Local Finances and Municipal Financial Equalisation in Germany

BENEFITS FOR DEVELOPMENT COOPERATION

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Introduction: Our way to municipal money

How do German cities and municipalities get their MONEY?

What are the TASKS of the municipalities?

What is the regional structure they are embedded in?

What EXPENDITURE results from these tasks?

How do the population and tasks develop over time?

What REVENUE do they need for this?

Despite all the complexity and the discussions about tasks, in the end it is often a question of one big and important question in Germany as well: the question of money.
The three levels of Germany
A large and multi-faceted federal state

1 federation

Population: 83 million

Gross Domestic Product (2017)
from € 26,500 per inh. (Mecklenburg-Western Pomerania)
up to € 64,600 per inh. (Hamburg)

from € 1,040 per inh. (Saxony)
up to € 31,800 per inh. (Bremen)

Intermediate Levels
Regional associations, districts, counties....

16 Länder

from 560,000 inhabitants (Bremen)
up to 17.9 million inhabitants (NRW)

from 9 inh. (Hallig Gröde)
up to 3.6 million inh. (Berlin)

approx. 12,000 municipalities
Municipalities in the German multi-level state

1. European Union
   - Single market, agriculture, regional policy, currency, etc.

2. Federal Republic of Germany (Federation)
   - Foreign affairs, social affairs, defence, environment, energy, economy, transport, etc.

3. 16 federal states
   - Administration, education, research, police, justice etc.

4. 284 districts
   - 107 district-free cities
   - Social affairs, education, culture, services of general interest, housing, infrastructure, etc.

5. 11 091 municipalities

Levels | Tasks | Cooperation | Taxes (proprietary) | Taxes (shared) | Financial equalisation | Transfers
--- | --- | --- | --- | --- | --- | ---
1 European Union | Single market, agriculture, regional policy, currency, etc. | | | Customs duties, indirect: Own resources | | |
1 Federal Republic of Germany (Federation) | Foreign affairs, social affairs, defence, environment, energy, economy, transport, etc. | | | Energy and mineral oil tax, tobacco tax, motor vehicle tax, solidarity surcharge, social security contributions | | |
16 federal states | Administration, education, research, police, justice etc. | | | Inheritance tax, real estate transfer tax, minor taxes | | |
284 districts | Social affairs, education, culture, services of general interest, housing, infrastructure, etc. | | | Property tax, trade tax, dog tax, minor taxes | | |
107 district-free cities | | | | | | |
11 091 municipalities | | | | | | |

Indirect: own resources + regional policy

14 municipal fiscal equalisations

Allocation of tasks between federation - Länder - municipalities

**Federation**
- Foreign Service
- National defence
- Social security
- Federal finance administration
- Pan-regional economic development
- Transport
- Climate protection

**Länder**
- Education
- Research and Science
- Municipal supervision and municipal financing
- Culture
- State finance administration
- Local public transport
- Police and Justice
- Regional economic development

**Municipalities**
- Sewage and waste disposal
- Urban land-use planning
- Child and youth welfare
- Museums, sports facilities
- Local schools
- Local transport
- Local water and energy supply
- Street cleaning
- Local social welfare

**Executive**

**Legislature**

**Judicial review**
### Principles of the municipal system and its finances

Municipalities are assigned to the state level of the Länder. They have the right to regulate all matters of the local community on their own responsibility. The following principles must be observed:

<table>
<thead>
<tr>
<th>Principle</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Principle of subsidiarity</td>
<td>Decisions as decentralized as possible. A higher level only intervenes when uniform regulation is clearly advantageous.</td>
</tr>
<tr>
<td>Principle of connectedness</td>
<td>&quot;He who orders pays.&quot; Centralized legislation requires centralized cost assumption.</td>
</tr>
<tr>
<td>Principle of equivalence</td>
<td>Correspondence between the revenue generated and the services provided on the spot</td>
</tr>
<tr>
<td>Principle of solidarity</td>
<td>Redistribution from financially strong to weak municipalities</td>
</tr>
<tr>
<td>Equivalence of living conditions</td>
<td>Justifies centrally organised regional compensation</td>
</tr>
<tr>
<td>Loyalty to other members of the federation</td>
<td>All for all (as last resort)</td>
</tr>
</tbody>
</table>

Loyalty to other members of the federation:
Regional planning and municipalities

- **Regional planning**: Determines certain tasks for certain municipalities that others do not have to / must not fulfil.

- **Overall objective**: To achieve equal living conditions in all regions / areas, especially in the area of public services.

- **Responsibilities**: Federation - Länder - planning regions - municipalities → From setting the frame down to minute details.

**Concept of area categories**
- Agglomerations and rural areas

**Concept of central places and axes**
- Upper, middle and basic centres; development axes

**Concept of the regions**
- For balanced functional spaces

**Concept of large-scale priority areas**
- Not in all Länder, e.g. densely populated areas

## Key data for municipal finances 2016-2021

<table>
<thead>
<tr>
<th></th>
<th>2016</th>
<th>2017</th>
<th>2018*</th>
<th>2019*</th>
<th>2020*</th>
<th>2021*</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Expenditure</strong></td>
<td></td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Personnel</td>
<td>57</td>
<td>59</td>
<td>62</td>
<td>65</td>
<td>68</td>
<td>71</td>
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<tr>
<td>Material expenditure</td>
<td>49</td>
<td>50</td>
<td>52</td>
<td>55</td>
<td>57</td>
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</tr>
<tr>
<td>Social benefits</td>
<td>59</td>
<td>59</td>
<td>61</td>
<td>64</td>
<td>67</td>
<td>71</td>
</tr>
<tr>
<td>Interest</td>
<td>3</td>
<td>3</td>
<td>3</td>
<td>3</td>
<td>3</td>
<td>3</td>
</tr>
<tr>
<td>Investments</td>
<td>24</td>
<td>24</td>
<td>26</td>
<td>28</td>
<td>30</td>
<td>32</td>
</tr>
<tr>
<td>Other expenditure</td>
<td>38</td>
<td>40</td>
<td>42</td>
<td>43</td>
<td>46</td>
<td>48</td>
</tr>
<tr>
<td><strong>Revenues</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Taxes</td>
<td>90</td>
<td>96</td>
<td>101</td>
<td>105</td>
<td>112</td>
<td>118</td>
</tr>
<tr>
<td>Fees</td>
<td>19</td>
<td>19</td>
<td>20</td>
<td>20</td>
<td>20</td>
<td>21</td>
</tr>
<tr>
<td>Ongoing grants</td>
<td>87</td>
<td>88</td>
<td>92</td>
<td>96</td>
<td>100</td>
<td>105</td>
</tr>
<tr>
<td>Investment grants</td>
<td>7</td>
<td>7</td>
<td>8</td>
<td>9</td>
<td>11</td>
<td>11</td>
</tr>
<tr>
<td><strong>Balance of financing</strong></td>
<td><strong>6</strong></td>
<td><strong>9</strong></td>
<td><strong>8</strong></td>
<td><strong>5</strong></td>
<td><strong>6</strong></td>
<td><strong>5</strong></td>
</tr>
</tbody>
</table>

*Projektionen.*

Quelle: Deutscher Städtetag (2018)
Taxes, contributions, fees

**Levies**

**Taxes**
- Compulsory levies without consideration (AO)
- Ability-to-pay principle
  - Examples: income tax, sales tax, property tax

**Contributions**
- Financing a specific service
- Payment independent of actual use
  - Examples: health insurance contribution, road construction contribution

**Fees**
- Cost/benefit: service has a certain "price"
- Administrative fees
- User fees
## German taxes and their distribution

<table>
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<th>Tax Category</th>
<th>Federation</th>
<th>Länder</th>
<th>Municipalities</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Community taxes</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Wage and income taxes</td>
<td>117 208</td>
<td>117 208</td>
<td>41 182</td>
</tr>
<tr>
<td>Sales tax</td>
<td>116 513</td>
<td>110 841</td>
<td>7 484</td>
</tr>
<tr>
<td>Corporate income tax + withholding taxes</td>
<td>28 301</td>
<td>28 301</td>
<td></td>
</tr>
<tr>
<td><strong>Federal taxes</strong></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Energy tax</td>
<td></td>
<td>40 882</td>
<td></td>
</tr>
<tr>
<td>Vehicle tax</td>
<td></td>
<td>9 047</td>
<td></td>
</tr>
<tr>
<td>Tobacco tax</td>
<td></td>
<td>14 339</td>
<td></td>
</tr>
<tr>
<td>Electricity tax</td>
<td></td>
<td>6 858</td>
<td></td>
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<tr>
<td>Insurance tax</td>
<td></td>
<td>13 779</td>
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<tr>
<td>Solidarity surcharge</td>
<td></td>
<td>18 327</td>
<td></td>
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<tr>
<td>Other</td>
<td></td>
<td>5 354</td>
<td></td>
</tr>
<tr>
<td><strong>State taxes</strong></td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Real estate transfer tax</td>
<td></td>
<td></td>
<td>14 084</td>
</tr>
<tr>
<td>Inheritance tax</td>
<td></td>
<td></td>
<td>6 813</td>
</tr>
<tr>
<td>Beer tax</td>
<td></td>
<td></td>
<td>655</td>
</tr>
<tr>
<td>Other</td>
<td></td>
<td></td>
<td>2 361</td>
</tr>
<tr>
<td><strong>Municipal taxes</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Property tax</td>
<td></td>
<td></td>
<td>14 202</td>
</tr>
<tr>
<td>Business tax (pseudo community tax)</td>
<td></td>
<td>2 058</td>
<td>46 795</td>
</tr>
<tr>
<td>Other</td>
<td></td>
<td>7 020</td>
<td>1 710</td>
</tr>
<tr>
<td><strong>Level totals</strong></td>
<td>372 666</td>
<td>287 283</td>
<td>111 373</td>
</tr>
</tbody>
</table>
The right to determine the local tax rate on company profits ("business tax") in each municipality has a long tradition, but is economically very controversial because of tax competition.

The map shows how strongly the state finances also affect the collection rates:
- Strong municipalities do not need high rates (BY, BW)
- Economically weak municipalities do not allow high rates (MV, BB, ST...)
- Underfunding of municipalities forces high rates (NW)
The right to determine the amount of local land and property tax in each municipality has a long tradition and, unlike business tax, is not economically controversial.

The map shows how strongly the state finances also affect the collection rates:
- Strong municipalities do not need high rates (BY, BW)
- Economically weak municipalities do not allow high rates (MV, BB, ST...)
- Underfunding of municipalities forces high rates (NW)
- Financial equalization laws of the Länder have additional influence (hetero-/homogeneous)
Vertical municipal financial equalisations

- Only a few municipalities finance themselves solely from levies – i.e. are "abundant".
- By far the majority of municipalities are integrated into the tax-revenue scheme of their federal state ("tax association"). The funds flow into the municipal financial equalisation schemes (KFA).
- The KFA are designed as **vertical financial equalisation tools with horizontal effect**.

- Models of **vertical resource allocation**:

<table>
<thead>
<tr>
<th>Model</th>
<th>Description</th>
<th>States</th>
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<td>Pure association quota model</td>
<td>Fixed percentage of federal states’ tax revenues</td>
<td>Baden-Württemberg, Bavaria, Lower Saxony, NRW, Saarland</td>
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<tr>
<td>Association quota model with symmetry requirement</td>
<td>Symmetrical state and municipal finances (revenue/expenditure)</td>
<td>Brandenburg, Schleswig-Holstein</td>
</tr>
<tr>
<td>Uniformity principle</td>
<td>Relative uniformity of state and municipal revenues</td>
<td>Mecklenburg-Western Pomerania, Saxony</td>
</tr>
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<td>Stabilisation model</td>
<td>Association model with economic compensation</td>
<td>Rhineland-Palatinate</td>
</tr>
<tr>
<td>Demand model</td>
<td>Municipal financial requirements on a cost basis</td>
<td>Saxony Anhalt, Thuringia, Hesse</td>
</tr>
</tbody>
</table>
## Structure of municipal financial equalisation schemes

### Allocations to municipalities

<table>
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<th>Within the financial equalisation system (association volume)</th>
<th>Outside the financial equalisation volume</th>
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<td><strong>Key allocations</strong></td>
<td><strong>Earmarked allocations</strong></td>
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<td>Demand-based allocations</td>
<td>Reimbursement for administration of orders and other allocations from the Land</td>
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<td>Forwarded reimbursements from federation or EU</td>
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</table>

### Requirements

- **Subsidiarity**: Exploiting your own revenue potential first.
- **Appropriate determination of needs**: Appropriate standards for determining financial needs and financial strength.
- **No levelling out**: Financial strength sequence not to be changed by equalization.
- **Transparency requirement**: In order to ensure acceptance of the results of equalization, it must be as comprehensible as possible for the municipalities.

### Local financial equalisation in a narrow sense

- Flat-rate **financial requirements** > flat-rate **fiscal capacity** -> key allocations
- Financial requirements are calculated on the basis of independent **indicators**.

Often:
- **Main approach**: number of inhabitants x size of town ("inhabitant scaling")
- **Secondary approaches**: Surface area, pupils, centrality, social charges...
Examples of different financial equalisation systems: Mecklenburg-Western Pomerania
Examples of different financial equalisation systems: North Rhine-Westfalia

- North Rhine-Westfalia
    - zuzgl. d. Kompensationsleistungen aufgrund d. Neuregelung d. Familienleistungsausgleichs
    - abzgl. d. Kompensationsleistungen (USK) für Finanzmehrverbrauchs- u. Ausgleichsleistungen
  - abzgl. der Erhöhungen der Gemeinde- und Kreiskassenbudgets nach Art. 3 KFGG
  - abzgl. der Erhöhungen der Gemeinde- und Kreiskassenbudgets nach § 24 EStG

- Gemeinde § 7 GFG 2018
  - Kreise § 10 GFG 2019
  - Landkreiseverbindungen § 13 GFG 2018

- Zuteilungen zu d. Kosten d. Leistungsausgleichsverwaltung (z.B. Kreisverwaltungen)
  - 2017: 4,0 Mio. €

- Zuteilungen zu d. Kosten d. Leistungsausgleichsverwaltung (z.B. Kreisverwaltungen)
  - 2018: 4.095,373,300 €

- Zuteilungen zu d. Kosten d. Leistungsausgleichsverwaltung (z.B. Kreisverwaltungen)
  - 2019: 4,095,373,300 €

- Zuteilungen zu d. Kosten d. Leistungsausgleichsverwaltung (z.B. Kreisverwaltungen)
  - 2020: 4,095,373,300 €
Review and evaluation

- Municipal finances in Germany are a **constant point of contention between the** municipalities and the Länder; now also involving the federation.
- The **numerous interests** and the **complexity of** the 13 different municipal fiscal equalisation scheme create a **network of actors and instruments**, also in the review and evaluation of fiscal equalisation laws and their financial resources.
Success factors 1 and 2: Goals and integrated laws

What has proven its worth? Everyone must be able to support the federal narrative. And federal finances should be handled in one place.

1. Equal living conditions: Semi-specific targets...

- ... as narrative strengthen the integrative power of a equalisation scheme, because they help to bridge latent contradictions between equalisation and autonomy.
- It offers means of identification to all sides, but creates a corridor of commitment. This creates an understanding the boundaries between autonomy on the one hand and equalisation on the other hand.

2. Integrated legislation for municipal finances...

- ensures that the overall effects of adjustments are always taken into account. All central financing issues are regulated in a (respective) Financial Equalisation Act.
Success factors 3 and 4:
Data standards and central balancing

What has proven its worth? With common data standards, everyone is talking about the same thing. Even if it goes against the principle of transparency, a little horizontal balancing by the central state makes it much easier for everyone to reach a consensus.

3. Common data and accounting standards...
   • ...significantly reduce the number of potentially contentious issues in negotiations, because you do not have to discuss facts, but can trust them.

4. Compensation by the central (state) level...
   • ...creates the political conditions for an indirect balance between financially strong and financially weak partners in difficult starting conditions.
Success factors 5 and 6:
Uniform taxation and subsidiarity

What has proven its worth? Uniform taxes reduce conflicts. Subsidiarity must be lived.

5. Homogeneous taxes...

- ...facilitate the recording of financial strength, which is decisive for financial equalisation, enormously. Everyone automatically knows both amount and composition of everyone else’s revenue.
- There still is intermunicipal tax competition though, which should be constantly recalibrated (which is not always achieved).

6. Municipalities as spaces to live - living and work - recognised

- Subsidiarity must be lived.
- Powerful municipalities and actors in local politics are needed -> Not always easy as based on voluntary work
We have raised many questions and answered some of them (…partly).

Now we come to your comments and questions!

Continue the dialogue:

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