Reform and Future of Federal Fiscal Relations in Germany

BENEFITS FOR DEVELOPMENT COOPERATION

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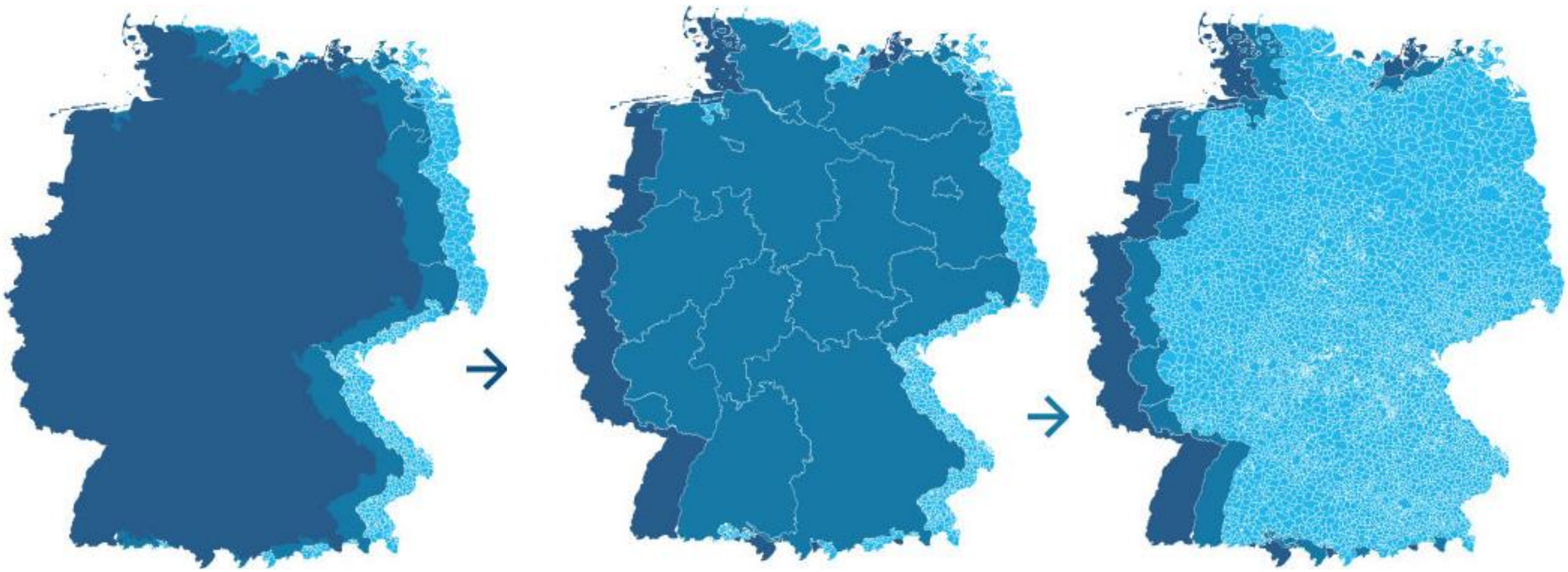
I. FEDERAL GERMANY – SOME BASIC FACTS

Three main levels of Germany

A large and heterogeneous federation



1 Federation	16 States (*Länder*)	ca. 12 000 Local Communities
Pop. 82.7 million	From pop. 550,000 (Bremen) to pop. 17.9 Million (NRW)	From pop. 9 (Hallig Gröde) to pop. 3.5 Million (Berlin)
Gross Domestic Product (2015)	From 25,000 EUR p.c. (Mecklenburg-Vorpommern) to 60,900 EUR p.c. (Hamburg)	
Public Debt (end of 2016)	From 1,300 EUR p.c. (Sachsen) to 32,300 EUR p.c. (Bremen)	

Overview: German fiscal federalism in one slide

Level	Tasks	Cooperation	Taxes (own)	Taxes (shared)	Fiscal Equalization	Transfers
1 European Union	Single market Agriculture, Regional policy, Currency etc.		Customs; Indirect: Own Resources		Indirect: Own Resources + Regional Policies	
1 Federal Level	Foreign, Social, Defence, Energy, Environment, Economic, Transport etc.		Energy, Mineral oil, Tobacco, Suppl. Tax on income, Social Security Contributions	Corporate Income, parts of PIT; Value Added Tax (VAT) , Personal income Tax (PIT)	Federal Fiscal Equalization	
16 States	Administration, Education, Research, Police etc.		Inheritance, Land transfer, Minor Taxes		14 Municipal Equalizations	
284 Rural Districts 107 Urban Districts	Social, Education, Culture, Amenities, Building, Infrastructure etc.	Indirect	Property, Land, Local Business, Dogs, Minor Taxes			
11 091 Municipalities						

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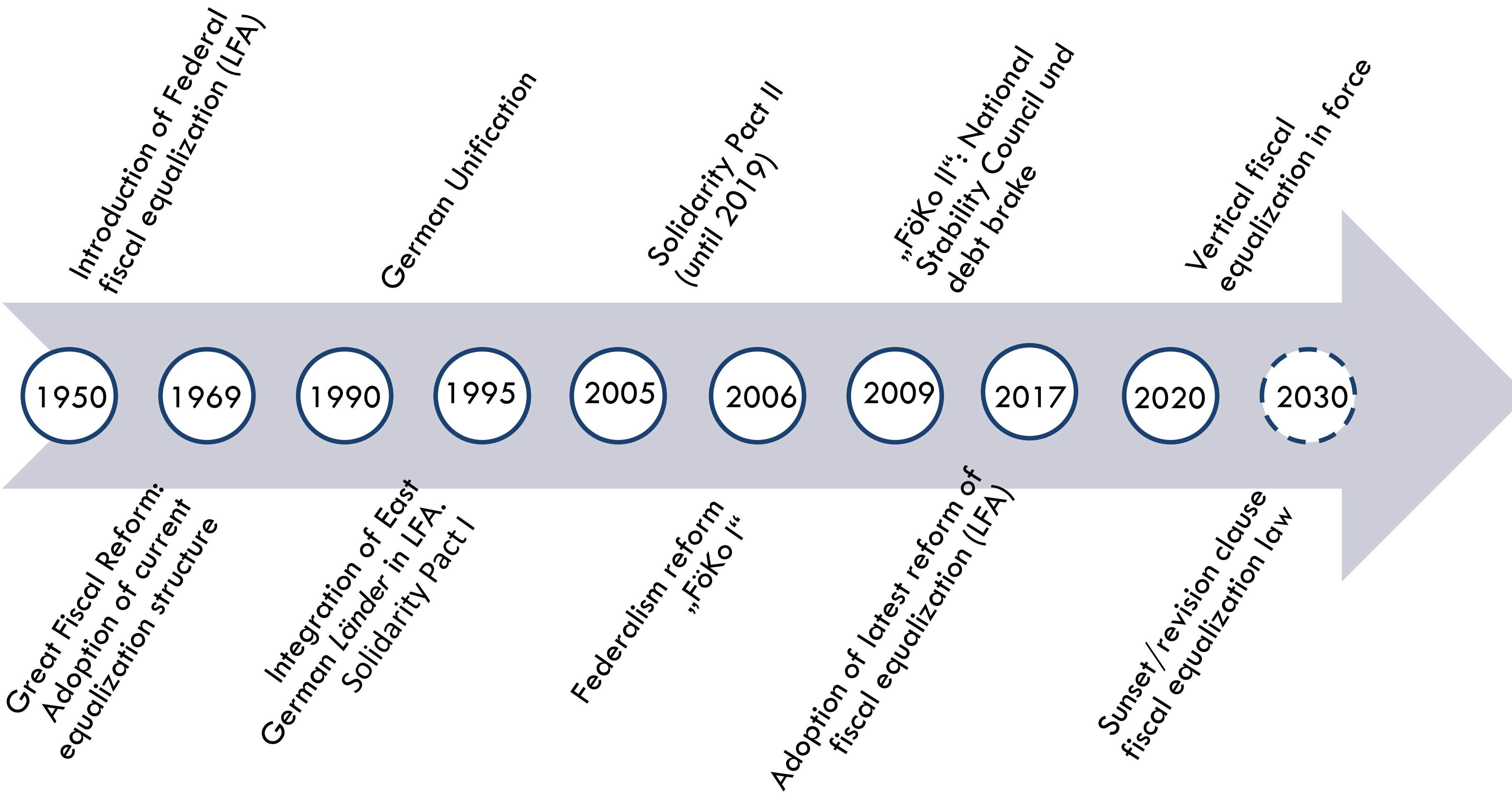
II. FEDERAL FISCAL RELATIONS AND THEIR REFORM IN 2017

Milestones of federal fiscal relations 1950-2030

On the timeline: Important decisions and the introduction of new processes.



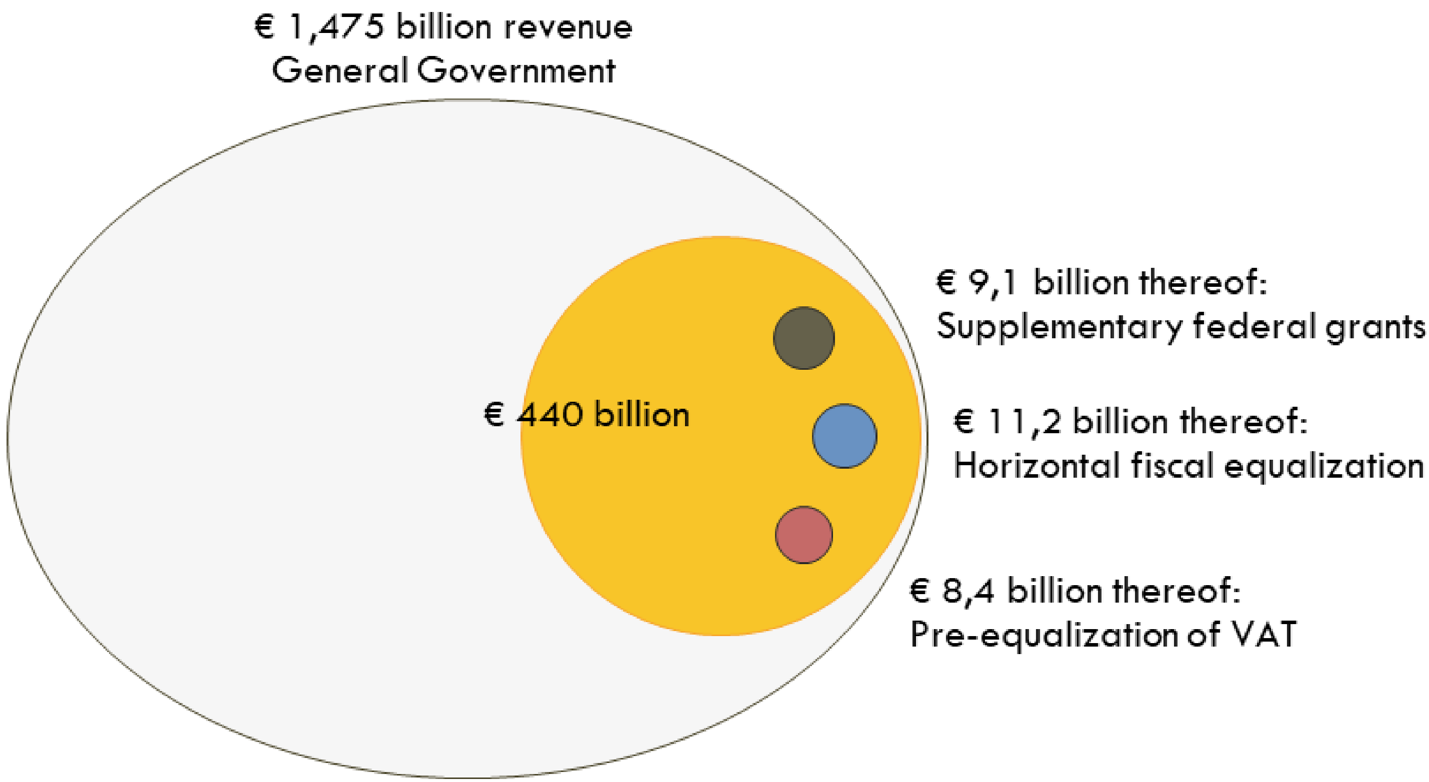
The five steps of the current fiscal equalization

Core functions and elements of the complex, historically grown system of federal finances. In this structure still in force until 2019.

Vertical distribution of separate and joint tax revenues between federal and state level	• Assigning taxes to the levels. • Joint taxes dominate with 72% of total tax revenues.
Horizontal allocation of joint tax shares	• Horizontal assignment of the duly "own" income tax and corporate tax revenues.
Horizontal pre-equalization of value added tax shares	• VAT shares of the *Länder*: Up to 25% according to below average tax capacity; the rest according to population.
Horizontal fiscal equalization	• Comparison of fiscal and standardized fiscal need. Partial equalization of the difference via formula tariff.
Vertical supplementary federal grants	• Complementary replenishment for all financially weak *Länder. Plus* financing of four different special needs.

Small equalization…

Equalizations compared to total revenues (2017)

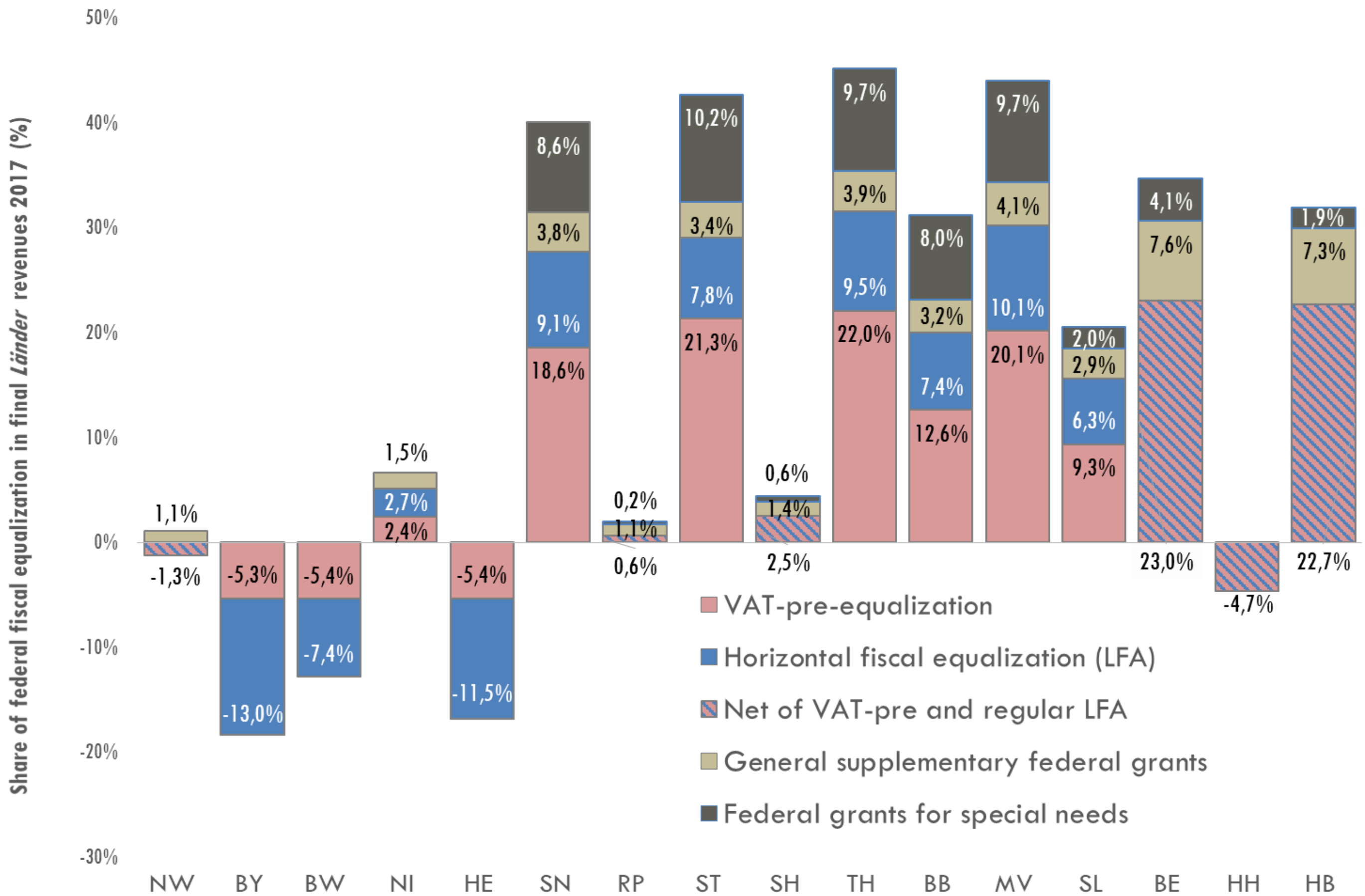


Sources: Own calculations, own figure; Daten BMF, Destatis (VGR)

In view of the small volume of the equalization elements in comparison to the total revenues, it is not yet plain why the federal fiscal equalization system plays such an important role in the financing of the *Länder* and in the public discussion. That changes when one looks at the individual *Länder*… [→ next slide].

…great significance

Share of federal fiscal equalization in final *Länder* revenues 2017 (2017)



Source: Own calculations; own figure; Grunddaten BMF; FAG.

… especially for the East German *Länder* as well as for Berlin, Bremen and the Saarland the equalization accounts for up to 46% of their revenues. The paying *Länder* give up to 18% of their final revenues.

Reform 2017: Motives and objectives

The existing system redistributes very efficiently. Nevertheless – or, from a payer's point of view, *therefore* – it was clear long before the 2017 reform decision that substantial changes were necessary. The reform objectives of the *Länder* heralded tough negotiations.

Motives

The existing system had to be revised by 2020.

- Solidarity Pact II and the equalization law would expire by the end of 2019.
- Two payer countries (Bavaria, Hesse) had filed constitutional complaints against the current equalization law; mainly because of their financial burden.
- Two *Länder* (Bremen, Saarland) were obviously unable to comply with the debt brake from 2020 onwards.

Objectives

of the *Länder* for the reform

- All *Länder* should be able to meet the debt brake from 2020 onwards.
- Not one *Land* should be fiscally orse off after the reform. Thus, a more important role of the federal level was planned from the very beginning.
- The municipal tax capacity should play a larger role in calculating the fiscal capacity of the *Länder* in the LFA.
- The VAT pre-equalization should be abolished as it artificially turns North Rhine-Westphalia into a recipient state.

Reform 2017: Changes from 2020 onwards

- VAT pre-equalization and horizontal equalization no longer apply. Instead, a vertical equalization with horizontal effects is employed directly in the VAT allocation. It is based on similar criteria as the current system.
- The municipal tax capacity now at 75% in the calculation of Länder the fiscal capacity of the *Länder* (instead of 64%). Plus: A new, softened tariff for the horizontally effective compensation calculation.
- The federal level pays € 4 billion net p.a. more; all *Länder* are bettered.
- Consolidation assistance for Saarland and Bremen.
  All countries will be able to comply with the debt brake from 2020 onwards.
- General federal supplementary grants rise.
  Federal grants for special needs partially revised
- The federal government receives additional competences
  (for motorway construction, tax administration, school financing).
- National Stability Council is strengthened in the monitoring of Länder budgets.

Many elements are being reassembled with the reform. But the proven mechanisms in the "engine room" of the federal fiscal equalization are largely retained.

Reform federal fiscal relations - a successful compromise

After intensive negotiations between the *Länder*, the reform was remarkably **unanimous**: At the end of 2015, all 16 *Länder* agreed on a common model of reform.

All 16 *Länder* will be **better off** than in status quo from 2020 onwards. The required additional financing is provided by the federal government.

After **transferring some competencies** to the central level, the federal government - which had been involved in the *Länder* process from the outset - agreed to the common *Länder* model.

The **compromise** has **not yet mastered all the upcoming challenges** for the federal government, the *Länder*, the local authorities and their fiscal relations. (→ See agenda in IV.).

However, the **central financial issues** between the federation and the *Länder,* as well as among the *Länder* are **well resolved until 2030**. Money continues to play an important role, but **the dominance of financial issues somewhat fades**: payers no longer pay "too much"; recipients no longer receive "too little".

III. SUCCESS FACTORS OF COOPERATIVE FISCAL RELATIONS

German federal finances – a good example?

What benefits do German experiences have for development cooperation?

Many elements of the German system of federal finances are closely interlinked. Nevertheless, these factors are not *specifically German.*

Rather, it is important to distinguish the respective structural side of a success factor from - sometimes specifically German - level effects.

By abstracting from the level effects of the indisputably rich country, the structural strengths that can also be exploited internationally are better revealed.

On the following three slides, we present a total of six structural, potentially exemplary success factors.

Success factors 1 & 2: Norms and integrated laws

What has proven effective? One needs a federal narrative that can be supported by all. And all important federal finances should be regulated in one place.

1. Equivalent living conditions: Semi-determined norms….

- … as a federal narrative strengthen the integrative power of an equalization system, because they help to bridge latent contradictions between equalization and independence.
- It offers all sides chances for identification, yet creates a corridor of commitment. This establishes an understanding of the limits of autonomy on the one hand, and of the limits for equalization on the other.

2. Integrated legislation for federal finances…

- … ensures that the total effects of adjustments are always taken into account. Because all central financing issues of fiscal federalism are regulated by one law.

Success factors 3 and 4:
Common data standards and vertical equalization

What has proven effective? With common data standards everyone talks about the same things. And: Even if transparency demands it differently, some vertical equalization with horizontal effects makes it 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 deal with facts, if you can trust in them.

4. Some equalization through the central level…

- …creates the political conditions for a mutually accepted horizontal equalization between financially strong and financially weak partners when starting conditions are demanding.

Success Factors 5 and 6: Uniform taxes and soft law

What has proven effective? Uniform taxes reduce conflicts. Joint committees create strategically important team spirit of the actors.

5. Homogeneous taxes of the *Länder*…

- … make it much easier to capture the fiscal capacity, which is crucial for financial equalization. Everyone automatically knows the revenue of each other as regards amount and composition.
- Tax competition is not a source of political controversy over the "right" degrees of tax and fiscal capacities.

6. Example Stability Council. Common commissions as soft law instruments…

- …ensure the permanent dialogue of finance ministers and related politicians in the federal state by organizing a monitoring of fundamental common decisions.
- Soft law committees are also useful for integrating the local level in political processes of the respective *Land*.

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

The nature of federal compromises

The 2017 reform of federal fiscal relations has overcome important challenges. To a certain degree, **money issues** will thus take a back seat until 2030.

However, **federal compromises** between many partners can not cover many issues at the same time.

So even with the 2017 reform, a number of **questions remain unanswered**.

Now, they are all the more on the federal agenda. In this sense, **after the reform is at the same time before the reform**.

In the final chapter, we name the **five most important challenges** for German fiscal federalism.

Agenda: Connectivity and Demographics

Two open topics are on the agenda, which must be tackled in the federal context.

1. Social benefits and the principle of connectivity

- Numerous social benefits are regulated by the federal legislature, but are implemented and partly financed by the municipalities and the *Länder*. These expenses have been growing very strongly for a long time.
- The federal government provides the federal states with many financial means according to the principle of the principle of connectivity ("who orders, pays."). But the sheer giving of money is not a solution to the mounting governance problems of this intertwined arrangement.
- It becomes necessary to involve the federal government organizationally in the provision of "its own" social benefits, so that responsibilities for finances and results lie in the same hands.

2. Demographic change and domestic migration

- Rural regions suffer above average from demographic change. Here, domestic migration adds to aging.
- Public services of general interest in affected regions are becoming increasingly expensive and difficult to organize due to economies of scale and remnant costs.
- As long as we want to maintain and strengthen the equivalency of living conditions – also in the spirit of the coalition agreement of the new Federal Government – a joint solution in the federal-*Länder* context is needed.

Agenda: Investments, debt management, pensions

Three other open issues are on the agenda that do not necessarily have to be addressed in a federal context. But they are more likely to land there for good.

3. Investive modernization

- Public investment has been neglected for too long in Germany, especially at the local level.
- If investments are to be stepped up under less favorable conditions, a structural solution beyond ad-hoc funding programs is needed.

4. Debt management for bad times

- Interest rates will rise sooner or later and the economy will slow down.
- Here, it is important to prepare the debt management of the *Länder* and municipalities for bad times.

5. Pension and pension costs

- The financing of pensions and health care of civil servants, judges and pensioners will become a major fiscal problem, especially for the West German *Länder*.
- Even if it is not a unique federal problem - without a joint effort of federal and *Länder* governments, no satisfactory solution is conceivable.

Fiscal sustainability and impact-oriented governance

The federal agenda boils down to a dual task: Creating fiscal sustainability and improving impact-oriented policies. This strengthens the Länder and their local communities in the long term.

Germany can accept and master these **great challenges** well. Provided it consistently reverses, i.e.

- Strengthens the s**ustainability of public finances** at all levels and
- 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.**

Closing remark on federalism

Whatever happens, no matter what the challenges the people and their elected representatives face, the very fact that several political levels can take care of it and that they may even compete with one another to offer solutions is a grand democratic added value.

In this sense, federalism always makes sense, always is valuable - no matter where the federal amplitude stands.

Thank you!

Continuing the dialog:

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