Reform and Future of Federal Fiscal Relations in Germany

BENEFITS FOR DEVELOPMENT COOPERATION

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The central findings of the upcoming report at a glance

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

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

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

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

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

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

The authors

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