

# COOPERATIVE FEDERALISM AND FISCAL FEDERALISM REFORMS IN GERMANY: LESSONS FOR DECENTRALIZED SYSTEMS

André  
W. Heinemann  
Prof. Dr., Faculty  
Business Studies  
& Economics,  
Professorship  
in Federal  
and Regional  
Financial  
Relations,  
University  
of Bremen

## The Starting Point for the current Fiscal Federalism scheme in Germany

After the Second World War, in the second half of the 1940s responsible person begun with the conception of a new form of government for the western part of Germany. Meanwhile, several German states («*Länder*») were founded or re-established. The main goal of the Parliamentary Council («*Parlamentarischer Rat*») was to found a federal system in Western Germany. The Basic Law for the federal Republic of Germany (German Basic Law) become effective on May 23, 1949 (Federal Law Gazette I, p.1). The idea was to implement a system with two levels of political-administrative decision-making and therefore to assign strictly the competences to the federal level («*Bund*») and the level of states («*Länder*») including the level of municipalities.

## Development of German Fiscal Federalism up today

Since 1949, the fiscal federalism system in Germany has evolved into a so-called «Cooperative Federalism» over time (Döring and Schnellenbach 2011: 89 f.). In last six decades, within the German fiscal federalism common competences and shared competences have become more and more of importance. At the end of the development over the long run, the Federation («*Bund*») dominates the expenditure competences substantially and the tax competences nearly completely. Competence shifting from *Laender* to the Bund and increase of scope of influ-

ence of the Bund has led to budgetary dependences of *Laender* as well as the municipalities. Already in the 1920's, Popitz (1927) mentioned on centralization processes in a federal system over the long run. Blankart (1999) has described the trend towards centralization in Germany in comparison to Switzerland and calls the process «insidious centralization» («*schleichende Zentralisierung*»).

But as Döring and Schnellenbach (2001: 84) point out, «not every increase in the share of central government spending (or taxation) relative to total public spending (or tax revenue) reflects a centralization of formerly decentralized competencies.» However, the interdependences of the *Laender* and the Federation within the multilevel system are very strong in Germany. Therefore, Döring and Schnellenbach point out: «The states have very limited exclusive competencies, which are mostly in the area of cultural and education policies, but also in law enforcement. The states are to a very large extent endowed with the task of enforcing federal law; the generic competencies of law enforcement at the central level are very limited. On the other hand, a majority of the *Bundesrat*, the upper chamber of parliament composed of *Länder* delegates, must approve of any federal legislation that in some way affects the *Länder* budgets. The formal constitutional framework itself therefore requires close vertical cooperation within the federal system.» (Döring and Schnellenbach 2011: 89).

ТЕОРІЯ

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### Current Fiscal Equalization Scheme

In Germany, more than 40 types of taxes<sup>1</sup> are existing. This large number of types of taxes has to be assigned on the different level in the multi-level system of Germany. This is difficult according to the provisions and requirements of the German Basic Law and, of course, to the fiscal needs and the development of fiscal needs of numerous public budgets on the different levels of decision-making. The challenge is to ensure sufficient funds for the public budgets to fulfill the assigned tasks and, on the other hand, to guarantee flexibility and autonomy for the political-administrative decision-makers. In this context, in particular a small part of the German Basic Law is emphasized and dominates the discussion on the arrangement and outcomes of the German fiscal equalization scheme. Article 72(2) states that:

«The Federation shall have the right to legislate on matters falling within clauses 4, 7, 11, 13, 15, 19a, 20, 22, 25 and 26 of paragraph (1) of Article 74, if and to the extent that the establishment of equivalent living conditions throughout the federal territory or the maintenance of legal or economic unity renders federal regulation necessary in the national interest.»

This most designated part of the German Basic Law in conjunction with questions on the adequate equalization contents the term «living conditions» which should be equal. But although it still needs «a precise definition of what «equal living conditions» really means» (Seitz 2008: 5), politicians on the federal level and of the federal states have used this term in recent decades to concentrate expenditure and tax legislation power on the federal level which has led to a hardly existent autonomous scope of the *Länder* for levying taxes independently (cf. Blankart 2000). While *Länder* parliaments and governments defend its sovereignty, it has to take

into account that upon approval by the *Länder* the dependency of each *Land* on other *Laender* and the Federation in terms of revenues, federal transfers, fiscal externalities, and budget policies has increased substantially. Against this background, the adherence to the term «equal living conditions» can be the last exit to solve regional problems within the institutional arrangement of Germany using the federal budget.<sup>2</sup> Nevertheless, article 72(2) seems to be over interpreted. «The literature on German constitutional law shows that this cannot be taken as an independent constitutional object, but is only used as an auxiliary rule and is to be understood merely as a limitation against expanding regional inequalities» (Zimmermann 1987: 68).

### The vertical dimension of tax competence assignment in Germany

The vertical tax assignment follows the vertical tasks and expenditures assignment in the German Basic Law. Article 30 (sovereign powers of the *Laender*) clarifies: «Except as otherwise provided or permitted by this Basic Law, the exercise of state powers and the discharge of state functions is a matter for the *Laender*.» This seems to be a very strong position for the *Laender* within the federal system. Actually, the German Basic Law means «exercise» what is important for the relationship between the Federation and the level of federal states in Germany. The Federal Ministry of Finance (2009: 7) formulated: «In the practice of government, legislative powers have mostly gravitated to the Federation overall. This is because the Federation has concurrent legislative powers in many areas and has made use of them. Over the years, the federal legislature – predominantly with the agreement of the *Laender* or at their request – has exercised its right to legislate on a wide variety of fundamental matters to preserve legal and economic unity in the national interest and equivalent living conditions throughout the country.»

<sup>1</sup> This number includes several special forms of taxes. For instance, the wage tax and the final withholding tax are special forms of the German income tax.

<sup>2</sup> In an expert opinion, Kersten, Neu and Vogel (2015) plead for «Regional Public Services» as a joint task (Federation/*Laender*) to fund *Laender* tasks by the federal budget.

While Article 70 of the German Basic Law divides the tasks competences of the federation and the *Laender* generally, Article 71 describes the area where the Federation has exclusive legislative power («*ausschließliche Gesetzgebung*») and Article 72 outlines the area of the concurrent legislative power («*konkurrierende Gesetzgebung*»). Articles 73 and 74 are the catalogues of tasks for the exclusive and concurrent legislative power.

After that, Article 104a (1) underlines the «principle of exercise casualty». That means that the level which is responsible for exercising a task bears the cost from its own revenue. Note that there is a difference between legislation and exercise. Thus, the Federation can change sublevel tasks by legislation power that impacts the financial ability to act of sublevel budgets. For instance, the area of social legislation is subject to the Federation and induces expenditure burden to the *Laender* and municipalities which has to bear the expenditure. Note that the *Laender* as a whole are embedded in the legislation process via the *Bundesrat*, but one single Land cannot prevent restrictions of budget autonomy caused by federal legislation (Wieland, 2012: 18). Bearing the cost of public tasks follows the administrative responsibility of each jurisdiction based by the general task assignment of the German Basic Law.

This would not be a problem in general if two requirements are satisfied. First, according the objectives of «administrative federalism» sublevel jurisdictions should be able specify expenditure caused by federal legislation. This leads to cost efficiency and an economical use of resources. Second, defining the level of expenditure requires expenditure and revenue autonomy for an efficient public provision of publicly provided goods and services. Without revenue autonomy, political-administrative decision-makers must substitute expenditure in the case of increasing expenditures in one selected field and

a given budget. This can be inefficient if publicly provided goods are valued higher than private goods and the underprovision of publicly provided goods takes place because of the impossibility to transform private goods into publicly provided goods. Against this background, taxation is part of instruments to transform private goods into publicly provided goods and to transform back.<sup>3</sup>

Unfortunately, the sublevel of German *Laender* is faced by given levels of expenditure caused by federal law and the *Laender* have hardly autonomous tax competences to adjust their budgets in terms of efficiency of cost and provision. The expenditure side in Germany features a high degree of centralized legislation power. This is accompanied by an arrangement of fiscal responsibilities where the largest taxes are shared. As Figure 1 shows, currently the vertical tax assignment is dominated by joint taxes (Income tax, Corporation tax and Value added tax (VAT) (including Import VAT)). Almost 72 percent of total tax revenue (2014: €643.7 billion) is collected by joint taxes in Germany. The legislation on joint taxes takes place under the system of shared competences. Therefore, *Bundestag* and *Bundesrat* will be needed for changes to enter into force.

It must be clear that interests of one individual *Land* play no role in the common tax pool system. The need to reduce regional tax burden or to set higher taxes to collect more revenue because of citizens' wishes and needs cannot be satisfied by one individual government, but just by a majority decision in *Bundestag* and *Bundesrat*. Thereby, the participation rates on income and corporation tax for any level are defined by German Basic Law (Article 106(3), sentence 2) which can only be changed by majority votes in *Bundestag* and *Bundesrat* to change the Basic Law. For example, if one level needs a rise in income taxation to fund level-specific tasks, it could be changed the tariff of the income tax commonly to rise income tax revenue with the consequence that

<sup>3</sup> For instance, tax cuts imply adjustment to individuals' decision over the balance between private and publicly provided goods which are both determine individuals' and finally social welfare.

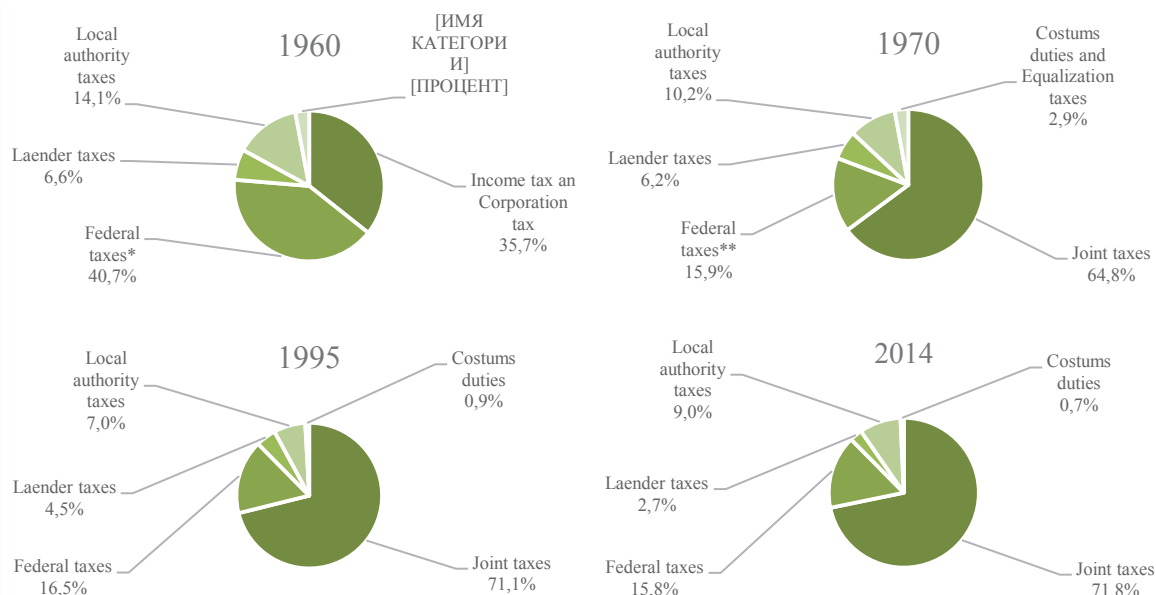


Figure 1. Vertical allocation of tax revenue in Germany

Source: Federal Ministry of Finance (2015), *Financial report 2016*; tab. 11, Own calculation; Own illustration.

\* Incl. VAT.

\*\* Excl. Customs duties.

Special taxes in 1960: Property levy, Mortgage profits levy, Credit profits levy, Coal duty.

according to the constitutionally anchored tax shares other levels collect higher revenue as well. Perhaps, these levels doesn't need higher tax revenue. This vertical tax assignment problem is one of the most crucial problems within the fiscal equalization scheme in Germany. The «flexible element of the fiscal constitution» is the vertical allocation of the VAT (Article 106(3), sentence 3 and 4). The German Basic Law requests Federation and an equal claim against current revenues for the Federation and for the Laender to cover their necessary expenditures. Though no one can define finally what expenditures are «necessary»<sup>4</sup>, the vertical allocation of VAT is the flexible equalization element between the Federation and the level of Laender and therefore subject to the Fiscal Equalization Act (Article 1) that can be changed by simple majorities in *Bundestag* and *Bundesrat*. However, the final approval of the Federation is needed in the case of higher revenue

required for the Laender.

The constitutionally assignment of the tax revenue under the system of separate apportionment allocates proceeds from Federal taxes to the Federation (article 106 paragraph 1), proceeds from Laender taxes<sup>5</sup> (article 106 paragraph 2) to the Laender and proceeds from Local authority taxes (article 106 paragraph 6) to the municipalities. Since 2006 the Laender are empowered to determine the rate of the Real estate transfer tax autonomously. Apart from that, the so-called Laender taxes have no non-fiscal objective because of lacking tax autonomy and the amount (2014: €17.6 billion, 2.7 percent of total tax revenue) is quite small. Surprisingly, the municipalities in Germany are authorized to establish «the rates at which taxes on real property and trades are levied, within the framework of the laws» (article 106 paragraph 6 of the German Basic Law). The Local real property tax (2014: €12.7 billion;

<sup>4</sup> In the political debate, necessary expenditure are those which are fixed in the public budget. The explanation is simple: If they are not necessary, they would not be fixed in the public budget.

<sup>5</sup> Laender taxes in Germany: Beer duty, Betting and lottery tax, Fire protection tax, Inheritance and gift tax, Real property transfer tax.



Class A and B) and the Trade tax (2014: €43.8 billion) are important local taxes and the Trade tax is also important for all businesses that operate in Germany because the Trade tax is levied on business profits. While Pitlik, Schmid and Strotmann (2001) mention that the large share of the joint tax system is an obstacle to competitive federalism in Germany, they obviously neglect the intensive tax competition among municipalities in Germany on Trade tax rates (Janeba and Osterloh 2013; Hauptmeier, Mittermaier and Rincke 2012). And what's more, The German Basic Law (Article 106(5)) even allows by a federal law that municipalities may establish supplementary or reduced rates with respect to their share of the income tax which shall accrue to the municipalities. In other words, municipalities in Germany have more taxation power to determine their revenue side than the *Laender* which have the status of state.

However, also the system of separate apportionment is dominated by the Federation. Tax laws ruling Federal taxes are legislated by Federation and tax laws ruling *Lander* taxes (tax bases, tax rates) are legislated by Federation and *Laender* explicit commonly. In other words, without the approval of the Federation, even *Laender* taxes cannot be changed. The dominance of the Joint tax system in conjunction with the centralized legislation on *Laender* taxes in Germany have led to a high degree of fiscal dependence of the *Laender* on the Federation.

#### **The horizontal allocation of tax revenue among *Laender***

The *Laender* taxes are allocated to that *Land* where tax revenue is collected by local tax offices as local Land authorities (article 107(1), sentence 1 of the German Basic Law). While this procedure is unproblematic, the distribution the proceeds of joint taxes is an economic and administrative-bureaucratic challenge. Following the principle of «Local Revenue» («*örtliches Aufkommen*») in Article 107(1), the distribution of the *Laender's* share of joint taxes to 16 *Laender* is more

complicated. The German Basic Law provides that the local revenue from corporation and wage taxes has to be allotted according principles which are regulated by a federal law requiring the consent of the Bundesrat (Article 107(1), sentence 2). The politicians have decided for the principle «residency» (wage tax) and the principle «place of local business» (corporation tax). Wage tax revenue which are collected at the place of employment are accrued to the place of residence of the wage-earner. This distribution follows the logic that a wage tax should burden the wage-earner. Therefore, the wage-earner can only bear the tax at the place of residence and the revenue should be distributed accordingly. With respect to the discussion on institutional congruency it seems to be justified if voters decide on publicly provided goods and know that they must bear the cost of their decision in terms of own tax revenue.

Firms which are burdened by corporation tax pay the tax at the location of their headquarter (Article 20(1) of the German Fiscal Code («*Abgabenordnung*»). The revenue shall be allotted to the place of the business following the logic that business-related taxes should be collected at the place of local value added.

A more controversial discussed issue is the horizontal allocation of the *Laender's* share of VAT. While the VAT plays a crucial role within the vertical allocation of tax revenue, the VAT plays also a distinct role within the horizontal allocation of tax revenue to the *Laender*. In principle, the VAT is allocated according to the *Laender* population shares (Article 107(1), sentence 4 of the German Basic Law). This, of course, already implies an indirect redistribution if the result of the per capita distribution differs from the per capita consumption. In reality, a uniform consumer behavior in per capita terms across the regions cannot be assumed. A maximum of 25 percent of the *Laender's* share can be distributed according to the *Laender* that are faced with revenue-generating capacity (*Laender* shares of revenue of income tax and corporation tax; *Laender* taxes;

excluding local authority taxes) below average revenue-generating capacity in per capita terms. Thus, tax revenue weak *Laender* receive a top up to bring weak *Laender's* revenue-generating capacity closer to the average revenue-generating capacity. Note, this step is carried out before actual fiscal equalization takes place. On the one hand, the Federal Constitutional Court qualifies the apportionment of the *Laender* share of VAT as «allocation of own financial resources» (BVerfGE 72, 330 (385)). On the other hand, obviously from an economic point of view the VAT revenue distribution and in particular the grants of supplementary shares («*Umsatzsteuer-Ergänzungszuweisungen*») (up to 25 percent of total *Laender* share of VAT) is a preliminary equalization system before horizontal equalization and therefore a hidden equalization step which conceals the actual equalization volume in Germany.

### Fiscal equalization

#### Equalization among *Laender*

In 1950, Germany has introduced the first horizontal equalization among the German *Laender*. The purpose is to ensure a reasonable equalization of the disparate financial capacities of the *Laender* (Article 107(2), sentence 1 of the German Basic Law). Therefore, the «real» financial capacity for each Land is measured by a capacity index which includes for any individual Land its *Laender* taxes, Land share of joint taxes, part of the revenue from Local trade tax to the Land and the Motor vehicle tax compensation amount<sup>6</sup> (Article 7(1) of the Financial Equalization Act) and 64 percent of the relevant municipal tax revenue (municipal shares of income tax revenue (including the Final withholding tax on interest and capital gains), municipal VAT revenue

and standardized amounts of Local real property tax and Local trade tax (Article 8(1) of the Financial Equalization Act). The financial capacity index is a modified indicator and reports the real financial power of a Land.

The equalization index for one *Land* is generated by adding up the financial need of a land a) on the level of the *Land* and b) of the level of its municipalities. Therefore, for each level the total sum of *Laender* financial capacity is divided by the population and afterwards multiplied with the population<sup>7</sup> of the individual *Land*. The result is an indicator of the «real» financial need.

The last step is to generate a ratio of financial capacity index and equalization index for each *Land*, the *Relative Financial Capacity Index (RFCI)*. In the case of shortfall ( $RFCI < 1$ ), a land receives contributions from the Fiscal Equalization scheme. In the case of surplus ( $RFCI > 1$ ), a Land has to contribute to the equalization system. The contributions and grants respectively are calculated based on a linear-progressive tariff (Article 10 of the Financial Equalization Act). In fact, because of grants each financially weak *Land* raise in financial capacity per capita to at least 73.4 percent<sup>8</sup> of the *RFCI*. In reality, no financially weak area *Land* reaches less than 95 percent and no financially weak city state (Berlin and Free Hanseatic City of Bremen) reaches less than 91 percent.

### The supplementary federal grants system

At a last step within the federal fiscal equalization scheme, from the federal budget certain grants are transferred to several German *Laender* which are still fiscal weak after transferring grants from fiscally strong *Laender* to fiscally weak *Laender*. The German Ba-

<sup>6</sup> Following the transfer of the motor vehicle tax to the Federation in 2009 that has strengthened the financial dependence of the *Laender* from the Federation because of additive vertical transfer system in the new Article 106b of the German Basic Law.

<sup>7</sup> On this step, the populations are weighted. For generating the equalization index for the level of the *Land*, the populations of the city-states Berlin, Bremen and Hamburg are weighted at 135 percent of the actual figure. For generating the equalization index for the level of municipalities, the populations of the city-states Berlin, Bremen and Hamburg are weighted also at 135 percent and the populations of the area states Mecklenburg-Western Pomerania, Brandenburg and Saxony-Anhalt are weighted at 105 percent, 103 percent and 102 percent of the actual figure.

<sup>8</sup> In the hypothetical case of  $RFCI = 0$ .

sic Law provides in the third sentence of Article 107(2) supplementary grants («*Bundesergänzungszuweisungen*») with different objectives to support fiscally weak *Laender*. These supplementary grants are transfers from the federal budget and therefore federal financial resources to entitled recipients.<sup>9</sup>

First of all, the federal government can transfer *General supplementary federal grants* («*Allgemeine Bundesergänzungszuweisungen*») for covering the general fiscal needs to fiscally weak *Laender* whose equalization index after fiscal equalization among the *Laender* is less than 99.5 percent.<sup>10</sup> Thereby, the fiscal gap to 100.0 percent will be covered to a degree of 77.5 percent. After that, the general financial needs of each financially weak *Land* should be covered. From year to year, with General supplementary federal grants, each financially *Land* reach no less than 97 percent of the average. That result shows the very strong equalization in general funds in Germany.

Additionally, *Supplementary federal grants for special needs* («*Sonderbedarfs-Bundesergänzungszuweisungen*») are provided by the Standards Act (Article 12 in conjunction with Article 11 of the Financial Equalization Act). The Federation pays for disproportionally high costs of the political-administrative system in small *Laender* (€0.5 billion p.a. for 10 of 16 *Laender* which are politically acknowledged to be small).<sup>11</sup> For structural unemployment, the Federation pays over €0.7 billion p.a. to the eastern German *Laender* (excluding Berlin). Finally, for cost of the German partition period until 1989 the Federation transfers financial resources to the eastern German *Laender* (including Berlin) to support structural adjustment and improvement of infrastructure. While the latter type of grants expires

in 2019 definitely (Article 11(3) of the Financial Equalization Act), the first two types of supplementary federal grants are unlimited in general. This is against the requirement of time limitation of supplementary federal grants for special needs (Article 12(3), sentence 1 of Standards Act).

#### **Fiscal outcomes of the German federal fiscal equalization scheme**

Due to the strong fiscal equalization the fiscal capacity of the *Laender* (including municipalities), the fiscal capacity of the *Laender* after equalization equals perceptibly.

Figure 2 shows the fiscal capacity (as defined in Article 6 in conjunction with Articles 7 and 8 of the Financial Equalization Act) in per capita (unweighted) terms before horizontal equalization, ranging from €5,088 in the Free and Hanseatic City of Hamburg to €3,240 in Mecklenburg-Western Pomerania. If ones take into account that higher tax revenues in agglomerations are expected, the range between Bavaria (€4.338) and Mecklenburg-Western Pomerania is also remarkable. In other words, Bavaria is up to 34 percent financially stronger than Mecklenburg-Western Pomerania before equalization.

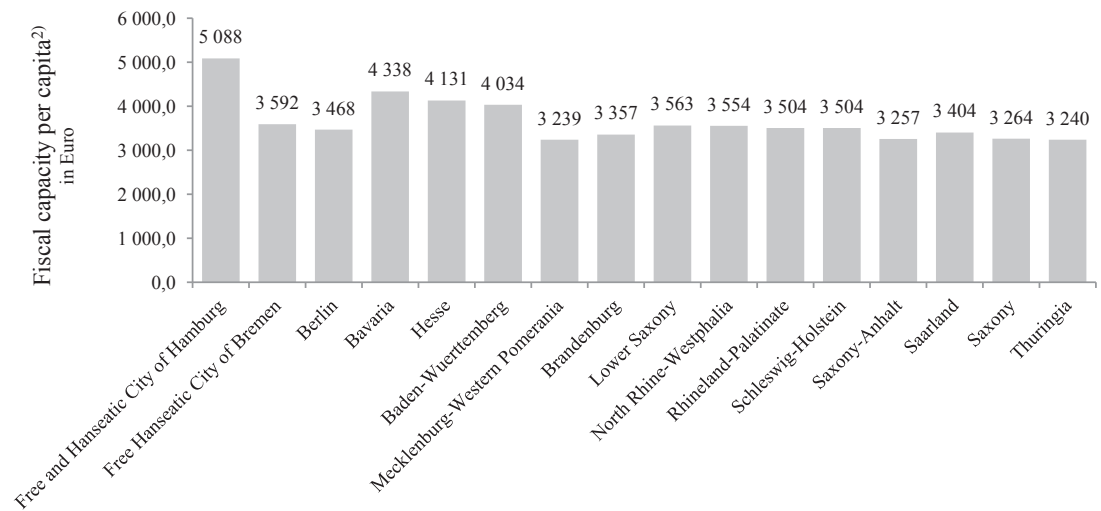
After horizontal financial equalization and General supplementary federal grants, the financial capacity of Bavaria differs about 8 percent from the financial capacity per capita of Thuringia, the *Land* with the lowest financial capacity after equalization (Figure 3).

The equalization transfers and the degree of equalization or the difference in financial capacity after equalization have to be justified. The justification required depends on the balance between responsibility and autonomy of jurisdictions on the one

<sup>9</sup> Please note that the concrete rules need to be negotiated between the German Parliament («*Deutscher Bundestag*») as the representation of the German population on the federal level and the Federal Council of Germany («*Bundesrat*») as the representation of the German *Laender* within the common federal legislation.

<sup>10</sup> Note that a gap larger than 0.5 percentage points to the average fiscal capacity means «fiscal weakness» in Germany.

<sup>11</sup> While the Free and Hanseatic City of Hamburg is financially strong as well as small in a politically sense, this land cannot receive supplementary federal grant for this special need, although there exist above-average political-administrative costs, too.



**Figure 2. Fiscal capacity of the German LAENDER before fiscal equalization<sup>1)</sup> – 2015**

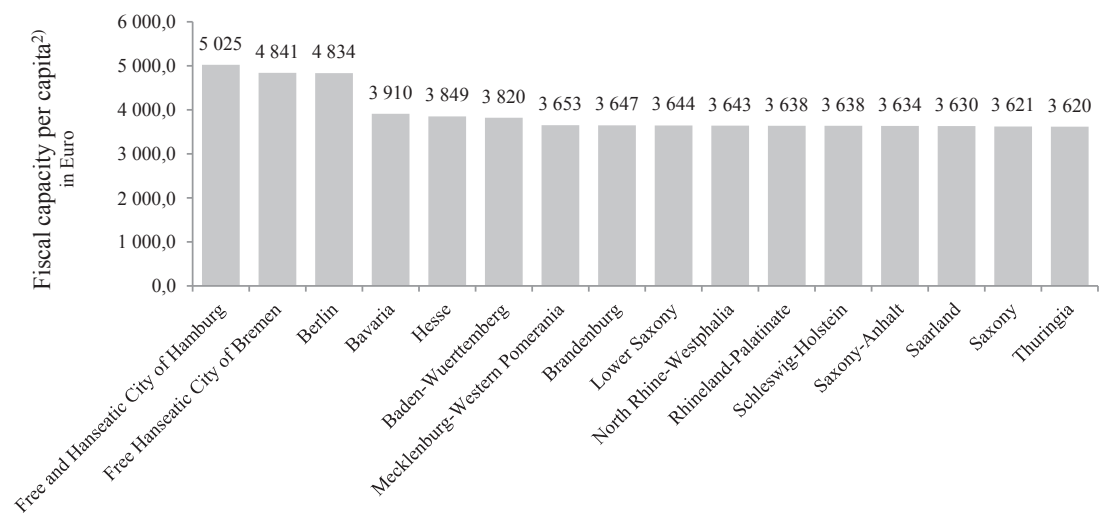
Source: Federal Ministry of Finance (2016), provisional fiscal equalization settlement for the year 2015; Own illustration.

1) After vertical and horizontal revenue allocation including distribution of the *Laender* share of Vat revenue.

2) Unweighted, real population.

1) Після вертикальної та горизонтальної алокації, включаючи розподіл частки надходжень ПДВ федеральних земель.

2) Незважена, реальна кількість населення.



**Figure 3. Fiscal capacity of the German LAENDER after fiscal equalization<sup>1)</sup> – 2015**

Source: Federal Ministry of Finance (2016), provisional fiscal equalization settlement for the year 2015; Own illustration.

1) After fiscal equalization and vertical transfer of general supplementary federal grants.

2) Unweighted, real population.

1) Після вертикальної та горизонтальної алокації, включаючи розподіл частки надходжень ПДВ федеральних земель.

2) Незважена, реальна кількість населення.



hand and economical needs to for vertical and horizontal transfers to solve economic problems, e.g. internalization of spill-over effects or funding tasks determined by political-administrative decision-makers on higher level. While the «traditional» fiscal federalism theory rejects the concept of joint tasks and shared competences, alternative concepts of fiscal federalism discuss common welfare function among the levels (cf. Tresch, 2008: 435 ff.).

### Development of the horizontal equalization volume

The volume of the horizontal equalization is often subject of criticism. In particular, fiscally strong *Laender* deplore a) the volume and b) the development of the volume. From this is deduced a reform of the fiscal equalization scheme and in particular a reduction of equalization contributions. As we can see in Figure 4, the volume of the horizontal fiscal equalization among *Laender* is not constant, amounting €9.6 billion in 2015. In 1995, the first year after the integration of the eastern German federal states, the volume of the horizontal fiscal equalization was €5.7 billion. Indeed, this can be interpreted as a rise in volume of the German fiscal equalization scheme. However, we should not forget some important aspects. Germany is one of the most high-

ly developed industrialized countries in the world. Therefore, we can expect increasing tax revenue over time. In other words, in normal times Germany moves from one historically high level of tax revenue to another historically high level. If this is not surprisingly, no one can be surprised on increasing transfer volumes which are based on total tax revenue. Due to this, more interesting is the line in figure 4 that shows the equalization volume's share of the total fiscal capacity. There was a downward development from 2000 (4.14 percent) to 2011 (2.90 percent). Since we can observe a rather constant development (2014: 3.13 percent).

According to that, the volume (approximately 0.3 percent of Germany's GDP) should not be an important problem of the German Financial equalization scheme. However, economic research analyze several deficits and sources of inefficiency.

### The Reform concept of the State Premiers of the *Laender*

On December 3, 2015, the State Premiers of the German *Laender* have decided unanimously during the conference of State Premiers on the general framework of a new scheme for the fiscal relationships between the *Bund* and the *Laender* (vertical dimension) and among the *Laender* (horizontal dimension).

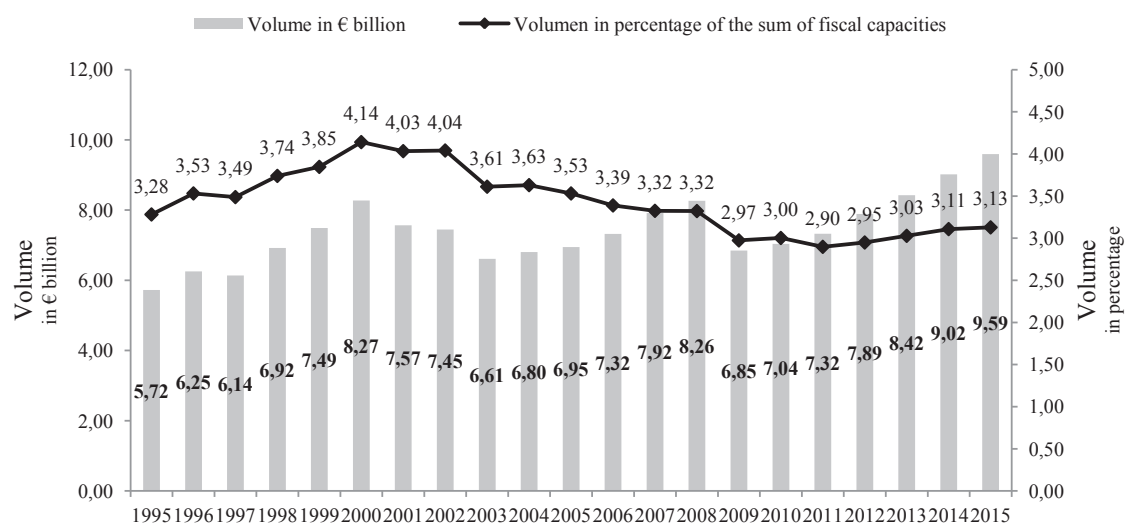


Figure 4. Volume of the horizontal fiscal equalization among LAENDER – 1995 to 2015

Source: Federal Ministry of Finance, Federal Statistical Office; Own calculations; Own illustration.

**Basic points  
of the reform proposal:**

- Abolition of the horizontal fiscal equalization among the *Laender*.
- Fiscal equalization of fiscal capacity differences among the *Laender* within the context apportionment of VAT revenue between the Federation and the *Laender*.
- Shifting of 4 billion Euros within the context of the vertical VAT revenue allocation from the federation to the *Laender*.
- Modification of current regulations
  - Municipal tax revenue in an individual Land will be set at 75 % (current: 64 %) of
    - the municipal shares of income tax revenue (including the final withholding tax on interest and capital gains),
    - the municipal shares of VAT revenue
    - and 75 % of the income from non-personal taxes (Local real property tax and Local trade tax; using multipliers that are standardized for the whole of the country).
  - Reduction of the Extraction levy under mining law to 33 % (current: 100 %)
- Modification of General supplementary federal grant
  - Increase up to 7.1 billion euros (2015: 3.8 billion euros)
- Modification of Supplementary federal grants for special needs
  - Increase amount (11 million euros p.a.) for Brandenburg (without economic justification)
- Implementation of new Supplementary federal grants for special needs
  - «Research support»; appr. 181 million euros p.a.
  - «Shortfall in fiscal capacity of municipalities»; appr. 1.5 billion euros p.a.
  - Supplementary federal grants for budget consolidation in Bremen and Saarland;
  - 800 million euros p.a.)

Figure 5 shows the fiscal effects of the reform proposal. Obviously, the Eastern German *Laender* could calculate

with fiscals gains between 122 euros per capita (Brandenburg) up to 224 euros per capita (Mecklenburg-Western Pomerania) while the proposal holds out the prospect of 84 euros per capita (Saarland) up to 105 euros per capita (Bavaria) for the Western German area *Laender*.

The average fiscal gain will be 109 euros per capita (without the federal restructuring aid for the Free Hanseatic City of Bremen and Saarland).

**Critical assessment of the reform  
proposal and conclusion**

The reform proposal would abolish the highly criticized horizontal fiscal equalization among the *Laender* and strengthen the vertical relationship between the Federation and the *Laender*.

Horizontal fiscal equalization scheme is a source of federal disputes among *Laender* because of equalization of «own fundings» which cannot be changed by one individual *Land*.

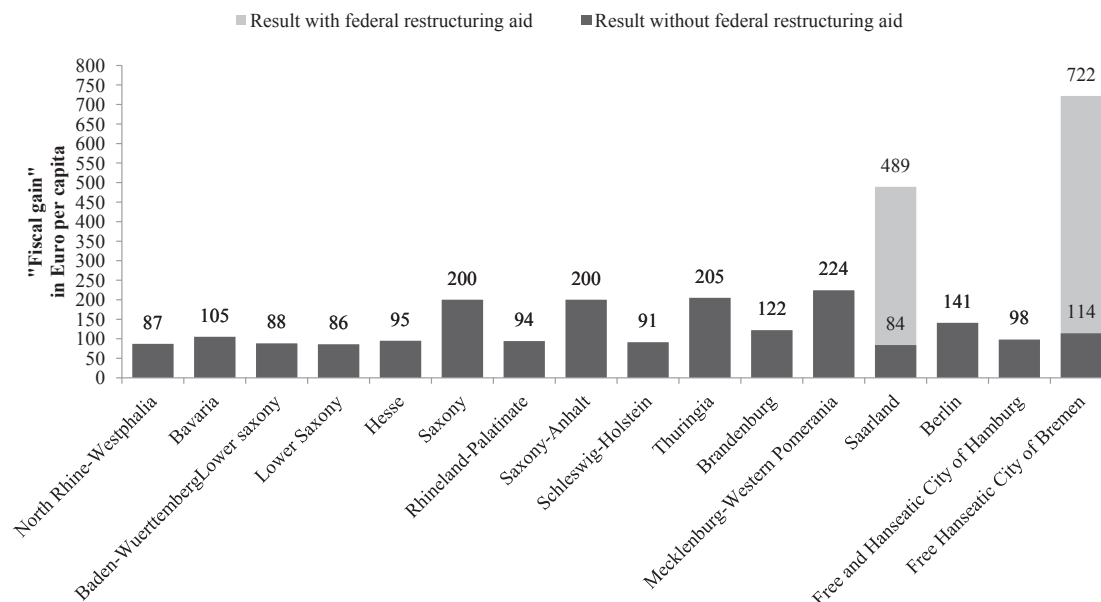
■ Vertical equalization uses federal fundings which are not yet entered by *Laender* budgets.

Federal level is the level for distribution and stabilization tasks within a federal system from an economic point of view. Therefore, the reform proposal is going into the right direction.

Some modifications and new supplementary federal grants are not justifiable and seem to be arbitrary. Obviously, this details are «prices of consent». However, from an institutional-economic point of view economists can interpret this details as economic rewards for a pareto-superior solution where consent of all «contract partners» is needed.

The fiscal and budgetary dependence of the *Laender* from federal decisions will remain. This deficit will be a source for the next fiscal federalism reform process.

It has to take into account that the «Cooperative Federalism» can be justified because of many interdependences between the jurisdictions on several levels of government within the multilevel system. The German fiscal federalism



**Figure 5. Fiscal effects of the reform proposal of the State Premiers**

Source: Annex to Decision of the Conference of the State Premiers of December 3, 2015; Own illustration.

scheme is dominated by the need of negotiations between the Federation and the *Laender*. This is indeed a special type of federal systems. In the face of several reforms of the German Basic Law and the economic and social development of the Federal Republic of Germany up to now, one can say the special type of fiscal federalism was less a problem or significant obstacle for reforms, constitutional adjustments and setting of frameworks for economic development and social welfare in Germany as discussed in many contributions of economic literature. Quite contrary to this, in recent decades the German type of fiscal federalism has proved effective in practice.

Nevertheless, jurisdictions need autonomous scopes of action to be less susceptible to developments in other jurisdictions and to tailor the public provision of public goods with respect to regional preferences. Therefore, an expansion of scopes of action for the German *Laender* is missing in the reform proposal.

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