The reform of financial relations in the German federal system

German fiscal policymakers face the challenge of reforming the complex system of financial allocation within the various levels of government by 2020. The existing federal financial equalisation system, including the special transfers for the states in eastern Germany, will expire in 2019. On the one hand, the reform must give due consideration to the fact that budgetary autonomy involves the federal states bearing responsibility for their own affairs. On the other hand, the German constitution (Basic Law, or Grundgesetz) prescribes a reasonable equalisation of differences in the financial capacity of the federal states.

The federal states are also obliged to implement the debt brake by 2020; this is designed to stop or prevent excessive borrowing by individual federal states. The existing regulations, which involve soft debt limits and de facto implicit debt guarantees between the different tiers of government, have not proven effective. Some federal states are still facing considerable challenges in achieving a (structurally) balanced budget by 2020 and thereafter.

Given the strict borrowing rules and the principle of individual fiscal responsibility, the obvious thing to do – in addition to the federal states' already increased discretionary scope on the expenditure side – would be to increase their tax autonomy, say, by means of individual limited surcharges and deductions for specific types of tax. In this way, greater consideration could also be given to varying preferences, and awareness of the link between taxes and spending could be strengthened. This could result in government activity becoming more cost-effective and targeted. Various forms of assistance from the German state as a whole are occasionally suggested to make the transition easier for federal states with a very difficult budgetary situation. If such assistance were to be introduced, it should be made conditional on strict implementation of the debt brake. It will ultimately be the task of elected politicians to decide on the desired level of equalisation in the financial equalisation system. In view of the cost differences and the federal states' own incentives to strengthen their financial capacity, it would seem worthwhile to consider reducing the level of equalisation. If the level of equalisation is largely maintained, a central tax administration might help to limit negative incentives in the collection of taxes. In any event, it would appear desirable to put the financial equalisation system on a more transparent and understandable footing.

Basic principles of financial relations in the German federal system

Several levels of government; central and state government have budgetary autonomy

Germany has a federal system in which government tasks are divided between several levels. In this system, central government and the federal states are entitled to decide on their own budgets (Article 109 of the German constitution), whilst also having to adhere to a number of jointly agreed principles. However, the individual federal states can regulate the details of their local authorities' budget management and can even reserve the right to approve budgets.

Different key responsibilities for different levels of government

In terms of budget expenditure, central government's key responsibilities are compulsory social security, labour market policy and defence. The majority of the federal states' expenditure centres around education (including research), internal security, justice and administrative activities (including tax administration). The main expenditure items for local authorities are social benefits (including assistance for young people and childcare for infants), funding for culture, sport and recreation as well as local service provision and waste disposal services (including infrastructure investment).

Financial relations the result of the division of responsibilities, but also of the objective of broadly equal living standards and the principle of common responsibility for the federation

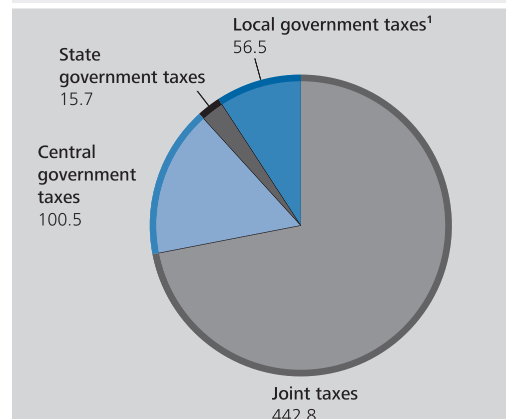
As a rule, the various levels of government are responsible for funding the tasks they perform (Article 104a of the German constitution), even if a different level is responsible for their legislation. In practice, a large degree of legislative power is based with central government, while the federal states can mostly have a coordinated influence via the Bundesrat. The constitutional aim of broadly equal living standards within Germany also plays a role in shaping the federal financial relations, which links in with the distribution of responsibilities. Moreover, following a ruling by Germany's Federal Constitutional Court, the German constitution also contains the principle of common responsibility for the federation, which involves an obligation to provide financial assistance in cases of extreme budgetary hardship and therefore elements of joint liability.

Dominant role of joint taxes, with further adjustment via the revenue shares in turnover tax

Budgets are mainly financed through taxation. The largest contribution is made by joint taxes (turnover, income and corporation tax), which are accrued at several tiers of government. In addition to this, there are taxes at the central government level (most notably special excise taxes and the solidarity surcharge), as well as a number of state-level taxes (especially real estate acquisition tax and inheritance tax) – which, however, yield far less revenue – as well as local government taxes (especially local business tax and real property taxes). Joint taxes are generally distributed between the tiers of government according to fixed quotas, while, pursuant to the German constitution, the distribution of turnover tax is a means of ensuring that central and state governments can cover their necessary expenditures on an adequately balanced basis. It would therefore make sense to correct any problems with the distribution of funds between central and state government via turnover tax distribution. (However, this article does not address issues relating to distribution between these two tiers of government or the debate surrounding the solidarity surcharge, for example.) In addition, there are several types of financial relations between central and state government which

Tax revenue in 2013

€ billion



Source: Federal Statistical Office. **1** Including the share of local business tax transferred to central and state government.
Deutsche Bundesbank

generally either take into consideration specific financial requirements of individual federal states or are intended to at least partially compensate for the effects of federal legislation on the lower tiers of government.[1]

Reform of financial equalisation system will be needed and debt brake for federal states will come into force in 2020

In terms of financial allocation among the federal states, a very complex system of tax revenue sharing and redistribution has developed in order to broadly equalise different financial capacities (horizontal financial equalisation). As might be expected, financially strong and financially weak federal states have very different interests. The Federal Constitutional Court has been called on several times to examine whether individual rules conform to the constitution. As a result of a ruling in 1999, a new version of the Act on Financial Equalisation *(Finanzausgleichsgesetz)* came into force in 2005. However, the new rules, which also cover the development programme for eastern Germany, were adopted by mutual consent after lengthy negotiations and included tapered special supplementary central government grants, are valid only until the end of 2019. From 2020, new rules on financial equalisation will be required. In addition, the national debt brake (Article 109 III of the German constitution), which is designed to prevent debt-financed expenditure almost entirely, will enter into force for the federal states by 2020 at the latest.

Fundamental reforms worth considering

In mid-2014, central and state government finance ministers established a working group to discuss approaches to reforming financial relations in the German federal system. There is a possibility of making more far-reaching changes. Looking at the current regulations in more detail, it can certainly be argued that fundamental reforms are needed.

Budgetary autonomy and scope for design of fiscal policy

Germany's constitution grants central and state governments the right to manage their budgets independently. Tying in with this, they are each responsible for their own finances, meaning that they must make independent decisions on how to fund their different responsibilities. Politicians in particular often complain that there is only a limited amount of scope for discretion in this area. For example, structural factors that state government policy usually has little influence over, such as the number of school-age children, and cost disparities associated with regional price differences play an important role in the level of spending in individual areas of responsibility. Moreover, federal legislation applies in numerous areas, but the federal states influence this to a considerable extent through the Bundesrat. For instance, social benefits are the same throughout Germany, and it appears that the remuneration framework for federal state civil servants and retired civil servants, which was standardised until the 2006 federal structure reform, still has a certain influence on current arrangements. However, scope for adjustment in this area has meanwhile increased significantly.[2] As a rule, state-specific factors can also be taken into account in arrangements for employees on negotiated pay scales. In addition, there is a large amount of discretionary scope, not least regarding the specific way in which tasks are performed and, for example, how personnel are deployed within different areas of responsibility. This can also be managed through working time arrangements, for civil servants at least.

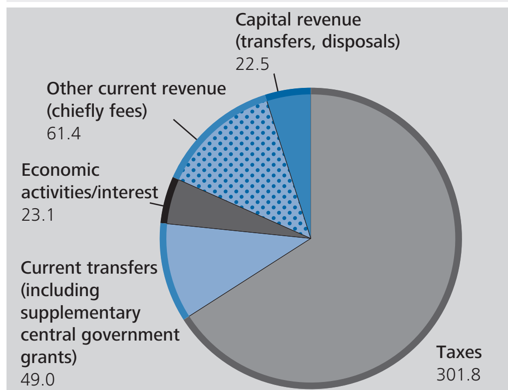
Leeway on the expenditure side for federal states, regardless of federal legislation and specific structural factors

For the state governments, tax revenue and associated transfers are the main items on the revenue side. However, the individual federal

1 These include joint responsibilities such as university construction or acts governing financial benefits, eg student loans and transfers, in which central government bears a certain share of the cost (in 2015, the share is set to rise to 100%). Central government can also grant the federal states financial assistance for investment deemed important from a nationwide perspective.
2 Of course, the provisions of Article 33 of the German constitution on civil servants' entitlement to a salary adequately reflecting the typical scope of responsibilities and to pay increases that are generally in line with overall income growth still set certain boundaries. For example, see the ruling of the Federal Constitutional Court for North Rhine-Westphalia of 1 July 2014.

State and local government revenue in 2013*

€ billion



Source: Federal Statistical Office. * Including off-budget entities.
Deutsche Bundesbank

Despite having limited tax legislation powers, state governments can influence revenue and cost coverage rate of fees

states only have very limited options for adjusting tax legislation in a way that would allow them to cover specific funding needs. Although it has been possible to modify the rate of real estate acquisition tax in individual federal states since the 2006 federal structure reform,[3] changes to other types of tax that accrue to the federal states fully or partially must be implemented for the whole of Germany via federal legislation. Nevertheless, the federal states have an influence over the total revenue due to them from joint, state and municipal taxes. For example, it is connected with the strength of the local economy, whose growth can be influenced through state government policy (eg through spending on infrastructure or education). The state governments are also responsible for tax administration. Although implementation is governed by nationwide rules, both staffing levels, which have an impact on regional tax collection, and the intensity of inspections can be adjusted.[4] The more the state government budgets benefit from regional tax revenue, the greater the incentive to strengthen regional economies and ensure effective tax collection. In addition, the federal states receive non-tax revenue, which is mainly attributable to fees or other service charges and, as a rule, is therefore linked to specific services in return. The upper limit of these fees is determined by the costs that may be included in fee calculations. Regular decisions must ultimately be made as to how far below this limit to remain, thus making other sources of funding necessary (eg for university fees).

Failure to curb debt and obligation to provide emergency assistance

Traditional borrowing limits inadequate

In the past, there was no process to ensure that all federal states (and their local authorities) had sound public finances. There also appeared to be limited public awareness of the general link between different levels of spending and different tax burdens. Insufficient account was therefore taken of the fact that budgetary autonomy entails the federal states bearing responsibility for their own affairs. Gaps between receipts and expenditure have regularly been bridged by net borrowing. Although the constitutions of the individual states set limits on net borrowing in principle, these limits were clearly inadequate. As a rule, they were linked to the volume of investment, which was defined broadly. Depreciation and asset sales were not taken into account. Furthermore, the states were able to significantly exceed these limits by invoking an exemption clause for overcoming a disruption to macroeconomic equilibrium, without any subsequent repayment obligations.

However, borrowing has varied significantly among the federal states. As early as the 1990s,

3 However, this tax only accounted for 3½% of state government tax revenue in 2013, despite several increases over the last few years.
4 The empirical study by C Baretti, B Huber and K Lichtblau (2002, A tax on tax revenue: the incentive effects of equalizing transfers. Evidence from Germany, International Tax and Public Finance 9(6), pp 631-649) indicates that the high revenue absorption rates in the financial equalisation system, which have hardly decreased since the study was published, had a negative impact on the tax revenue of the federal states. This is regarded as a sign that the individual tax authorities of the federal states are not collecting taxes adequately (from the point of view of general government). For example, in its 2012 annual report (pp 51-61), the Court of Auditors of the state of Bavaria reported an increasing shortage of staff in tax administration and associated shortfalls in revenue.

Prospect of emergency assistance undermines budgetary autonomy and reduces incentives to pursue sound budgetary policy

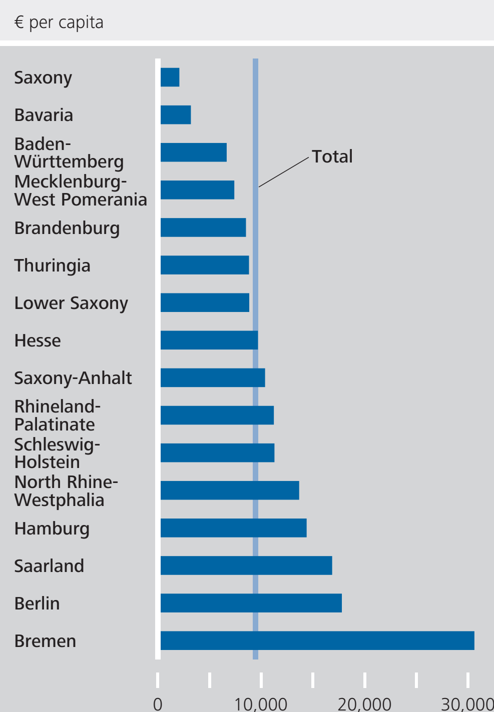
Bremen and Saarland applied to the Federal Constitutional Court to secure emergency assistance from the German state as a whole owing to their very large per capita deficits and debt burdens. Substantial financial assistance was then granted over a decade without any clear improvement in the budgetary situation subsequently. Although in 2006 the Federal Constitutional Court rejected a request for assistance from the heavily-indebted state of Berlin, not least on the grounds that Berlin had not yet exhausted all potential for independent budget relief measures, state governments can still hope for support from the German state as a whole if their financial situation spirals out of control. This ultimately calls the basic principle of budgetary autonomy into question at a crucial point owing to the resulting mismatch between liability and control. There is therefore a risk that, in the event of high deficits in individual states, steps to consolidate budgets will not be taken early or decisively enough. Lenders charge low risk premiums even for federal states with budgetary difficulties, probably because they assume that joint liability exists as a result of the principle of common responsibility for the federation set out in the German constitution. This encourages state governments to delay consolidation measures, which appears politically attractive in the short term.

Corrective purpose of debt brake is to rein in deficit almost fully

To alleviate the problem of excessive debt in the federal state of Germany, a debt brake for both central and state government was enshrined in Germany's constitution in 2009. As at that time a number of federal states were experiencing difficulties[5] and very high budgetary deficits were expected in the wake of the economic and financial crisis, long transitional periods were granted. The permanent, strict deficit ceilings anchored in the debt brake are not scheduled to take effect until 2016 for central government and, for state government, they will come into force later still – as of 2020 (Article 143d of the German constitution). Even though state governments could find a certain degree of leeway when transposing the debt brake into state law, the debt brake is likely to ensure not just more ambitious but also more binding debt limitation than previous arrangements and require countermeasures to be taken as soon as imbalances arise. In a departure from the scenario hitherto, any future deficits that breach prescribed ceilings are to entail notable political costs both in terms of inconvenient short-term corrective measures and repayment obligations under the debt brake should borrowing limits be exceeded. However, the individual state legislators themselves are free to spell out the details of such obligations (in particular, their time frame).

State and local government debt in 2013*

€ per capita



Source: Federal Statistical Office. * Including off-budget entities. Excluding debt to the public sector (for a definition, see Federal Statistical Office, Fachserie 14, Reihe 5).
Deutsche Bundesbank

Stability Council is overseer but has no major powers of sanction

When the decision was taken to introduce a debt brake, provisions were made in Germany's constitution (Article 109a) to establish a Stability Council to supervise budgetary policies. As early as 2012, the Stability Council ruled that

5 See the report by the Working Group on Budgetary Analysis for Bremen, Saarland and Schleswig-Holstein (2008), Federal Reform Commission II, Drucksache 102.

Berlin, Bremen, Saarland and Schleswig-Holstein were facing looming budgetary emergencies and initiated a budgetary recovery procedure for these states, which involved agreeing consolidation plans with them spanning several years. The Stability Council carries out regular checks to ensure that the plans are on track, both in terms of content and implementation. It has requested that Bremen and Saarland make subsequent improvements to their planned budget relief measures. If the Stability Council finds the planned consolidation measures to be insufficient, it can issue publications to exert political pressure on the states in question. Aside from decisions regarding transitional assistance pursuant to Article 143d of the German constitution (consolidation assistance), the Stability Council has no major powers of (financial) sanction or even intervention.[6]

Distribution of tax revenue and the federal financial equalisation system

Constitution stipulates extensive equalisation of federal states' financial capacity

As tax revenue is the main source of revenue for central, state and local authority budgets, its distribution is of vital importance. The aim of ensuring broadly equal living conditions throughout Germany features prominently in the German constitution. Article 107 of the constitution stipulates that there must be a reasonable equalisation of the financial capacities of the state governments. This is to ensure that individual states (including their local authorities) are in a position to provide essential public services that are not substantially below the average level in Germany in terms of both quality and volume.

Regional tax revenue allocated according to place of residence and place of business

There are different rules governing how revenue from the various types of tax is distributed among the federal states. With the exception of turnover tax, receipts from state and joint taxes are allocated according to the principle of regional revenue. For income tax, this is based on the taxpayer's place of residence. However, for corporation tax (and, similarly, for local authority trade taxes), the profit to be taxed is generally broken down between the different business locations based on the respective share of the wages in the total. Even at this level, doubts have been raised as to the adequacy of the distribution keys, for example whether they are linked closely enough with the usage of public services provided at that location. For instance, city-states are at a disadvantage if their services are used by commuters from neighbouring municipalities whose income tax is allocated to their place of residence. From an incentive perspective, it would seem worthwhile considering whether to give a greater weighting to the place where taxable income is generated.

Stage 1 of federal financial equalisation system: supplementary shares in turnover tax

Turnover tax receipts – which are even more difficult to allocate adequately between regions – are generally distributed among state governments according to population size. However, where required, up to one-quarter of the federal states' share in total turnover tax revenue – prior to distribution of the remainder among the federal states – is used to reduce differences in financial capacity (per capita tax revenue adjusted for differences in state-specific taxes and state average multiplier differentials). The aim is to raise the financial capacity of each federal state to at least 94½% of the nationwide average calculated on the basis of state taxes and state government shares in joint taxes (without any further inclusion of turnover tax revenue). In 2013, this resulted in redistribution of €7½ billion compared to the distribution of the federal states' total share in turnover tax solely according to population size. It is not just the eastern German states (excluding Berlin) that benefitted from this on

6 For those federal states that are scheduled to receive consolidation assistance up to and including 2019 because of high debt burdens, this assistance can be repealed if they do not comply with the agreed adjustment paths. This applies to Berlin, Bremen, Saarland, Saxony-Anhalt and Schleswig-Holstein. For a critique of the set-up of the Stability Council, see Deutsche Bundesbank, The role of the Stability Council, Monthly Report, October 2011, pp 20-23.

balance but also Saarland, Lower Saxony and Bremen.[7]

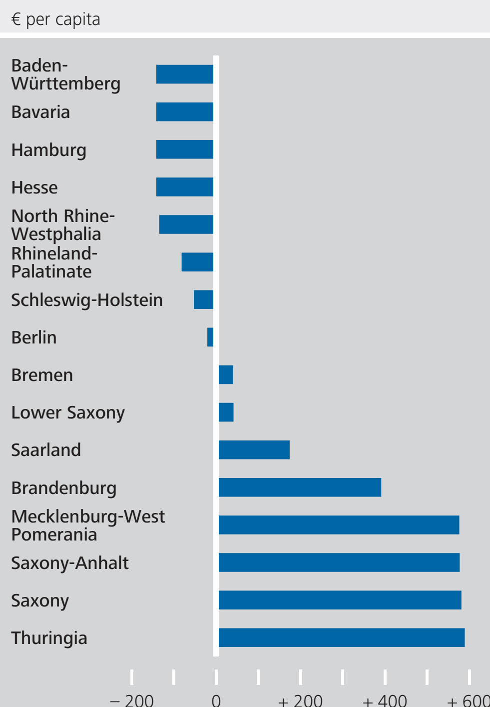
Financial equalisation system among the federal states: (parts of) local authority taxes factored in and number of residents "upgraded"

In stage two of the federal financial equalisation system – the financial equalisation system among the federal states (the state government revenue-sharing scheme) – local authorities' tax revenue is considered in addition to that of the federal state[8]. However, (as with real estate acquisition tax) this is not based on their actual local revenue; instead, local business tax and real property taxes are adjusted for differences in local authority multipliers. Furthermore, local authorities' tax generation capacity is not included in full but only 64% thereof. On top of all the revenue included in the financial equalisation system among the federal states the population of city-states is notionally increased ("upgraded") by 35% to account for structural exceptional burdens, such as the higher costs caused by urban agglomeration or the provision of services for residents of other federal states, too. The weighting of the population sizes of Mecklenburg-West Pomerania, Brandenburg and Saxony-Anhalt is marginally "upgraded" solely for local authority taxes to account for the higher costs of providing public services in particularly thinly-populated regions. In relation to the equalisation benchmark[9], before this equalisation stage, the federal states' financial capacity in 2013 ranged from 69% in Berlin (or 86½% in Mecklenburg-West Pomerania, the financially

7 For the results of the preliminary settlement, see Federal Ministry of Finance, Results of the financial equalisation system among the federal states for 2013, Monthly Report, February 2014, p 31.
8 This includes mining royalties.
9 This benchmark shows the tax revenue, as defined in the financial equalisation system among the federal states, that a federal state requires in order to have an average financial capacity. The state-specific benchmark is calculated from all the federal states' state and local authority per capita tax revenue that is included in the financial equalisation system multiplied by the population size of this particular federal state (whereby in both cases the population size is "upgraded" as outlined above). Unlike the minimum financial capacity aimed for in the ex ante redistribution of turnover tax receipts, this benchmark also includes shares in turnover tax, mining royalties and local authorities' tax generation capacity (with a discount) and sets them in relation to the "upgraded" population size.

Ex ante redistribution of turnover tax in 2013*

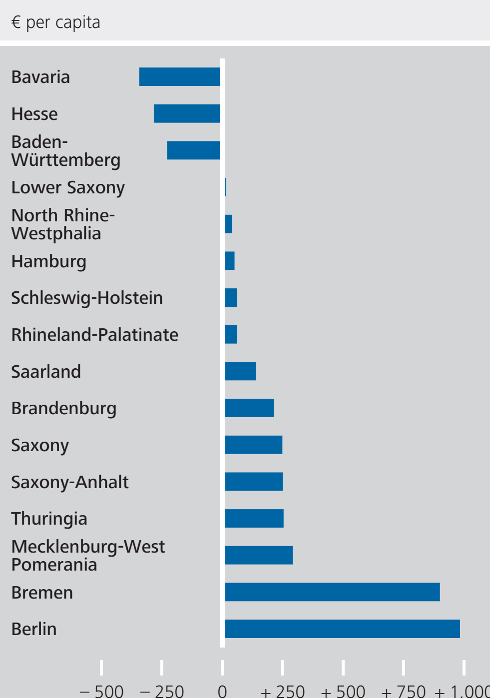
€ per capita



Source: Federal Ministry of Finance and Bundesbank calculations. * Redistribution compared to distribution based purely on population size; according to preliminary settlement.
Deutsche Bundesbank

Redistribution within the financial equalisation system among the federal states in 2013*

€ per capita



Source: Federal Ministry of Finance and Bundesbank calculations. * Preliminary settlement.
Deutsche Bundesbank

weakest non-city-state) to 116% in Bavaria.[10] After this equalisation stage, a total of €8½ billion in revenue was redistributed, which already largely balanced out the differences in financial capacity. In relation to the equalisation benchmark, this equalisation stage narrowed the range in financial capacity to between 90½% in Berlin, which received almost €3½ billion, (or, of the non-city-states, just over 95% in Mecklenburg-West Pomerania) and 105½% in Bavaria, which provided almost €4½ billion in revenue to be redistributed under the financial equalisation system among the federal states.[11]

"Premium" for disproportionately large revenue growth fails to make up for high revenue absorption rates and negative incentives caused by financial equalisation

Given the constitutional requirements, it is ultimately the task of elected politicians to negotiate an appropriate level of equalisation. However, account must also be taken of the associated negative incentives, and this is the subject of much criticism. For instance, a federal state is chiefly alone in funding measures to strengthen its local economy, and thus its tax revenue, in the long term and in paying the costs of tax administration, whereas its revenue is shared via the financial equalisation system among the federal states. For example, after all stages of financial equalisation, the most populated state, North Rhine-Westphalia, was able to keep only 18½% of additional income tax revenue in 2013 (or 32% of the share accruing to the state and its local authorities).[12] Yet, due to its large population and moderate deviations from the equalisation benchmark (ie close-to average financial capacity per "upgraded" resident), North Rhine-Westphalia usually has to make the lowest equalisation payments of all recipient countries that are entitled to supplementary central government assistance, whereas small, financially weak states have much higher revenue absorption rates.[13] To ensure that greater account was taken of this issue, the last reform of the financial equalisation system among the federal states introduced a retention of 12% of disproportionately large per capita revenue growth at state government level as of 2005 (which was not actually applied to North Rhine-Westphalia, the state cited in the example above, in 2013). However, last year this arrangement ("premium model") resulted in only €¼ billion being excluded from the financial equalisation system among the federal states (the largest individual amounts were in Bavaria, Hesse and Berlin) and, in relation to financial capacity at state level, at a maximum of ¼%, the amounts retained were very limited. Thus the "premium model" does not appear to set significant financial incentives for state governments to boost their own tax generation capacity.[14]

Stage 3: general supplementary central government grants

In a final stage, differences in financial capacity are reduced further by means of general supplementary central government grants. Those federal states whose financial capacity, after other equalisation payments, is still below 99.5% of the equalisation benchmark receive 77.5% of the difference as a central government grant. These funds, which amounted to

10 If local authorities' tax generation capacity is included in full and the number of residents is not "upgraded", per capita financial capacity ranged from 82½% in Mecklenburg-West Pomerania to 130½% in Hamburg.

11 If local authorities' tax generation capacity is included in full and the number of residents is not "upgraded", this results in extreme values of 89½% in Thuringia and 132% in Hamburg.

12 If the local authorities' share of 15% is factored out (ie if solely the state government budget is considered), this would even drop to only 3½% of total additional revenue, and just under one-quarter of this would still have to be passed on to the municipalities under the financial equalisation system for the local authorities.

13 The revenue absorption rate would be much higher in Bremen, for example, as only 6½% of the additional total revenue would not be deducted within the whole system of financial equalisation. If the local authorities' share is factored out, the state budget would even lose some of its funds. For more information, see also the calculations of marginal absorption rates and residual quotas in the financial equalisation system in B Huber and K Lichtblau (1998), Konfiskatorischer Finanzausgleich verlangt eine Reform, Wirtschaftsdienst 78(3), pp 142-147; H Fehr and M Tröger (2003), Die Anreizwirkungen des Länderfinanzausgleichs: Reformanspruch und Wirklichkeit, DIW Vierteljahreshefte zur Wirtschaftsforschung 72(3), pp 391-406; C Fuest and M Thöne (2009), Reform des Finanzföderalismus in Deutschland, Stiftung Marktwirtschaft, vol 37, in particular pp 51-56; J Ragnitz (2013), Wie funktioniert eigentlich der Länderfinanzausgleich?, ifo Dresden berichtet, 6/2013, pp 5-19; and I Deubel (2013), Schuldenbremse und Finanzausgleich – Wie stark muss der Finanzausgleich im Jahr 2020 ausgleichen, damit (fast) alle Länder die Schuldenbremse einhalten können?, ifo Dresden berichtet, 6/2013, pp 20-34.

14 Instead, they may be tempted to postpone/bring forward tax revenue-generation measures to benefit from the arrangements in certain years.

just over €3 billion at last report, ensure that the financial capacities of recipient states are raised to at least 97½% of the equalisation benchmark and, as a result, perceptibly reduce the remaining differences in financial capacity.[15]

Special supplementary central government grants for higher costs of political administration, burdens caused by long-term unemployment …

In addition, supplementary central government grants are also granted for special requirements (special supplementary central government grants) and these can even reverse the rankings of the states' financial capacity (in relation to the equalisation benchmark). While the Federal Constitutional Court has ruled that general supplementary central government grants and horizontal financial equalisation among the federal states must not change these rankings, this does not apply to special supplementary central government grants. However, they can only be granted if there is specific justification and as long as there is no discrimination between the federal states. Currently, a total of €½ billion has been granted to cover the "above-average costs of political administration" in smaller states, and just over €½ billion has been paid to eastern German states (excluding Berlin) due to higher burdens caused by structural long-term unemployment in connection with the Hartz IV reform.[16]

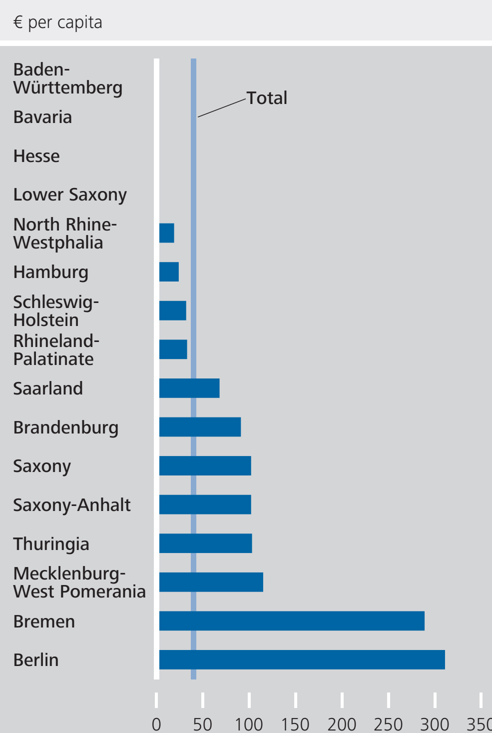
… and, above all, the former partitioning of Germany; but funds not always used as intended

The third reason for granting special supplementary central government grants is to cover burdens resulting from the former partitioning of Germany (with regard to infrastructure and local authorities' below-average financial capacity) in eastern German states and Berlin. These make up by far the largest share of the special supplementary central government grants but will be gradually phased out by the end of 2019. Last year €6½ billion was granted for this purpose (down from €10½ billion in

15 If local authorities' tax generation capacity is included in full and the general supplementary central government grants are factored into the calculations (in the numerator and the denominator), financial capacity ranged from 91½% in Thuringia to 131% in Hamburg (without "upgrading" the number of residents).
16 The preconditions for the former are checked every five years, and for the latter a needs-based review is envisaged every three years.

General supplementary central government grants in 2013*

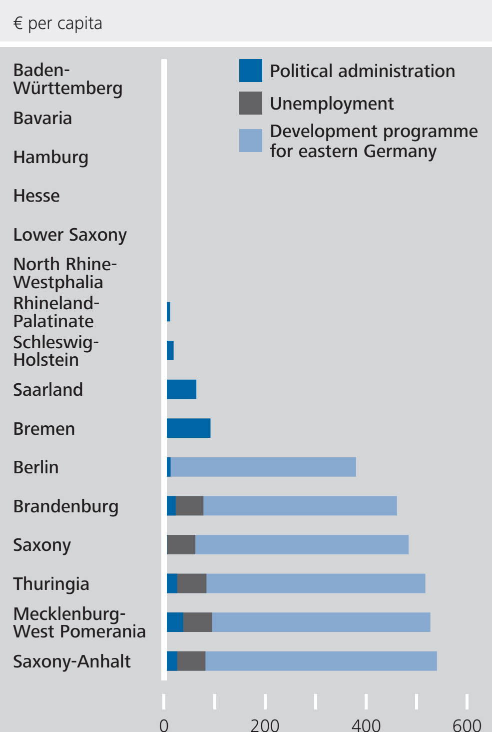
€ per capita



Source: Federal Ministry of Finance and Bundesbank calculations. * Preliminary settlement.
Deutsche Bundesbank

Special supplementary central government grants in 2013

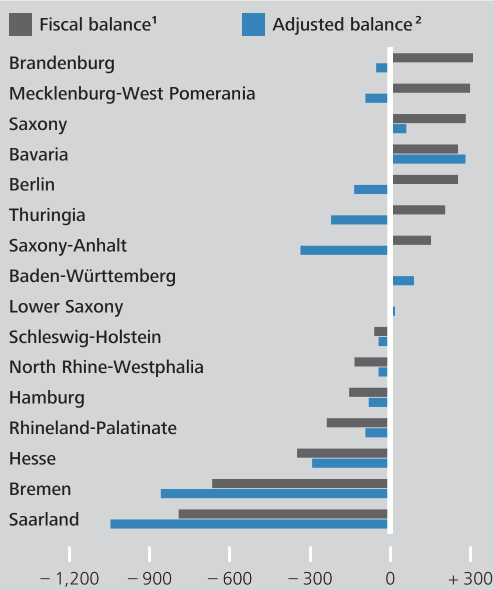
€ per capita



Source: Federal Ministry of Finance and Bundesbank calculations.
Deutsche Bundesbank

State and local government fiscal balances in 2013

€ per capita



Sources: Federal Statistical Office, Federal Ministry of Finance and Bundesbank calculations. **1** Including off-budget entities and the results from the preliminary settlement of the financial equalisation for 2013. **2** Excluding financial transactions, special supplementary central government grants for the development programme for eastern Germany and consolidation assistance pursuant to Article 143 d of the German constitution.

Deutsche Bundesbank

2005), of which almost half was paid to Saxony and Berlin. Recipient states report to the Stability Council once a year on the usage of funds. However, in the past, many federal states were unable to provide the required proof that they had used enough of these funds for investment.[17] As a result, the gaps in infrastructure provision which were assumed when the payments were agreed are not being closed with these grants as was originally planned.[18] There is also criticism that some other federal states also have considerable infrastructure deficits but are not entitled to such assistance.

Starting points for the reform of federal financial relations[19]

Greater tax autonomy seems appropriate in view of responsibility for own affairs and debt brake

Debt brake requires adjustments of varying sizes from one federal state to the next

Indebtedness in many federal states has increased sharply in recent decades, influenced in part by extensive budgetary autonomy (particularly in terms of expenditure) combined with less stringent credit limits and de facto implicit federal budgetary bail-outs. An important step has been taken in enshrining the debt brake, which the federal states will also have to implement in full by 2020, in the German constitution. However, some states still face substantial challenges in ensuring reliable compliance with requirements by 2020 and beyond. The scope of the necessary adjustment measures varies drastically from state to state.[20] These differences are due, among other factors, to current budget deficit levels, the prior burden placed on budgets by debt servicing, the level of and increase in pension benefits for civil servants at state government level, and the future phase-out of special supplementary central government grants and consolidation assistance. With regard to the imminent reform of federal financial relations, the fundamental objective of en-

17 See statements by central government on the progress reports concerning the development programme in eastern Germany at www.stabilitaetsrat.de.
18 However, the calculations submitted as proof also include debt repayments. As a result, it seems that either the catch-up process has not come as far as indicated by the calculations or that the pent-up need for investment has been overestimated.
19 An extensive discussion on the reform of federal financial relations would also cover issues such as the solidarity surcharge, the distribution of turnover tax receipts between the different tiers of government, the mixed financing of central and state governments and the allocation of responsibilities within the federal state of Germany. However, these aspects of a vertical financial equalisation system will not be covered in detail here.
20 The same applies to the local authorities (which have to be included, not least in line with European budgetary rules), for which the respective state government shares responsibility.

suring broadly equal living conditions throughout Germany must be taken into account, as should federal states' responsibility for their own affairs (including for debt accumulated in the past) and the necessary flexibility that this entails.

Greater leeway with respect to revenue appears likely

With respect to revenue, individual federal states currently have little leeway in terms of making changes to tax law in order to cover their respective financial needs. Consequently, higher state-specific spending preferences or other special needs have hitherto been financed by borrowing in many cases, which has further increased the sustained squeeze on budgets. The debt brake is designed to prevent this method of financing, and specific preferences for additional public services will have to be financed through shifts in expenditure or higher revenue. As a result, greater focus now has to be placed on extending avenues to permit variations in tax law. Limited, state-specific surcharges and discounts on individual types of tax such as income and corporation tax, as proposed by some parties, could address this. Given the differences in the economic strength of individual federal states, identical surcharges could, for example, result in different levels of additional revenue and budgetary scope per capita being formed. However, the financial equalisation system could, to a certain extent, make adjustments for such differences (see explanatory notes on pages 44 to 46). Switzerland's experience illustrates that permitting variations in tax law, despite considerable differences in economic strength across cantons, need not result in the states undercutting each other's tax rates in a "race to the bottom" that would lead to substantial cuts in public services.

Extended tax autonomy strengthens efficient provision of public services and responsibility for own financial affairs

From an economic perspective, extending tax autonomy in this way would forge a desirable link between public services and the level of taxation in individual federal states, with individuals and enterprises ultimately able to decide whether they are prepared to pay more tax for the improved public services on offer. At the same time, the clearer link between revenue and expenditure would increase pressure to make government activities more cost-effective in order to keep the tax burden as low as possible and to ensure that the federal state remains attractive. This would strengthen the states' responsibility for their own financial affairs in the long term while taking into account the significantly reduced scope for borrowing under the debt brake. Otherwise, almost all adjustments would have to be made on the expenditure side.

Transparency and degree of equalisation under the financial equalisation system

Differences in financial capacity should be limited, but degree of equalisation is a political decision

The marked differences in economic strength from region to region mean that the distribution of tax receipts across the federal states according to the proceeds collected by the tax administrations in their territory would lead to relatively wide disparities in the financial capacity of the federal states (including their local authorities). The precise extent to which these disparities should be limited is a political decision, which must meet the constitutional requirements.

Differences in financial capacity also reflect regional price differences, …

As a result of the various equalisation mechanisms in place, there is currently a maximum range of around 15 percentage points[21] in the financial capacity of the different federal states. This is relatively narrow. An argument in favour of allowing these disparities to persist is that federal states with high economic strength, a high wage level and, as a result of these factors, above-average financial capacity will also tend to have higher price levels and thus higher (nominal) financial needs. While disparities be-

21 Population-weighted according to the applicable rules including local authorities' overall tax-generation capacity but excluding special supplementary central government grants, which, like the "upgrading" of the number of inhabitants, reflect special needs and should therefore not imply higher general financial capacity. In this manner, the overall effect of the equalisation scheme on relative financial capacity can be better assessed.

The introduction of state-level tax surcharges and discounts

General aspects

In principle, there are various means of increasing the federal states' tax autonomy. Introducing a comprehensive system of separate taxation, with each federal state levying its own taxes alongside central government (potentially also including taxes that already exist at the central government level, as in the United States or Switzerland) would amount to a sea change in the German fiscal federal system, yet this is not on the fiscal policy agenda.

A much less sweeping change would be to transfer legislative powers for the existing state-level taxes to the individual states[1] or entitle them to levy surcharges on a portion of the joint taxes which are shared among different tiers of government. The state-level taxes do not yield especially high revenues, and allowing regional variation in turnover tax rates would probably cause both sizeable shifts and substantial difficulties relating to input tax deductions. Consequently, the option of a surcharge on income and corporation tax[2] is usually the main focus of the debate.[3] This would not only mean giving the states legislative powers to introduce their own individual surcharges or discounts but also establishing rules on revenue entitlements so that the receipts can flow into federal state budgets. All in all, practical implementation would probably be more complex for corporation tax than for income tax given the difficulties involved in the regional division of profits under the "business location" principle, which is already applicable prior to tax assessment. Even so, local business tax is already levied in a similar way, with different multipliers applied in different local authorities. The option which appears easiest to implement is the introduction of state-specific proportional surcharges or discounts using a uniform assessment base, eg the fixed tax liability (before transfer components for child benefit are deducted). As tax generation capacity varies across the federal states, the same surcharge would yield different amounts of revenue from state to state. Imposing upper and lower limits on the surcharges could help to allay any concerns about their use. An additional option in this kind of reform would be to give local authorities the power to set their own multipliers for their respective shares in income tax, which is already made possible by Article 106 (V) sentence 3 of the German constitution (Basic Law, or *Grundgesetz).*

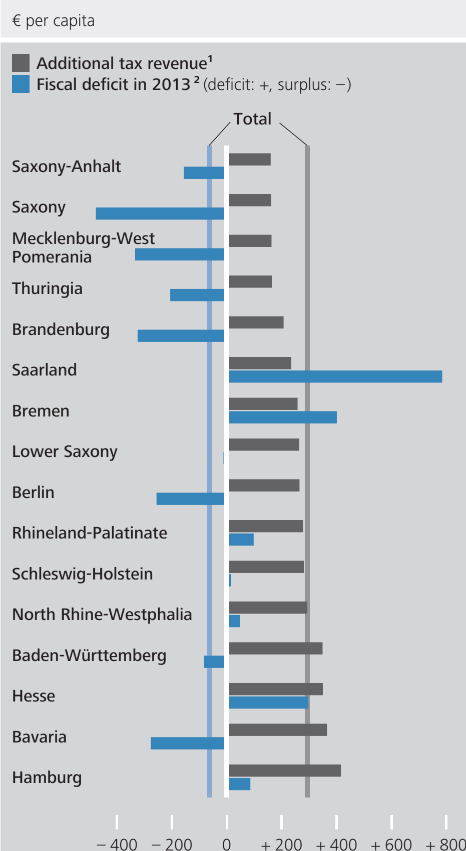
1 This would apply, in particular, to inheritance and gift tax, beer tax, race betting tax, lottery tax and sport betting tax (totalling just over 3% of the federal states' tax revenue). Legislative power to set the rate of real estate acquisition tax has already been transferred to the federal states.
2 It would generally seem advisable to exclude taxation of capital gains from state-specific powers to levy surcharges, as the assessment base is likely to be highly mobile. For technical reasons, however, this is not entirely possible in the current tax system. As an alternative, withholding tax on interest income and capital gains and non-assessed taxes on earnings (mainly investment income tax on dividends) are factored out of our calculations here.
3 See, for example, T Büttner and R Schwager (2003), Länderautonomie in der Einkommensteuer: Konsequenzen eines Zuschlagmodells, Jahrbücher für Nationalökonomie und Statistik, Vol 223/5, pp 532-555; T Mudrack (2010), Länderzuschläge auf die lokale Einkommen- und Körperschaftsteuer – Wirkung auf den Länderfinanzausgleich und Optionen für eine aufkommensneutrale Implementierung, Schmollers Jahrbuch 130, pp 513-540; Expert Advisory Committee to the Federal Ministry of Finance, Gutachten zum Länderfinanzausgleich in der Bundesrepublik Deutschland, Schriftenreihe des BMF, Heft 47; German Council of Economic Experts, Jahresgutachten 2001/02 and 2004/05, C Fuest and M Thöne (2009), Reform des Finanzföderalismus in Deutschland, Stiftung Marktwirtschaft, Vol 37, and L Feld, H Kube, and J Schnellenbach (2013), Optionen für eine Reform des bundesdeutschen Finanzausgleichs, Gutachten im Auftrag der FDP-Landtagsfraktionen der Länder Baden-Württemberg, Bayern und Hessen, pp 49-53.

Response of tax assessment base and financial equalisation system

The decision to apply surcharges and discounts and the associated revenue effects depend, among other factors, on the response of the tax assessment base and on the extent to which the revenue effects caused by the surcharges and discounts are included in the financial equalisation system. It is conceivable that varying tax rates could lead to relocations within Germany. Taxpayers in smaller states and border regions would probably be more inclined to relocate because of changes in tax rates. However, the cost of relocation, which can be substantial, is another factor to consider. For example, a large influx of new arrivals to a location with more favourable tax rates could drive up local real estate prices and rents and lower them in the areas they have just left. If these new residents continued to work in the same place, the longer commute would usually increase their travel costs. There are therefore significant factors working against relocation, thus limiting the mobility of the tax base. Ultimately, the tax burden in a federal state is not the only relevant factor which plays into such decisions; there are many others, such as the tax-funded public services that the state has to offer.

Revenue effect of a 10% state surcharge on income and corporation tax in 2013

€ per capita



Sources: Federal Statistical Office and Bundesbank calculations. **1** Surcharge on total revenue accruing to the federal state (adjusted for child benefit transfers) from wage tax, assessed income tax and corporation tax; surcharges not taken into account in the financial equalisation system. **2** Federal state and local authorities (including off-budget entities); including the provisional settlement under the financial equalisation system; excluding financial transactions.

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Another important aspect to consider is the interaction between the federal states' tax autonomy and the financial equalisation system. If the revenue from a state tax surcharge were fully included in the financial equalisation system, and if the revenue differences caused solely by differences in tax rates were also evened out, this would create an undesirable incentive for each state to reduce its own surcharge rate at the expense of the other states. Consequently, the measurement of financial capacity should not be based on the actual revenue collected by the states but their revenue adjusted for tax rate differences – much like the current arrangements for real estate acquisition tax, local business tax and real property taxes. Depending on how the financial equalisation tariff is designed and how many of the federal states impose surcharges or discounts, this could cause a greater portion of the varying tax generation capacity underlying the surcharge to

be evened out than under the current financial equalisation arrangements.[4]

Possible revenue effects of a limited surcharge

This paragraph outlines the results of some sample calculations to determine the revenue effects of state-specific surcharges or discounts. Under a status quo scenario, no relocations, other changes in the tax base or effects within the financial equalisation system are taken into account.[5] If, for example, a maximum surcharge or discount of 10% on the tax liability were considered acceptable, this would result in maximum additional revenue or a maximum revenue shortfall of around €24 billion based on the tax receipts which accrued in 2013. The range of the per capita revenue effects across the individual states would be substantial. At around €160 in most cases, these effects would be lowest in the federal states in eastern Germany, although the differences would be small (with the exception of Brandenburg). The revenue effect in Hamburg, at almost €420, would be far above the nationwide average of around €290, although this average would also be exceeded by one-fifth in Hesse and Baden-Württemberg and by one-quarter in Bavaria.[6]

Based on the 2013 deficits,[7] the additional revenue that could be generated from surcharges for Bremen and Saarland, for example, would not be sufficient on its own to avoid new borrowing – despite the fact that the substantial consolidation assistance based on Article 143 d of the German constitution is taken into account in these calculations. It would only be possible to close around two-thirds of the funding gap in Bremen and less than one-third of the gap in Saarland. Consolidation measures on the expenditure side would thus remain unavoidable. Hesse, on the other hand, could easily eliminate its high deficit through a surcharge alone. In Hamburg, North Rhine-Westphalia and Rhineland-Palatinate, the existing deficits would be significantly below the maximum additional revenue. Other states, such as Bavaria or some states in eastern Germany, are currently posting surpluses, which would, in principle, allow them to use most of the available discount. However, the phase-out of the special supplementary central government grants by 2019 will place a strain on the budgets of the eastern German states, and for all states the significant rise projected in pension payments for civil servants should also be taken into account.

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4 Applying the rules currently in force for taxes with state-specific or local authority-specific rates, under the financial equalisation system the total revenue from surcharges and discounts in Germany would be allocated to the individual states in proportion to their tax assessment base. If all states levied the same surcharge, differences in revenue relating to the surcharge would therefore be evened out in the same way as other tax receipts under the usual financial equalisation arrangements. However, should only a few smaller states levy a surcharge, for example, the additional revenue accruing to states with high financial capacity would remain very limited. As a result, under the financial equalisation system hardly any additional revenue would then accrue to the states levying the surcharge even if their financial capacity were far below the average. If a larger state with particularly high financial capacity opted for a discount, most of the tax reduction would be imputed to the other states under the financial equalisation system, meaning that only a small portion of the budget burden would ultimately be taken into account in the financial equalisation system.
5 The estimates include a global correction for deductions of child benefit transfers from income tax revenue.
6 In the current financial equalisation system, and if surcharges are factored into the calculations in a similar way to real estate acquisition tax, levying the surcharge in full in all states would significantly reduce the range across all stages of redistribution. The states in eastern Germany, like those with lower financial capacity in western Germany, would gain additional revenue of around €280 per capita; the outcomes in Bavaria, Hesse and Baden-Württemberg would only be around one-tenth higher. As a result of the “upgrading” of the number of inhabitants, all city-states would receive additional revenue of at least €380 per capita.
7 All figures include local authorities and off-budget entities and the provisional settlement under the federal financial equalisation system; excluding financial transactions.

tween urban and rural areas undoubtedly play a central role in price level differences,[22] differences are also mirrored appreciably at federal state level.[23]

… which makes very far-reaching equalisation appear problematic

As a general rule, no revenue equalisation could be justified if the differences in financial capacity were solely the result of diverging price levels that were also reflected accordingly in the federal states' expenditure (costs). At federal state level, a number of other factors are certainly also involved, but differences in federal states' financial capacity and costs should not ultimately be attributable to them. For example, options for regional variation in civil servant salaries (and pension benefits), which are a central cost component for the federal states, are permitted with good reason and are also likely to be used to a greater extent in the future. This could also play a greater role with respect to salaried public employees so that distinctive regional features are taken into account; furthermore, some federal states have not participated in the collective wage bargaining system of the federal states in the past. This allows the federal states to take account of the level of remuneration and pay trends in the local private sector. Differing price levels (eg in connection with regional rents) would also make nominal remuneration differences between federal states possible without this causing systematic differences in employees' purchasing power. Due to the currently relatively narrow range in pay for public-sector employees – whose duties are generally comparable – across the federal states, real pay in financially weak federal states is likely to be especially high on account of lower regional price levels. Overall, the significance of regional price differences for the federal financial equalisation system has scarcely been reflected in the reform discussion up to now. Taking this fully into account would also be difficult. Even so, the notable differences in regional price levels suggest that the existing gap in (nominal) financial capacity should, at the very least, be maintained, or ideally increased further so as to prevent the potential reversal of financial capacity rankings in real terms.[24]

Reform the financial equalisation system by …

A reform of the financial equalisation system which is designed to increase transparency and reduce negative incentives should incorporate all stages of the horizontal and vertical financial equalisation system.[25]

… abolishing the turnover tax revenue-redistribution scheme, …

The ex ante redistribution of turnover tax receipts (ie supplementary shares), which is based on a narrower definition of financial capacity, could be abolished. Turnover tax revenue would then be fully distributed among the states according to population size, and interstate redistribution could be relocated entirely to the actual financial equalisation system among the federal states.

In order to mitigate the high marginal revenue absorption rates, which vary considerably from state to state, and the negative incentives that

22 See also iw-dienst No 35 of 28 August 2014, pp 4-5.
23 According to the federal states' purchasing power indices calculated on the basis of the Regional Price Index (Bonn 2009) published by the Federal Institute for Research on Building, Urban Affairs and Spatial Development (Bundesinstitut für Bau-, Stadt- und Raumforschung) (eds), the differences could amount to a maximum of 15 percentage points. There is a correlation between a federal state's financial strength and the regional price level. Values are below average in the eastern German states, in particular. Although the data are not completely up to date, it is unlikely that there have since been any major changes to the overall picture. See also J Zimmer (2014), The German Financial Equalisation System: Taking Account of Differences in Governmental Purchasing Powers, mimeo.
24 See J Zimmer (2014), op cit.
25 For similar reform proposals, see, for example, L Feld, H Kube and J Schnellenbach (2013), Optionen für eine Reform des bundesdeutschen Finanzausgleichs, Gutachten im Auftrag der FDP-Landtagsfraktionen der Länder Baden-Württemberg, Bayern und Hessen; C Fuest and M Thöne (2009), Reform des Finanzföderalismus in Deutschland, Stiftung Marktwirtschaft, vol 37; W Kitterer and R C Plachta (2008), Reform des Bund-Länder-Finanzausgleichs als Kernelement einer Modernisierung des deutschen Föderalismus; German Council of Economic Experts, Annual Economic Report 2001/02, pp 211-215; and Expert Advisory Committee to the Federal Ministry of Finance (1992), Gutachten zum Länderfinanzausgleich in der Bundesrepublik Deutschland, Schriftenreihe des BMF, Heft 47. More recent simulations of distribution effects can also be found in M Broer (2014), Reformoptionen des Länderfinanzausgleichs unter politökonomischer Betrachtung, Wirtschaftsdienst 2014/4, pp 258-266; and M Bickmann and K van Deuverden (2014), Länderfinanzausgleich vor der Reform: Eine Bestandsaufnahme, DIW Wochenbericht 28, pp 671-682.

Financial repercussions of simplifying and limiting the federal financial equalisation system in Germany

Like the distribution of turnover tax receipts between central government and the federal states, and the central government transfers which supplement the actual financial equalisation system among the federal states (state government revenue-sharing scheme), the redistribution of tax revenue among Germany's federal states is governed by the Act on Financial Equalisation *(Finanzausgleichsgesetz)* in line with requirements set out in the German constitution (Basic Law, or *Grundgesetz).* The question of how best to adequately reduce differences in financial capacity between the federal states has traditionally been the subject of lengthy and complex political negotiations. When considering how to reform the federal financial equalisation system in Germany, it is important to bear in mind that the revenue and expenditure of a federal state, including its local authorities, are not readily accessible in the short term. If prepared some time in advance, however, even fairly substantial corrections are possible, although these must ultimately satisfy the constitutional aim of ensuring broadly equal living conditions throughout Germany. In parallel with the reform of the financial equalisation system, the federal states will also be obliged to meet the strict debt brake requirements under Article 109 III of the German constitution from the 2020 budget year at the latest. This box outlines, by way of example, the repercussions of various reform options based on data taken from the preliminary settlement for the federal financial equalisation system for 2013.

The current financial equalisation system is extremely complicated, and a significantly simpler and more transparent set-up would be welcome. To help to achieve this, the ex ante redistribution of turnover tax receipts could be abolished (with all turnover tax shares being distributed among the states according to population size), full account could be taken of local authority taxes (after adjustment for differences in their multipliers), a proportional equalisation tariff (with a constant revenue absorption and top-up rate) could be introduced and the rather ineffective practice of partially factoring out disproportionately large growth in state government tax revenue could be eliminated. The same proportional tariff could also be applied to the general supplementary central government grants, which could continue to provide additional partial compensation for states whose financial capacity is below 99.5% of the equalisation benchmark.[1]

The outcome currently obtained in the federal financial equalisation system could be almost matched in the framework outlined above with a constant revenue absorption and top-up rate of 60% (reform model 1). For a state whose financial capacity is close to the equalisation benchmark, this rate would be higher than the current rate in the progressive tariff. The volume of funds redistributed under the financial equalisation system among the federal states would increase to €13 billion and would thus be €4½ billion higher than in the current system. However, factoring in the ex ante redistribution of turnover tax receipts – which admittedly works somewhat differently – would result in a (limited) net reduction in the burden on the states obliged to make equalisation payments. By contrast, the burden on central government created by the general supplementary central government grants would be around €1½ billion higher (just over €3 billion at last report). In most cases, there would be only a moderate reduction in the portion of additional tax revenue that is absorbed.

Reducing the revenue absorption and top-up rate to 50% (reform model 2) would strengthen the incentives to increase tax generation capacity. States with above-average financial capacity would then actu-

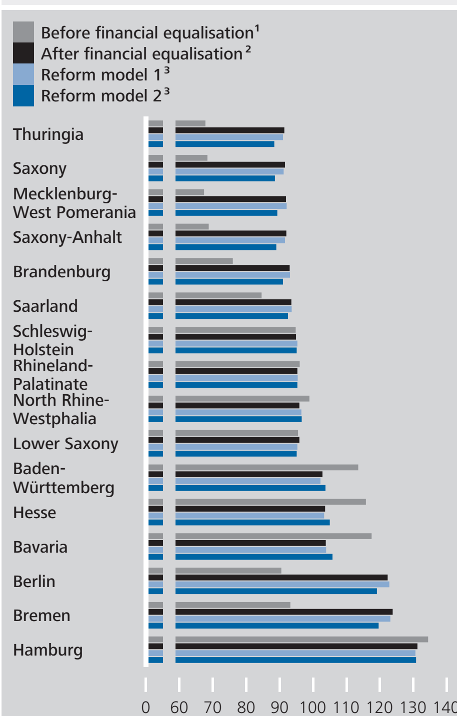
1 See footnote 9 on p 39 for the definition of the equalisation benchmark.

ally retain, in total, just over half of the additional tax revenue included in the financial equalisation system;[2] for states with below-average financial capacity, the portion that is absorbed would remain relatively high because of offsetting against the supplementary central government grants. For example, in the most populated state, North Rhine-Westphalia (which, if the ex ante redistribution of turnover tax receipts were abolished, would have above-average financial capacity and would no longer receive supplementary central government grants), just under 40% of the additional revenue would still be absorbed, compared with 68% in the current system. In Bremen, the smallest state, which would still be affected by offsetting against the supplementary central government grants, the total deductions would amount to almost 75%, compared with nearly 89% in the current system.

However, the lower revenue absorption rate would somewhat widen the remaining differences in financial capacity after the general supplementary central government grants had been paid. The volume of funds redistributed under the financial equalisation system among the federal states would be just under €11 billion, and central government would contribute €5 billion via the general supplementary central government grants. While, in the current system, the non-city-states' financial capacity in euros per "non-upgraded" inhabitant (factoring in the local authorities' financial capacity in full) would range from 91½% of the nationwide average in Thuringia to 104% in Bavaria, the outlined reform would widen the gap between these two states somewhat, which would then range from 88½% to 105½%. While North Rhine-Westphalia, Baden-Württemberg, Hesse and, above all, Bavaria would see significant increases in their financial capacity, which would range from around €50 to €100 per capita, the states of Thuringia, Saxony and Saxony-Anhalt would each see a loss of around €100 per capita. Looking at the city-states, the amount of funds lost in Berlin would be similar, while in Bremen the loss would amount to around €130 per capita. It is the task of elected politicians to decide whether these financial losses should be regarded as more important than the positive incentives

Financial capacity of the federal states in 2013 under different financial equalisation systems*

% of the nationwide average in € per capita



Sources: Federal Ministry of Finance and Bundesbank calculations. * Figures shown refer to unweighted population size; local authorities' tax generation capacity included in full. **1** States' share in turnover tax distributed in full according to population size. **2** After general supplementary central government grants, according to the provisional settlement under the status quo. **3** Local authorities' tax generation capacity included in full; without ex ante redistribution of turnover tax receipts; 60% (reform model 1) and 50% (reform model 2) compensation of differences under the financial equalisation system among the federal states, 60% and 50% top-up rate within the framework of the general supplementary central government grants.

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2 The reason for the higher retention of funds in the state collecting the tax compared with the amount remaining after applying the revenue absorption rate is that the total revenue to be distributed (and thus also the equalisation benchmarks for all states according to their share in the weighted number of inhabitants) would be higher. These calculations include only the portion of the revenue that accrues to the states and the local authorities (central government's share in the proceeds of joint taxes is not included). When looking at how much a state would retain of the total additional tax revenue it collected (eg through more intensive tax inspections), the additional shares transferred to central government would also have to be taken into account.

Financial capacity of the federal states in 2013*

€ per capita

Federal state	Before financial equalisation[1]	Status quo after financial equalisation[2]	Reform model 1	Reform model 2
Hamburg	5,180	5,110	5,110	5,120
Bremen	3,590	4,820	4,820	4,690
Berlin	3,490	4,760	4,800	4,660
Bavaria	4,530	4,040	4,060	4,140
Hesse	4,460	4,030	4,040	4,110
Baden-Württemberg	4,370	4,000	4,000	4,060
Lower Saxony	3,680	3,730	3,730	3,730
North Rhine-Westphalia	3,810	3,730	3,780	3,780
Rhineland-Palatinate	3,700	3,710	3,740	3,730
Schleswig-Holstein	3,650	3,690	3,730	3,720
Saarland	3,260	3,640	3,670	3,620
Brandenburg	2,930	3,620	3,640	3,560
Saxony-Anhalt	2,650	3,580	3,590	3,490
Mecklenburg-West Pomerania	2,600	3,580	3,600	3,500
Saxony	2,630	3,560	3,560	3,470
Thuringia	2,610	3,560	3,560	3,460
Total	3,850	3,890	3,910	3,920

Sources: Federal Ministry of Finance and Bundesbank calculations. * Local authorities' tax generation capacity included in full in the figures shown. **1** States' share in turnover tax distributed according to population size. **2** Financial equalisation: ex ante redistribution of turnover tax receipts, financial equalisation system among the federal states and general supplementary central government grants.

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to boost local tax generation capacity; they could also opt to introduce temporary assistance to help cushion the impact of transitional problems.

… devising a proportional equalisation tariff with a lower equalisation rate overall, including local authorities' tax generation capacity in full, …

they create, the next step could be to introduce a proportional equalisation tariff (with uniform revenue absorption and top-up rates) and to lower the equalisation rate, at least on average[26] (see explanatory notes on pages 48 to 50). At the same time, full inclusion of local authorities' tax-generation capacity would be appropriate from an economic perspective.[27] The federal state and its local authorities form an economic unit, and the federal state is ultimately responsible for ensuring that its local authorities have adequate financial resources.

… reviewing the "upgrading" of the number of inhabitants …

The overall "upgrading" of the number of inhabitants of city-states and less densely populated states when determining their financial needs should also be reviewed. More detailed evidence of these additional burdens needs to be provided. City-states do appear to face higher costs relating to urban agglomeration (for instance, due to higher land prices, construction costs or wages), particularly with respect to the provision of public services at local government level.[28] However, it must also be noted that their additional financial needs in connection with social benefits should fall as a result of increased relief provided by central

26 It would then be possible to dispense with the opaque and rather ineffective premium model, in which disproportionately high tax revenue growth at federal state level is partly factored out.
27 In 1992 (Bundesverfassungsgericht 86, 148) and 1999 (Bundesverfassungsgericht 101, 158), the Federal Constitutional Court ruled that a global reduction in financial capacity would be acceptable with respect to local non-personal taxes due to the link between the amount of tax paid and the use of public services at local level, whereas this would not be mandatory for shares in joint taxes. However, a systematic financial equalisation system should fully include local authorities' overall tax generation capacity. Any corrective action deemed necessary would need to be explained in detail.
28 See for example T Büttner, R Schwager and D Stegarescu (2004), Agglomeration, population size and the cost of providing public services: an empirical analysis for German states, Public Finance and Management 4 (4), pp 496-520. By contrast, this study finds that functional areas typically governed solely at state government level (eg political administration, financial administration, legal protection and public order and safety) do not generate significantly higher agglomeration-related costs that would justify the "upgrading" of the number of inhabitants with respect to state tax revenue.

government. In addition, it would appear to make more sense to compensate for "spill-overs" from the use of city-states' public services by surrounding regions, which are often used as an argument for "upgrading" the number of inhabitants, by improving coordination with neighbouring states or changing the way in which wage tax yields are allotted to those states (taking greater account of the "business location" principle), rather than via a financial equalisation system among the federal states which has redistribution effects throughout Germany.

… reviewing the special supplementary central government grants …

The special supplementary central government grants also appear to be in need of reform. These are currently paid to 10 of the 16 states given the "above-average costs of political administration" in smaller states. However, the city-state of Hamburg, which is small but has relatively high financial capacity, does not receive this payment. In addition to this unsystematic set-up, however, the rationale behind these grants does not appear to be convincing either. Empirical studies indicate that the additional costs associated with small administrative units are limited.[29] It would also seem reasonable to consider merging federal states as a response to possible cost disadvantages for smaller states or, should residents prefer smaller (administrative) structures, to also allocate the corresponding costs to them. Furthermore, eastern German states (excluding Berlin) receive special grants due to higher burdens caused by structural unemployment. Critics point out that other federal states with at least similarly high levels of unemployment do not receive such payments.

… and preserving the purely supplementary role of general supplementary central government grants

With respect to general supplementary central government grants, which are the final stage in the process of evening out differences in financial capacity, the constitutional provision preserving their subordinate role to the actual financial equalisation system among the federal states should be taken into account.

The degree of redistribution under the financial equalisation system will need to be determined during the forthcoming negotiations. Should these again ultimately result in a relatively substantial reduction of the differences in financial capacity, leaving the states with only moderate financial incentives, at best, to implement tax legislation as effectively as possible, the option of transferring tax administration to the central government level should be considered.[30] This would facilitate uniform application of the law across Germany, which is desirable, and limit any potential incentive-related deficits in implementation.

Central tax administration worth considering if level of financial equalisation is only marginally reduced

Possible relief for highly indebted federal states and safeguarding of sound budgets

Much-discussed assistance during transition to new system …

When the debt brake is implemented, highly indebted federal states must have either lower primary expenditure than the nationwide average or impose substantially higher tax surcharges – should these be introduced – compared to the other federal states. The debt servicing burden is currently being dampened very strongly by the extremely low interest rate level, with the average rate of interest among the federal states having fallen by a third between 2007 and 2013 from almost 4½% to just under 3%. With respect to the interest burden, budgetary autonomy together with responsibility for own affairs implies that the federal states should bear this alone and, in particular, that it should not be possible to pass the burden on

29 See, for example, M Reiter and A Weichenrieder (1997), Are public goods public? A critical survey of the demand estimates for local public services, Finanzarchiv 54 (3), pp 374-408 for an overview of the empirical literature. C A Schaltegger (2001), Ist der Schweizer Föderalismus zu kleinräumig?, Swiss Political Science Review 7(1), pp 1-18 found no economies of scale effects in the provision of public services in the Swiss cantons.

30 A study conducted on behalf of the Federal Ministry of Finance put the possible efficiency savings for general government of a central tax administration at €11½ billion annually (see Federal Ministry of Finance, Monthly Report, March 2007, pp 75-86). Alternatively, the costs of tax collection could be covered by a joint budget for all federal states, to which the states would allocate funds according to their tax revenue or population size. However, it is uncertain whether actual tax collection would be more effective as a result. It would probably be necessary to assess its actual effectiveness in great depth.

to other federal states. On the other hand, for a more extensive reform of the fiscal constitution in particular, it has been proposed that states with particularly high debt levels receive support during the transition to the new system. Various options are being discussed in this regard. For example, funds from the federal state of Germany as a whole could be used to cover part of these states' interest expenses for a set period, or payments could be granted along similar lines to the existing transitional assistance. However, the prerequisite for such support would be for the states in question to achieve and subsequently safeguard budget consolidation.

… only if budget consolidation is safeguarded

Stability Council could monitor compliance and have powers to sanction rule breaches

The Stability Council could be tasked with monitoring compliance with the corresponding obligations. It would be essential to ensure that the data used for such decisions were sufficiently meaningful. In particular, it would appear necessary to use budgetary and financial planning data updated to the cut-off date for all federal states (including with respect to the tax estimate), to include off-budget entities and to record net financial transactions, global budget items that have yet to be set out in detail, and one-off expenses and cost savings in a transparent manner. Generally speaking, it would stand to reason that budgetary surveillance within the German state would be more stringent than at the European level. Should this surveillance reveal that federal states receiving transitional assistance are in danger of breaching the debt brake requirements, this information should be made public and the states in question should be required to take immediate corrective action. Should the states fail to make sufficient improvements, financial assistance could be withdrawn.[31] In addition, another prerequisite for financial assistance could be to invest central government or other federal state governments with the right to propose motions in the state constitutional courts examining whether controversial budget acts comply with constitutional requirements.

Strict compliance with the debt brake simplified with greater tax autonomy

Overall, it is very important that the debt brake, as laid down in the German constitution, is implemented consistently in all federal states. This includes limiting ways of circumventing[32] the debt brake as much as possible. As the debt brake will require swift action to counteract any deficits, it would appear advisable to expand the fiscal policy adjustment options available to the individual federal states. Allowing them to impose their own limited surcharges and discounts on income and corporation tax would also be suitable for this purpose. To be able to avoid potentially procyclical countermeasures in the event of unexpected negative shocks, it would also make sense to plan in safety margins below the upper credit limits, as at the central government level.

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31 The introduction of tax surcharges and/or across-the-board spending cuts in areas governed by state-specific legislative powers, which will come into force automatically, would seem even more effective. However, their implementation could present substantial problems.
32 Ways of doing this include, for example, the use of off-budget entities, determining extremely prolonged redemption schedules where use is made of exemptions (emergency situations), inadequate cyclical adjustment methods or factoring out budgetary burdens from the structural deficit by classifying them as financial transactions. For the cyclical components taken into account, it would be advisable to introduce a control account which, in principle, would need to be balanced out over time.