipalities receive 15% of wage tax and projected income tax and 12% of tax on savings income ('withholding tax').

Although the income tax share paid to the municipalities is a historic 'substitute' for income from local business tax, in normative terms it can be seen as a supplement to or completion of the municipal tax system. Fiscal equivalence in the sense of a performance-consideration ratio between municipality and individual user is confined to the area of rates, charges or contributions (see Section II.D. It is replaced by the concept of group equivalence as formulated by the Advisory Board to the Federal Ministry of Finance<sup>25</sup> in 1982 based on the principle of reconciliation of interests. As outlined above, the key groups to be considered here are local residents, the local business community and house and property owners. In the best-case scenario, each of these groups should have to pay its own municipal tax that should be paid at a variable rate determined through the local democratic process. Local business tax fulfils this function for the local economy, and property tax is collected from house and land owners. Both entail the right to establish collection rates.

This trio of municipal taxes based on the principle of a reconciliation of interests is completed by the municipal

<sup>24</sup> Federal Ministry of Finance (2019), pp. 1-2.

<sup>25</sup> Advisory Council to the Federal Ministry of Finance (1982), p. 32 ff.

share of income tax. The parallels to the two impersonal taxes go so far that (pursuant to the Basic Law) it can be established by federal law that the municipalities are also entitled to apply their own rates for collecting their share of income tax (Article 106 para. 5 sentence 3 GG). However, a federal law of this type has never been seriously launched within the policy debate.<sup>26</sup>

Notwithstanding all this, there is today no doubt that the municipal share of income tax as the 'third pillar of the system' substantially enriches and stabilises the income system.

#### D. Rates, contributions and concessions

One of the key roles of independent municipalities is to efficiently provide local public goods to citizens and businesses. As well as municipal democracy, this above all presupposes fiscal equivalence. The public goods on which decisions are made at local level, which are offered there and used by citizens, should also be financed from local revenue from taxes and rates. Fiscal equivalence itself in turn increases incentives for active participation in formulating municipal policy. Where fiscal equivalence can be ensured as a clear-cut relationship between the municipality and its inhabitants, financing via the charging of rates is advisable. Income from rates and charges plays a key role in German municipalities in three areas: rates, contributions and so-called concessions. Rates are the most important in financial terms.

Today, municipal rates are mainly charged for:

- water
- wastewater
- refuse collection and landfill
- street cleaning.

Rates have a dual character. On the one hand, they are the 'prices' for municipal services to the extent that they may only cover the cost of actually provided services. The

cross-subsidisation of other municipal services by levying charges that was common practice in Germany until well into the 1980s has been curbed by a number of landmark decisions by courts. Rates collected may only be used for their declared purpose. Other municipal activities must be financed from taxes and financial equalisation grants. On the other hand, rates completely lack a key element of prices on the given markets: their voluntary nature. Although rates have to be calculated like prices, they are obligatory payments for services that are associated with compulsory grid connection and use.

**Contributions** are used as the equivalent of rates in connection with municipal investments and are clearly attributable to potential users. Unlike rates, actual use plays no role in connection with contributions. The possibility or probability of use is sufficient. Development charges, for example, are widespread: A municipality develops a construction area with public roads and supply and disposal facilities. Development charges are collected from the neighbouring private properties and those who acquire them. Contributions for roadworks are clearly declining, though. If roads and the corresponding facilities are radically renovated or extended, contributions can be levied that are often calculated based on the length of the boundary between the property and the road. Depending on the cost of the measure, the contributions to be paid by the landowner may present a heavy burden or even exceed their economic capacities. Since such contributions may nowadays cause a great deal of 'excitement', more and more federal state governments are creating ways to avoid levying such charges.

**Concession fees** are charges paid to a municipality (or other territorial authority) by public or private companies. As a rule these are charges paid in return for allowing these companies to install electric cables, gas or water pipes under public roads. Unlike rates and contributions, concession fees are designed much less on the basis of sovereignty, and their status somewhere between a 'charge' and a 'price' is causing much more critical discussion in Germany than this key instrument of municipal financing actually deserves.<sup>27</sup>

<sup>26</sup> Apart from the understandably low level of interest on the part of policy-makers to establish collection rates for income tax too, there is also an important systematic reservation against it: although property tax is formally collected from house and land owners, Germany is a country of rented apartments. Fifty-five per cent of German accommodation is rented. Most Germans live in rented property rather than property of their own. This very high percentage of rentals by international comparison would at first appear to endorse the trio of taxes based on the principle of the reconciliation of interests, since the inhabitants of a municipality and the homeowners there are two groups that do not necessarily overlap to any great extent. However, property tax is regularly passed on to lessees. In Germany, it is permissible to state property tax quite explicitly as a separate item in the list of ancillary rental costs. Although such a formal possibility of passing on taxes must not necessarily tally with their economic transfer, the visible burden is indeed passed on to lessees. Property tax thus has the character of a tax that is autonomously influenced by the municipalities and paid by inhabitants. The introduction of the right to fix collection rates for income tax too would presumably meet with little acceptance against this backdrop.

<sup>27</sup> See Kastrop (2019).

In a nutshell:  
lessons learned for development cooperation

### Financing of the municipal level

The German municipal finance system cannot be summed up in a few sentences. The study makes this clear. Instead, we have listed a **few points that may be important to bear in mind** from a development cooperation perspective.

**Income for the tasks to be performed:** This study focuses on municipal finances. Money is not our starting point, however. Before speaking of municipal finances, we must start with how tasks are distributed within the state and how they are financed.

Questions of municipal finance are thus always a **question of political power**. Apart from the constitutional safeguards on municipal rights of codetermination and responsibilities, in practice it is important to have **accessible constitutional courts** that ensure the protection of municipal finances on the basis of soundly considered principles. These are based on the incontrovertible **guarantee of self-government** for the local authorities and local authority associations that is enshrined in the German Basic Law.

One particularly important **principle** that has emerged in Germany over the past 20 years is that of **connexity**. This protects municipalities against having additional tasks allocated to them from above without receiving suitable additional funding.

In Germany, municipal financing is based on several pillars that have evolved over time and today mutually complement and support each other. The foundation are the **rates** that create **well-accepted financing similar to prices** for the municipal services that can be clearly attributed to their beneficiaries. Fresh water supply and wastewater disposal, refuse collection and street cleaning are almost entirely financed from clearly regulated rates that do not allow the cross-financing of other tasks.

**Impersonal taxes** form the backbone of municipal taxation. These are two long-standing taxes, local business tax and property tax. Both are (as yet) regulated on a standard basis that applies throughout Germany. However, each of the 11,000 German municipalities has the right to establish the applicable tax rates themselves. This **freedom to establish collection rates** gives the municipalities a great deal of influence over their tax income. At the same time, the establishment of their own tax rates is intended to strengthen the link between municipal policy and citizens because it supports the obligation of democratic **accountability** and strengthens the concept of performance and consideration for local services.

Die konkreten Realsteuern selbst sind dabei nicht die besten Vorbilder für gute Gemeindesteuern. Die **Gewerbesteuer** ist über mehrere, jeweils kaum vermeidbare Reformrunden zu einer sehr konjunkturabhängigen und interkommunal ungleich verteilten Gewinnsteuer für bestimmte mittlere und große Unternehmen geworden. Gäbe es diese Steuer nicht schon seit langem und würden vor allem die Großstädte nicht stark von diesem alten Modell profitieren, würde sie heutzutage niemals als Kommunalsteuer eingeführt.

The specific impersonal taxes themselves are not the best models for good municipal taxes. Via several virtually unavoidable reform cycles, **local business tax** has become a profit tax for specific medium-sized and large companies that depends heavily on the economic cycle and is inequitably distributed between municipalities. If this tax had not already existed for a very long time and if the larger cities in particular did not benefit strongly from this old model, it would never be introduced today as a municipal tax.



The previous **property tax** was so inefficient and had been so unjust for decades that it was declared unconstitutional by a supreme court ruling. A follow-on model was decided for Germany in 2019. Consensus was only reached because individual German federal states were given the right to decide on their own property tax model for their municipalities at variance with the standard model. To date, no practical experience has yet been gathered with this constellation that is an oddity for Germany, since it implies that major taxes are no longer regulated uniformly across the entire country. By international comparison, property tax in Germany is unusually low, both in the old and the new model. Particularly in states where hardly any or no independent municipal charges are levied, property taxes should be much higher than in Germany.

Perhaps also because Germany has experienced decade-long and often fruitless debates concerning the reform of the two major municipal taxes, a long tradition has emerged of systematically formulating **yardsticks for better municipal taxes**. The criteria for a good municipal tax include among other things a high yield in income and a positive ratio to growth, the local reconciliation of interests and the harnessing of local economic power. No single tax on its own can meet all of these criteria. It is therefore all the more important for municipalities to have access to a **healthy mix** of taxes and rates.

It has also long been clear that traditional municipal taxes are not sufficient to create a sufficient financing basis everywhere in a federal state. That is why German municipalities have for 50 years received a share of the major **joint tax** (wage and income tax). The **municipal share of income tax** is roughly 15% of the tax liability of the municipality's 'own' inhabitants. Municipalities also receive a share (albeit only 2.2%) of the second largest joint tax, **value-added tax (VAT)**.

But the differentiated and individually adjustable municipal tax system can only offer sufficient funding to few municipalities that allows them to discharge their statutory duties and inject vitality into their democratic right to self-government. Hence the need for municipal financial equalisation, which is used in all 13 of the German non-city states for additional funding at municipal level. It is these financing and equalisation tools, not the taxes, that make it possible to comply with our initial intention to think about municipal services from the perspective of their tasks rather than from a monetary perspective. In the following section, this study will focus on these financing and equalisation tools.

### III. MUNICIPAL FINANCIAL EQUALISATIONS IN GERMANY

#### A. Introduction

Taken together, the German federal states and municipalities provide an impressive list of public services that all need to be financed. Since not every subnational authority has corresponding income sources of its own, and thus the possibilities to provide these services to the same extent, various vertical and horizontal equalisation payments are made between the federal government and the federal states on the one hand and between the federal states and their municipalities on the other. These payments are meant to ensure that the relevant tasks are performed by supplementing the existing funding of these entities by means of transfers that are tailored as closely as possible to their needs.

First of all, there is a financial equalisation at the top level between the federal government and the federal states. At this level, the income sovereignties as regards separate and joint tax income are established, and equalisation payments between federal states with abundant and less abundant income are determined. The financial equalisation across the federal states is meant to ensure that each individual federal state has adequate funding to perform its own tasks and to guarantee that its municipalities can perform their tasks (subsidiarity principle).<sup>28</sup>

Municipalities are not able to finance their tasks solely from their own revenue from taxes and rates in any of Germany's non-city states. There is indeed a small minority of cities/large towns and municipalities that receive sufficient tax income in each of the federal states. These are termed 'abundant municipalities'. In most municipalities in each federal state, though, their own income is not sufficient and must be supplemented by funds from federal state level. This is done via municipal financial equalisations that are individually designed in each federal state, though they are based on similar foundations throughout Germany, some of which are prescribed by the Basic Law. The techniques used to perform the financial equalisation are also similar. Together they form a toolbox that can be used to find individual solutions for each federal state. The following explanations on municipal financial equalisation in Germany will focus on the basic principles that these two forms of equalisation have

in common and provide examples to illustrate how they are applied in practice.

Municipal financial equalisation is intended to secure funding for the municipalities of the given federal state that is reliable, economical and cost-effective, allows tasks to be performed and leaves the municipalities their constitutionally guaranteed freedom (self-government). Municipal financial equalisation in the federal states is always designed as 'vertical financial equalisation with horizontal impact'. That means the municipalities are guaranteed to receive part of the federal state's income. These funds are distributed across the cities/large towns, municipalities and municipal associations in such a way that the differences in their revenues are sufficiently balanced out to achieve funding that roughly equates to their individual tasks in each case. Apart from differences in financial capacity, different funding requirements due to different tasks and structural circumstances also play an important role.

Whether and to what extent this funding is sufficient to ensure general satisfaction is very hard to determine objectively because when it comes to struggling for the allocation of limited public resources, none of the actors is motivated to say when they have received enough. The institutional incentives for the federal states to 'unselfishly' ensure adequate funding for municipal tasks are equally weak until they have secured sufficient funds for their own tasks. Naturally, each level and each individual subnational authority puts priority on its own interests. However, large reciprocal dependencies between municipal and federal state policy usually ensure that the balance does not shift completely from one level to the other. Remaining asymmetries in the balance of power between a federal state and its municipalities<sup>29</sup> explain why judicial control and (as a flanking and sometimes preventive measure) the academic examination of municipal finances each bear such weight in the disputes concerning municipal financial equalisations.

28 Our study J. Bullerjahn and M. Thöne (2018), Reform and Future of Federal Fiscal Relations in Germany. Benefits for development cooperation, GIZ Bonn/Eschborn, presents the financial equalisations at federal state level in detail.

29 See Section II.A above.

## B. Vertical financial equalisation

### Financial equalisation as a constitutional duty

In accordance with the German Basic Law, the federal states are obliged to transfer part of their tax income to their municipalities to enable the latter to perform their municipal duties. Article 106 para. 7 GG regulates the implementation of a vertical municipal financial equalisation via the pooling of taxes: ‘An overall percentage of the Land share of total revenue from joint taxes, to be determined by Land legislation, shall accrue to the municipalities or associations of municipalities. In all other respects Land legislation shall determine whether and to what extent revenue from Land taxes shall accrue to municipalities (associations of municipalities).’

### Allocations by the federal states to their municipalities

The Basic Law does not prescribe which share of which federal states tax revenues is to be transferred to the municipalities, i.e. the composition of the overall amount available for financial equalisation. Many options are conceivable for fleshing out this transfer. Both the specific configuration of the financial equalisation system and its endowment are to be determined by federal state legislation. This unspecificity means that the vertical design of the municipal financial equalisation system is often the subject of lively controversy between a federal state and its municipal level. These disputes are frequently resolved before the responsible constitutional courts. Where purely vertical equalisation is concerned, the lines of dispute are usually clearly defined because the so-called ‘municipal family’ (often represented by the representatives of the interests of larger cities and large towns, those of the smaller towns and municipalities and the association that represents the interests of the rural districts) presents a united front against the federal state and has homogeneous objectives.

When horizontal aspects of distribution between the various municipalities, cities/large towns and rural districts are added to the equation, the lines of conflict automatically become more fluid. It is often difficult to draw a clear line between purely vertical and purely horizontal aspects because the financial flows between a federal state and its municipalities have usually evolved over time, and vertical and horizontal aspects are commingled in myriad ways. This is because allocations from a federal state to the municipalities are not only made via the municipal financial equalisation systems. Even the overall tax revenues formed by pooling taxes are not the only source of grants that are made from federal state to federal state or federal state to municipalities. Figure 10 provides a general overview.

The huge variety of municipal financing systems in Germany results not least from the fact that different instruments are used to achieve similar goals. Depending on the legislation in the respective federal state, specific tasks may be financed from the total amount available for financial equalisation or from outside it. Municipal financial equalisation in the stricter sense can also be financed via the formula-based grants for a specific task. Alternatively, this task is financed via grants that are earmarked for a specific purpose or to meet specific needs. These grants are taken from the overall amount of tax revenue available, but are provided parallel to the formula-based grants. That means that the types of federal state allocations to the municipalities shown in Figure 10 are partially (but not wholly) substitutive.

The specific design of the second, horizontal level of municipal financing forms a constant feedback loop to the upstream vertical level. Since allocations from the federal state level are not only made via overall federal state tax revenues, but also via separate channels, the respective tax pools do not have to be the same in different federal states in order to achieve similar results with the transfers.

FIGURE 10: TYPES OF ALLOCATION BY FEDERAL STATE TO MUNICIPALITIES

Allocations by the federal states to their municipalities		
Within the financial equalisation system (overall tax revenues)		Outside the total amount of financial equalisation
Formula-based grants → municipal financial equalisation in the strict sense	Earmarked allocations Needs-based allocations	Reimbursement of administrative costs Other allocations by the federal state
Average approx. 15% of federal state revenues		Cost reimbursements transferred by the federal govt./EU
Average approx. 30% of federal state revenues		

Authors' own graphic.

### Obligatory and facultative tax pool

What specific form do the tax pools between the federal states and their municipalities take? The Basic Law gives the federal state legislature ample scope for specifically fleshing out the system, as described above. Two questions are paramount when it comes to municipal financing: What proportion of which tax revenues flow into the overall amount? And how is this overall amount<sup>30</sup> dynamised or stabilised in the course of time?

The so-called ‘obligatory tax pool’ refers to the tax revenues of which the federal states must give a share to their municipalities. According to the Basic Law, these are the federal state revenues from joint taxes, i.e. from wage and income tax, VAT and corporation tax. These tax revenues are pooled. They contribute 12.75% (Bavaria) and 23% (Baden-Württemberg, among others) to the pooled funds. These differences in the obligatory tax pool are partially compensated by reverse participation in the ‘optional tax pool’. Many federal states have decided to let their municipal family participate in other forms of federal state revenue. The most widespread form of

participation is in revenue from real estate transfer tax. Most federal states also give the municipal family a share of revenues from the federal state financial equalisation system made up of supplementary grants from the federal government and the compensation funds for motor vehicle tax.<sup>31</sup> Participation in redistribution of local business tax and inheritance tax is also fairly widespread but very mixed.<sup>32</sup> Since these forms of participation in the various taxes are usually implemented by means of very disparate shares, the different overall amounts of available funds can only be compared after they have all been aggregated.

But such a comparison would not be very useful even if aggregated (e.g. ‘overall amount’ per inhabitant) for two reasons. For one thing, municipal financial equalisation systems are mechanisms that supplement the financing of municipalities and rural districts. Yet there are significant differences in the primary tax revenues at municipal level between the federal states.<sup>33</sup> In regions with a strong economy and high tax revenues, the need to top up municipal income by means of financial equalisation is in any case lower than in regions with low tax revenues. Added to this,

FIGURE 11: OVERVIEW OF VERTICAL FINANCIAL EQUALISATION MODELS BY FEDERAL STATE

Federal state	Vertical financial equalisation model
Baden Württemberg	Pure quota system
Bavaria	
Lower Saxony	
North Rhine-Westphalia	
Saarland	
Brandenburg	Quota system with symmetry requirement
Schleswig-Holstein	
Hesse (since 2016)	Stabilisation model
Rhineland-Palatinate (since 2007)	
Mecklenburg-West Pomerania (since 2002)	Principle of uniformity
Saxony (since 1996)	
Thuringia (since 2014)	
Saxony-Anhalt (since 2010)	Needs-based model

Source: table produced by the authors based on Hummel/Lamouroux/Thöne (2018).

30 Usage varies: The ‘overall amount’ usually refers to the municipal share of the tax pool. In the laws of some of the federal states, the ‘overall amount’ is made up of all funds that are applied to the quota. We follow the first convention.

31 This former federal state tax is now taken in by the federal government, which gives the federal states lump-sum compensation for the resulting loss in revenue.

32 See Lenk/Hesse (2013), p. 33

33 Even though abundance is a phenomenon that is restricted to individual municipalities in all of the federal states.

the distribution of tasks between the federal state level and the municipal level is not the same in all federal states. In some federal states, many social services are delivered by municipal institutions, whereas other federal states do this themselves. Such differences in the ‘degree of municipalisation’ of social services and some other tasks also call for the different vertical distribution of funds between the federal states and the municipalities.

### Vertical financial equalisation models

To determine the vertical financial relationship between a municipal level and its respective federal state, the comparison with neighbouring federal states is therefore usually less relevant than the question of the principles that govern its own vertical financial equalisation in order to ensure an equitable and dynamic supply of funds in line with the tasks to be accomplished. Fig. 11 gives an overview of the models practised today.

Four different vertical financial equalisation models are currently used in Germany. The total amount of financial equalisation funding is determined in line with a quota model, a stabilisation model, the uniformity principle or a needs-based model<sup>34</sup>.

#### Quota model (entitlement to a share of the federal state’s tax revenues)

The **quota model** is still the one most widely used today. It sets the total amount of financial equalisation funds as a share of the federal state’s overall tax revenues. These are dictated by the obligatory and the federal state-specific form taken by the optional tax pool. Quota rates establish the share of federal state revenue that is passed on to the municipalities. In the quota system pure and simple, this means the overall amount of available financial equalisation funds fluctuates just like the federal state revenues themselves over the economic cycle via the rates that are fixed by law for the long term. Municipal revenues and federal state revenues develop similarly, at least as far as the overall amount of available funding is concerned.

#### Quota system with symmetry requirement

There are far more elements to consider in the two federal states that have since added a **symmetry requirement** to the quota system. These include not only the revenue from the tax pool but also all of the regular revenues from the federal state level and the municipal level (without debt). The burdens resulting from the performance of tasks at both levels are also taken into consideration. This is based on the understanding of a distribution of

financing that is in symmetry with tasks, where not only different revenue dynamics are balanced between the levels, but changes in the demand for municipal public services and those provided by the federal state are also balanced. If the symmetry coefficients that have been developed specifically for these federal states deviate too far from the ideal value of perfect vertical balance, the federal state legislature is prompted to change the applied quota model accordingly.

#### Stabilisation model

An extended form of the quota system is the **stabilisation model** that is used in Rhineland-Palatinate and Hesse. The aim is to stabilise municipal revenues by balancing out potential fluctuations in the overall tax revenues of the federal state, which are always exposed to fluctuations in joint taxes in response to the prevailing economic situation. Possible fluctuations in the overall tax revenues are buffered by means of a stability fund. This makes it possible to balance deficits and top up the fund when surpluses are available. The previous nine budgetary years are set as the path for growth in the stabilisation sum.

#### Principle of uniformity

In contrast to the quota system, the use of a **principle of uniformity** takes into consideration the revenues at municipal level as well as the federal state revenues. In so doing, consideration is given when calculating the total amount of financial equalisation funding to a positive development of municipal revenues with a negative factor. The equalisation rate results endogenously from the development in revenues at both levels. As with the quota system, different design options are conceivable as regards the fixed shares of the incoming federal state taxes when determining the overall federal state tax revenues available. The principle of uniformity creates an explicit link between financial trends at federal state level and municipal level with a much more implicit sharing of risks: If income grows more strongly at one level, this has a positive effect on the other level. This argument for the principle of uniformity that is convincing in theory only has a significant effect in real terms if the municipal and federal state taxes develop independently of each other. As a rule, though, the revenues show similar development, meaning the actual effect of taking municipal revenues into consideration will usually be low.

#### Needs-based system

In Saxony-Anhalt the total amount of financial equalisation funding is determined using a **needs-based system**.

<sup>34</sup> Re. below, see: Hummel/Rauch/Gerhards/Thöne (2015).

This is geared to municipal tasks and the expenditure they induce in order for tasks to be performed at municipal level. Depending on the capability of the federal state, the minimum financing is topped up. The total amount of financial equalisation funding is determined each year. Implementation of a needs-based system calls for time-consuming and constantly updated data surveys in order to determine costs for the individual tasks and to compare expenditure with income.

### **Appropriateness of financing irrespective of individual models**

As has become clear, the systematic differences between the models each entail instrumental advantages and disadvantages. There can be no 'objectively' correct deter-

mination of the amount of available funding from an academic perspective. If properly designed and regularly reviewed, each system can ensure equitable distribution. The final yardstick for assessing whether the amount of funding is appropriate is the distribution of tasks between the federal state and the municipalities. There is no general hierarchy in the value of tasks between state and municipal level. They are all considered to be of equal value. The division of tasks and funding of the federal state level and the municipal levels can therefore only be examined and assessed together. The total amount of financial equalisation determines which share of federal state financing is provided to the municipal level. This in turn depends on the vertical distribution of tasks. The total amount of financial equalisation funding available is therefore the key factor for ensuring vertically equitable distribution.

### **The partner country perspective: Togo**

Togo held municipal elections in June 2019 after a delay of more than 25 years. The 2018 amendment to the law on fiscal transfers also shows that Togo's decentralisation process is finally picking up speed after a long standstill. The foremost aim of the reform was to reduce the dependence of local governments (regions and municipalities) on the central state level, to strengthen fiscal autonomy and to thereby improve the provision of local services. Key impetus for reform came from the directives of the West African Economic and Monetary Union (WAEMU). The Government was required to ensure legal conformity with WAEMU standards in the fields of financing and accounting, administration and the internal control of the local governments.

At present, the municipalities are mainly tasked with civil registration procedures but also with water supply and sanitation, basic health care, basic education and local streets and parks. More and more responsibilities and with them funding and personnel are to be transferred to the municipalities, though the influence of the central government on service provision remains comparatively strong. From 1998, the transfers from central government to the municipalities were de facto suspended. Experts at the GIZ decentralisation project were given an opportunity in 2017 to become involved in the fundamental restructuring of the intergovernmental financial architecture. The project was asked to draw up proposals for establishing an equitable and predictable vertical financial equalisation system for Togo that complies with WAEMU regulations. A municipal development fund as an equalisation fund for structurally disadvantaged municipalities was elaborated, discussed by the relevant partner structures and adopted by the Government in October 2019. A local finance committee was also set up as an independent governmental organisation for the purpose of determining the medium-term financial requirements of the municipalities and developing transparent distribution mechanisms for transfers to the municipalities. Disbursement of the funding lines, on the one hand for general operating costs and on the other for investments, is to be announced via the annual budget law from now on. To enhance the effectiveness of transfers, GIZ is also supporting the establishment of a commission to supervise local finances that will monitor these financial transfers.

## C. Horizontal financial equalisation

### Statutory fixing of financial equalisation

Statutory fixing of vertical financial equalisation automatically determines the amount of funding used for municipal financial equalisation. Horizontal financial equalisation, which is also fixed at statutory level, is also linked to this amount of financial equalisation funding. Both of these central principles are laid out in a financial equalisation act. Each individual municipality therefore knows from the start which financial equalisation rules apply to it and to all other of the federal state's municipalities. For this purpose most of the federal states use laws on financial equalisation that apply for an indefinite period. These laws should be basically designed so as to be constant and calculable.

To reflect the latest trends and requirements, the **laws on financial equalisation** are regularly adjusted in most federal states, though. The largest German federal state, North Rhine-Westphalia, long ago came to the conclusion that a new municipal financing law should be passed each year. However, this differs only externally from the other laws on financial equalisation. In North Rhine-Westphalia too, the bases for municipal financial equalisation have remained fairly stable over time.

The statutory establishment of the core element of municipal financing in each of the German non-city states means that each municipality knows before the start of the budget year under which conditions, and according to which criteria, it will receive funds from the municipal financial equalisation system. The conditions are transparent and can usually be understood based on statistical parameters. The criteria are applied uniformly to all municipalities. This ensures that revenues from the municipal fiscal equalisation system are transferred systematically and equitably and without any political reciprocation vis-à-vis the federal state level, just as is the case with the municipality's own taxes. Although the poorer municipalities are financially dependent on financial equalisation, politically the individual cities/large towns, municipalities and rural districts do not depend on the good will of the federal state government or the federal state legislature. In these laws, constellations that are the same (comparable municipalities) must receive the same treatment according to objective standards. There is no scope for putting municipalities whose political leadership is closer to the government of a federal state or in opposition to it in a better or worse position.

This does not entirely exclude the possibility that a municipal law on financial equalisation might favour specific groups of municipalities in relative terms due to its choice of distribution standards, and disadvantage others. Municipal financial equalisation systems must not only treat the same situations in the same way – in order to be fair, they must also treat different circumstances differently. This opens the door for group favouritism, because it is

objectively difficult to distinguish between which kind of unequal treatment is right and appropriate, and which leads to slight favouritism or discrimination against specific groups. Federal state governments whose electorate is present in large numbers in rural areas therefore easily gain a reputation for implementing financial equalisation to the detriment of urban areas, and vice versa. But here too, strict limits apply. Most of the lawsuits dealt with by the constitutional courts at federal state level in relation to municipal laws on financial equalisation address the very question of whether different circumstances were handled in an appropriate or inappropriate manner. This means that any attempt to act more than very subtly in favour of specific sub-groups of the 'municipal family' of a federal state in connection with financial equalisation will end up being reviewed in court and by academic bodies in the foreseeable future. Protection against arbitrary or political discrimination is therefore very effective in this respect too, owing to the statutory establishment of horizontal financial equalisation.

### Many requirements to be met by financial equalisation

Although it is now taken for granted, this guarantee of fair and non-arbitrary treatment for each municipality, city/large town and association of municipalities is a key prerequisite if a municipal financial equalisation system is to perform its task of ensuring funding for the municipalities of a federal state that is meant to be simultaneously

- in line with the tasks to be performed
- economical and cost-effective
- respects the guarantee of self-government and the subsidiary principle
- redistributes funds to ensure equal living conditions
- and is reliable and
- transparent.

Meeting these **multiple requirements** is a tall order for any federal state or for any law on financial equalisation. Even more so than is the case for vertical financial equalisation between a federal state and all municipalities, it is particularly the requirement for transparency that conflicts with the requirements listed above, as will become clear further on. Horizontal financial equalisation systems that must allow for the performance of the given tasks, guarantee freedom and be efficient and redistributive can be reliably designed since they are laid out in law. However, it is difficult to design them so that they are simple and offer maximum transparency. The complexity of forms of municipal organisation and municipal tasks constitutes an obstacle for solutions that are simple – too simple as

compared with the reality they need to reflect. It is therefore all the more important to make efforts to ensure the best possible transparency and to remove unnecessary complexity that has grown over time. This is often much greater than the complexity of the horizontal financial equalisation system itself.

### Formula-based grants

In essence, all municipal financial equalisation systems in Germany are based on a similar mechanism. Once the total amount of vertical funding has been established, most of this amount is distributed among the municipalities of the federal state in accordance with a specific formula. Such **formula-based grants** can be used quite freely. They are the closest thing to the municipality's own tax revenues. Unlike earmarked allocations, formula-based grants therefore match the goal of protecting municipal self-government and freedom.

A municipality receives formula-based grants if its financial requirements as determined in line with the law on financial equalisation are greater than its own fiscal capacity, which is calculated based on income from joint taxes and standardised income from impersonal taxes. The difference between fiscal capacity and the fiscal needs indicator is

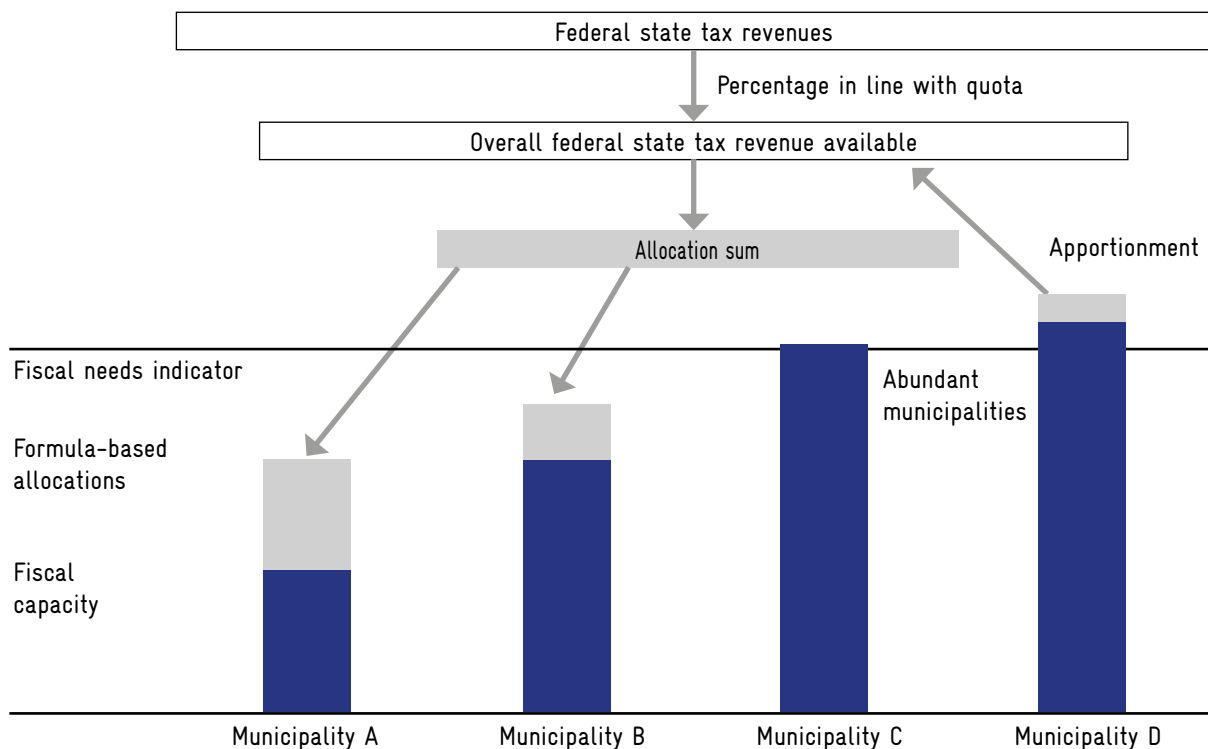
always expressed as a quota that is less than 100%. This ensures that the poorest municipalities receive the most formula-based grants in relative terms. This redistribution reduces the initial differences in fiscal capacity.

### Equalisation rates

At the same time, though, **equalisation rates** lower than 100% ensure that there is no levelling out of initial differences in financial capacity. Some federal states use staggered equalisation tariffs in which minimum funding is secured in the first step by actually topping up the missing amounts to 100% below a very low ratio of fiscal capacity to fiscal needs indicator. The final equalisation rate that is decisive for the final allocation also in the two-stage system is then lower, between 50 and 90% depending on the federal state concerned. This curbs redistribution so as not to undermine incentives for the municipality to maintain its own sources of taxation (harnessing and exhausting its own income potential). The ban on levelling out ensures that financially weak municipalities are not placed on a better footing than financially strong municipalities.

If the tax capacity of a municipality exceeds the fiscal needs indicator, this abundantly endowed municipality receives no formula-based grants. In some federal states, this is

FIGURE 12: BASIC HORIZONTAL FINANCIAL EQUALISATION MECHANISM





how it remains: abundantly endowed cities/large towns and municipalities receive nothing from the formula-based mechanism but neither do they have to hand over a share of their high financial capacity. Municipal financial equalisation thus remains purely vertical, with horizontal impact, since only the funds provided vertically via the total available tax revenue lead to the (partial) equalisation of differences in financial capacity.

### **‘Abundance’ and financial equalisation apportionments**

Meanwhile, though, several federal states use **‘abundance’ apportionments** in their municipal financial equalisation systems. This involves collecting a percentage of the difference between the (higher) fiscal capacity indicator and the (lower) fiscal needs indicator as an apportionment that is usually fed into the total amount of financial equalisation funding. The ‘abundance’ apportionment usually factors in a specific allowance, i.e. the apportionment does not become due as soon as fiscal capacity is only slightly higher than the fiscal needs indicator. The apportionment rates used are also noticeably lower than the applicable equalisation rates. There is therefore no uniform linear rate that is applied in the same way to recipient and payer as in the German financial equalisation system at federal state level. By using an ‘abundance’ apportionment, municipal financial equalisation systems nevertheless turn into a mix between vertical and horizontal financial equalisation systems (with horizontal impact).

This also applies to the two federal states, Baden-Württemberg and Rhineland-Palatinate, that use **financial equalisation apportionments** rather than ‘abundance’ apportionments. Here, the municipal fiscal capacity (Rhineland-Palatinate) or the fiscal capacity plus the formula-based grants received the year before last (Baden-Württemberg) is the basis for apportionment, not the excess municipal fiscal capacity. Whereas in Rhineland-Palatinate only municipalities with above-average fiscal capacity are called upon to contribute to the apportionment, in Baden-Württemberg all municipalities (and rural districts) are liable to contribute. The apportionment is therefore correspondingly large. Of the presumed EUR 16.4 billion to be distributed to the municipalities by the federal state of Baden-Württemberg via the financial equalisation system and other mechanisms in 2019, EUR 4.4 billion come from the financial equalisation apportionment that is collected from the municipalities.<sup>35</sup>

### **Fiscal capacity**

The type, scope and especially the appropriateness of fund allocations via the formula-based mechanism crucially depend on two factors that are compared in the described equalisation system: the fiscal capacity of the municipality on the one hand, and its financial requirements determined by the financial equalisation mechanism on the other.

The **fiscal capacity** of a municipality in the financial equalisation system is calculated according to the same basic principle in all of the federal states. The municipal revenue from the joint taxes, i.e. income tax and VAT, are added to the artificially standardised revenues from property tax and local business tax. In nearly all federal states, 100% of local revenue from joint taxes is taken as a basis. Only three federal states envisage basing the calculations on merely a share of these revenues (between 65 and 90%).

With regard to the two impersonal taxes, the municipalities have the constitutionally guaranteed right to steer the amount of local taxation by establishing collection rates. If the tax capacity for municipal financial equalisation were measured based on the actual income from property tax and local business tax after application of the actual assessment rate, this tax law would be almost completely neutralised ‘through the back door’: increased revenues due to higher collection rates would largely be seen as a level of fiscal capacity that reduces the grants received, whereas lower revenues due to tax reductions would largely be compensated by higher grants in the municipal financial equalisation system. Apart from undermining autonomy with regard to revenue from the impersonal taxes, this would also create quite the wrong incentives, because all municipalities would have good reason to constantly further reduce their collection rates and count on adjustment via the financial equalisation system.

To avoid this, the actual revenue from impersonal taxes is adjusted taking into account the impact of the collection rates established by the municipalities themselves. This is done by dividing revenues from local business tax by the local collection rate and multiplying the result by a uniform ‘levelling’ or ‘standardising’ collection rate that is specified by the financial equalisation law. The same procedure applies to property tax A and property tax B. This generates ‘fictitious’ tax indicators for the municipal financial equalisation system that capture the structural tax revenue capacity of a municipality fairly well and at

<sup>35</sup> According to the Ministry of Finance of Baden-Württemberg (2019).

the same time leave all of the surplus income or deficit in income with the municipalities, which is based on the tax collection rates they themselves decided.<sup>36</sup>

### Financial requirements

It is much more difficult to determine **financial requirements** to be used as a basis for calculating financial equalisation for a municipality. It is no exaggeration to say that this amounts to a 'science in itself' in most of the federal states. The aim is to determine a fiscal needs indicator that is compared to the respective fiscal capacity indicator such that the amount of funding available for formula-based grants provided via vertical financial equalisation and any 'abundance' apportionments is always completely used up.

The so-called **basic amount** meets these two simple mathematical requirements (a) 'monetary' and (b) 'completely used up'. This is a monetary multiplier that is determined in such a way for each financial equalisation year that the funding available to satisfy needs (the total of standardised fiscal capacity indicators and the total amount of financial equalisation funding available) is exactly used up.

It is a different matter when it comes to the structural fiscal needs indicator that applies to the individual municipality and is multiplied by this basic amount. This indicator, usually termed '**total appropriation**', must cover the factors that determine the relative financial requirements of a municipality as compared with all other municipalities in the federal state. The total appropriation must therefore objectively describe the factors that can determine the municipality's financial requirements resulting from the cost-effective performance of its duties (including freely chosen self-government tasks).

### Inhabitant weighting and assessment of inhabitants

The most obvious indicator for determining the financial requirements of a municipality, and the one most frequently used, is population size. In all federal states, the number of inhabitants is the central factor for determining requirements and is the basis for **inhabitant weighting**. However, only three of the 13 non-city states directly use the latest available number of inhabitants for inhabitant weighting. In 10 federal states, the number of inhabitants

in the municipalities is 'enhanced' using a multiplier so that larger towns are recognised as having a greater per capita requirement than smaller ones. In an extreme case in Saxony, this goes so far that an inhabitant in the largest city counts almost twice as much (1900%) as an inhabitant in a rural area. The starting and final value of the inhabitant weighting scales used in the various federal states (which are usually not linear) are shown in Figure 13.

The fact that municipalities are recognised as having financial requirements that grow disproportionately to their increasing size is by no means a matter of course. From an economic perspective, larger towns should actually have lower per capita financial requirements if they can achieve economies of scale when providing public services. That can indeed be expected with regard to the provision of identical public services by small and large municipalities.

The increase in weighting with increasing population numbers is in fact justified by other arguments in the German federal states, some of which reach far back into the past. In 1932, the subsequent Prussian Minister of Finance Johann Popitz asserted the theory of the (urban) 'inhabitant with access to sanitation', based on an analysis of municipal expenditure in 1928. According to Popitz, per capita financial requirements in cities were greater than in rural areas because infrastructure and services were required in the city that are superfluous in the countryside. What he meant were, among other things, asphalted roads, sewers and street lighting. In the same year, 1932, top-level civil servant Arnold Brecht formulated his 'law on the progressive parallelism between expenditure and population concentration'. He primarily attributed the higher expenditure observed in larger towns to higher costs in the cities, e.g. property costs, or higher civil servant salaries in his time. Both arguments had a major impact back then and soon determined municipal financing in the German Reich.

If the increase in weighting with increasing population numbers is criticised and rejected today, this is often done with reference to the long-outdated Brecht/Popitz laws. It is indeed true that it is no longer applicable in Germany to say that no sewers, wastewater treatment plants or asphalted roads lit up at night are needed in rural areas. The disproportionately high costs of public services can only be plausibly explained in very special cases (e.g. in local

36 In practice, selecting the right 'standardising' collection rate and updating it over time involves more of a challenge than it would at first appear, because the looming repercussions of the fictitious collection rates on municipal assessment rate policy must be taken into account (see Lenk/Hesse/Lück, 2013). Prompted by studies on municipal financial equalisation in North Rhine-Westphalia, Hummel and Rauch (2016) show in an empirical causal analysis that fictitious collection rates used for standardising financial equalisation have an unintended but clear effect on the collection rates selected by individual municipalities. Many municipalities take guidance from the collection rates used for standardisation purposes. When the fictitious collection rate is increased, it can regularly be observed that many municipalities raise their own collection rates accordingly, if these were previously lower. If the fictitious collection rates are implemented as the current average in each case, this may lead to highly undesirable circular reasoning. Especially in times and/or federal states where the collection rates have a tendency to rise anyway for fiscal reasons, this self-reinforcing effect can contribute to spiralling collection rates. A legislature that recognises this financial psychology effect will take this into account in the municipal financial equalisation system, even though it does not approve of such an effect.

FIGURE 13 INHABITANT WEIGHTING SCALES IN THE FINANCIAL EQUALISATION SYSTEMS OF THE FEDERAL STATES

Federal state	Inhabitant scale		
	from	to	population
Bavaria	112 %	150 %	000
Baden-Württemberg	100 %	186 %	
Brandenburg	100 %	130 %	55,000
Hesse	107 %	158 %	50,000
Lower Saxony	100 %	180 %	000
North Rhine-Westphalia	100 %	142 %	
Saarland	104 %	133 %	200,000
Saxony	100 %	190 %	100,000
Saxony-Anhalt	100 %	130 %	60,000
Thüringen	100 %	150 %	200,000
Mecklenburg-West Pomerania		No inhabitant scale	
Rhineland-Palatinate		No inhabitant scale	
Schleswig-Holstein		No inhabitant scale	

Table produced by the authors based on Zimmermann/Döring (2019).  
Data: Financial equalisation laws of the federal states.

public transport services, underground stations versus bus services in the country). A much weightier argument in favour of inhabitant scales and the related requirements is the customary regional planning structure that allocates additional central services to municipalities and cities/large towns as they grow in size. The bigger a town or city is, the greater the number of services and the more differentiated services it provides in many areas (culture, economy, health etc.), also for the towns in their immediate or more distant vicinity.

But it should come as no surprise that inhabitant scales still meet with repeated criticism despite this convincing argument. The main criticism is voiced not against the fundamental use of such scales but against how they are specifically designed, i.e. the weighting used and the progression of the scales. It can be presumed that this is down to circular reasoning. Given that inhabitant weighting scales have now been used for decades, the mere fact that expenditure is growing disproportionately to size cannot lead to the conclusion that requirements are also growing on the same scale. This may simply be the result of long-established better funding, i.e. more money is spent if more money is provided.<sup>37</sup>

### Secondary approaches

Inhabitant weighting scales attempt to lump together in one indicator a bundle of factors that create needs and to use this as a key parameter for differentiating financial requirements. However, the municipal financial equalisation systems of the federal states also use opposing instruments by separately capturing specific fiscal needs indicators and using secondary approaches as well as inhabitant weighting. These approaches are used as a substitute for inhabitant weighting scales and capture similar phenomena. This is most clearly evident in the explicit 'centre-based' or spatial planning approaches used in Bavaria, Rhineland-Palatinate and Schleswig-Holstein. These replace the inhabitant weighting scales in the latter two federal states, whereas Bavaria uses a combination of both. Secondary approaches that are intended to reflect social service burdens sometimes substitute and sometimes complement inhabitant weighting scales, though they are primarily considered as a supplement in practice.

Secondary approaches make it possible to move away from a one-dimensional focus on inhabitant weighting and to take into account additional factors that sometimes reflect multi-faceted municipal needs more accurately in terms

37 See for example the Federal Constitutional Court (BVerfGE dated 27 May 1992, No. 86, 148).

of the related tasks. The following list of the secondary approaches used in the federal states does not claim to be exhaustive (particularly in view of the fact that legislation is currently changing in some of the federal states):

- Social expenditure
- Children
- Students
- Military personnel
- Population growth
- Population decline
- Centres
- Number of schoolchildren
- Promotion of schoolchildren
- Police
- Territory
- Roads
- Centrality (workforce)
- Structural weakness
- Mining communities
- Spa towns

Some federal states use few secondary approaches, others a large number of them. (Where few secondary approaches are used, earmarked and needs-based grants play a greater role).

### Further differentiation

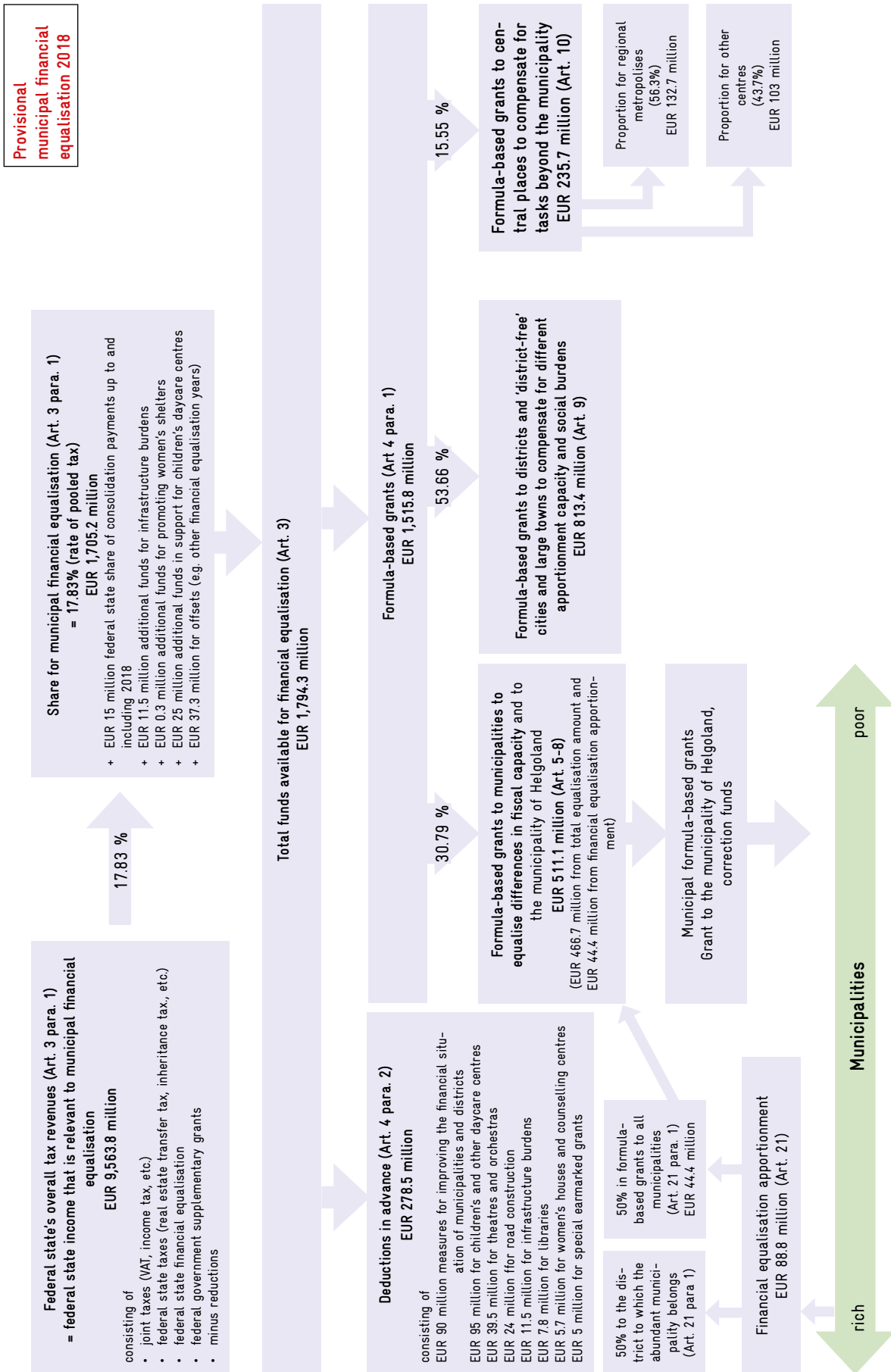
The federal states use very different methods for mathematically linking up inhabitant weighting and secondary approaches, or placing them alongside each other. Nor are all municipal tasks or all municipal authorities financed from the same overall amount of formula-based funding. One typical distinction is the pillar model according to which large towns and cities that are not attached to a rural district, villages and small towns that do belong to a rural district and rural districts themselves receive their own part of the overall funding, or the level model, according to which rural district and municipal tasks are financed from two different parts of the overall funding (with 'independent' cities/large towns receiving grants from both sources).

Using the comparatively simple financial equalisation system in the federal state of Schleswig-Holstein, Figure 14 illustrates the fact that the basic mechanisms described in this study cannot completely explain municipal financial equalisation in Germany. It stands for the 13 different and complex financial equalisation situations in the 13 non-city states.

But there is no reason for resignation in face of the further complexity of the system. The basic principles and mechanisms reveal all of the essential functions. The further ramifications have generally evolved gradually in everyday political processes. Complexity is usually the result of many small decisions, some of them historical, that are connected to the existing financial equalisation system. It is almost always easier from a policy viewpoint to supplement existing and accepted systems in a minimally invasive way when external reasons for change make this necessary, rather than taking the whole thing apart and rediscussing all financing and distribution issues from scratch. The organic complexity of political systems is therefore often, paradoxically, the result of political processes that (have to) avoid complexity in the decision-making process.

These processes are obvious and to a certain extent unavoidable. But of course, the proliferation of financing systems that has arisen through a number of changes cannot be continued *ad libitum*. However unavoidable a growth in complexity appears, a 'dialectic' move in the opposite direction is equally necessary. If complexity becomes an obstacle rather than an enabler, or if the reason for establishing a special rule has been half forgotten, but the rule persists in the form of a law, this calls the system as a whole into question. This may be done by means of judicial review, by academic evaluation or by an initiative stemming from the political realm itself. Frequently (but not automatically), the outcome of such a review is a new, clear and simple financial equalisation system that is ready to flourish by finding future, gradual solutions to new problems and to gain in complexity again.

FIGURE 14: DIAGRAM OF THE MUNICIPAL FINANCIAL EQUALISATION SYSTEM IN SCHLESWIG-HOLSTEIN



Source: Ministry of the Interior, Rural Areas and Integration, Federal State of Schleswig-Holstein, diagram of municipal financial equalisation, provisional status 2018 (2019).

In a nutshell:  
lessons learned for development cooperation

### Municipal financial equalisations

The German municipal financial equalisation system cannot be summed up in a few sentences. Instead, we have listed a few points that may be important to bear in mind from a development cooperation perspective.

Municipalities are not able to finance their tasks solely from their own revenue from taxes and rates in any of Germany's 13 non-city states. Most municipalities in each federal state must supplement their own income by additional funds from federal state level. This is done via municipal financial equalisations that are individually designed in each federal state, though they are based on similar foundations throughout Germany, some of which are prescribed by the Basic Law. The techniques used to perform the financial equalisation are also similar. Together they form a toolbox that can be used to find individual solutions for each federal state.

The starting point in each of the German non-city states is the so-called vertical financial equalisation between the federal state and all of its municipalities. The federal states are obliged by the Basic Law to perform this equalisation. In vertical financial equalisation, an amount of funding is taken from the tax revenues of a federal state and is subsequently distributed among the individual local authorities and associations of local authorities. This distribution of funds between the federal state and the municipalities also determines the political scope of both levels. One side's loss is the other one's gain. Vertical financial equalisation systems are therefore highly controversial. Since it is the parliaments at federal state level that have the final say in passing financial equalisation laws, legal protection of the municipal level before the constitutional courts is particularly important in this area. In practice, slightly different criteria have developed in the German federal states for equitable vertical distribution of funds. In this study, we look into their strengths and weaknesses.

Horizontal municipal financial equalisation is the culmination and conclusion of municipal financing in Germany. In some federal states, funds are indeed taken from the rich and given to the poor by means of so-called 'abundance apportionments'. But in all of the federal states, the transfer system is primarily designed as a vertical equalisation with a horizontal effect. This means the funds of the federal state are not equally distributed right from the start across the municipalities, but according to the capacity of the individual municipalities to generate their own income. Municipalities that are relatively weak in terms of funding receive many formula-based grants, whereas relatively financially powerful municipalities receive few such grants or none at all. This makes the subsequent horizontal financial equalisation the crucial phase of German municipal financing.

Once funds have been distributed to a satisfactory degree between the federal state and all of its municipalities, this last phase determines whether the municipalities have sufficient funds to perform their tasks appropriately and equitably. Municipal financial equalisation can (and must) therefore buffer the imperfections and obvious deficiencies in the preceding phases of municipal financing. That does not mean, however, that previous stages, especially the design of a good municipal tax system, can be neglected. Municipal financial equalisations cannot iron out all deficiencies. The fewer the deficits that need to be compensated for from preceding stages, the better a municipal financial equalisation system can fulfil its real purpose: To ensure that each individual village, town, city and rural district receives adequate funding to perform its tasks properly.

To achieve this purpose, the German federal states use methods that are often highly differentiated and that have been developed over decades to determine the financial capacity and financial requirements of each municipality. There is also an unparalleled variety of mechanisms that are used to make the actual adjustments between financial capacity and financial requirements. This study provides in-depth insight into the methods used and thus acts as a toolbox. However, the study is not designed as a recommendation to use the various options presented as a role model in the international context. Often, this highly specialised complexity is more of a burden than a political success for the German stakeholders themselves.

For a municipal financial equalisation system to fulfil its essential role as the conclusion and culmination of municipal financing that corrects the most flagrant deficiencies, it needs **only a few basic decisions and attributes**.

Each municipal financing process should be **prescribed by law**, be based on clear principles of the performance by municipalities of their roles and their financing, and thus be open to **judicial review**. The higher the **quality of the financial data used**, the fewer disputes there will be and the greater the acceptance of outcomes. When measuring the financial capacity of a municipality, its **own efforts to mobilise income** should not be penalised. This would punish rather than foster autonomy in financial policy issues. In Germany, differences in the collection rates for property tax and local business tax are discounted in the municipal financial equalisation system. The **number of inhabitants** must be used as a key yardstick for municipal needs, and the **tasks of central locations** must be recognised in larger municipalities. Depending on the municipal tasks to be performed, needs indicators for **schoolchildren**, for **municipal spaces** and for **municipal social services** may also be added as future-ready indicators.

These few ingredients can also serve as the **foundation stone for an efficient municipal financial equalisation system that is not too complex**. Germany's experience shows that this can be achieved at policy level if the municipal level has strong representative organs as well as effective **legal protection**. **Municipal associations**, often (but not necessarily) broken down into rural and urban regions, are not only key actors for implementing legal guarantees, they above all act in the policy process proper of designing municipal financial equalisation laws, whether as informal lobbyists who are highly relevant to the system, or as legally recognised consultative organs. Together with the responsible governments and parliaments, the municipal associations are **'good craftspeople'** who are willing and able to use the **'good tools'** offered by the municipal financing system and ensure a successful outcome.

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