Central-State-Local Relations in Germany
Paul Bernd Spahn
Goethe-Universität, Frankfurt, Germany. July 2004

Key elements of German democracy

- History helps to understand some key elements of Germany’s political reality and traditions:
  - the desire to regroup the nation in line with language and cultural heritage
  - the acceptance of uniform standards throughout the nation, and homogeneity of policies at lower tiers of government
  - the readiness to share the national wealth on an even footing (interpersonal, sectoral, and regional solidarity)

Legislation

- Legislation is exclusive and concurrent.
- Concurrent legislation means that "the States have power to legislate as long as and to the extent that the Federation does not exercise its right to legislate".
- Concurrent legislation has enlarged the competency of the federal government over the years.
- In addition to the exclusive and concurrent legislation, Article 75 GG enables the federal government to enact framework legislation for the legislation of the States as far as Article 74a GG does not aver otherwise.
Protecting state sovereignty

- Today, legislation is typically centralized, and the administration of laws and their enforcement as well as service delivery are almost entirely decentralized.
- There is a safeguard to protect state sovereignty: the Upper House or Bundesrat.
- The states inject their voice into federal legislation through the Bundesrat, but only conjointly.
- There are a number of institutional arrangements for cooperating among governments: vertically and horizontally (cooperative federalism).

„Cooperative“ power sharing

- Cooperative federalism includes joint decision making and even cofinancing.
- A prominent example is the „joint tasks“.
- Cooperative federalism exhibits a strong trend toward consensus forming—within institutions, and among institutions.

Interjurisdictional solidarity

- Apart from having created a „consensus democracy“, the German federation is characterized by a high degree of interjurisdictional solidarity.
- After the War, the „uniformity of living conditions“ throughout the nation was a vital concern. It achieved constitutional rank.
- Solidarity has reigned the equalization arrangements of post-war Germany, and has survived even the challenge of German unification.

Joint taxation: taxes by layer of government
Main features of tax sharing

- **Income and corporation taxes** are shared 1:1 between the Federal and State governments.
- From the personal income tax, each of the upper two layers grants 7.5 percentage points to municipalities.
- **VAT** is shared at varying proportions altered by simple legislation.
- This avoids vertical fiscal imbalances.

Interjurisdictional solidarity and **vertical** equalization

- Germany attempts to achieve a vertical fiscal balance between layers of government.
- The constitution presumes that it is possible to define “necessary expenditures” at both levels (state and federal governments), and to achieve a “fair compensation” (billiger Ausgleich) between both levels.
- VAT sharing assumes the decisive role in securing “fairness” among layers of government. At present, the federal share of VAT is 50.5 percent.

Vertical fiscal adjustment

The German States’ shares of VAT

Interjurisdictional solidarity and **horizontal** equalization

- The horizontal apportionment of the states’ VAT share by region follows basically the number of population (for 75 percent of the share).
- The assignment of VAT revenue embodies a large degree of horizontal equalization already.
The equalizing effect of VAT assignment

Revenue per capita relative to average

Horizontal redistribution:
Finanzausgleich (1)

- The scheme equalizes tax capacities, not „needs“ or „cost differentials“.
- The measuring of tax capacity differentials requires a benchmark.
- It is found in a standardized “equalization yardstick” for state fiscal capacity (basically a national average per capita, times population).

Explicit horizontal equalization:

„Coverage ratios“: Tax revenue/own expenditures

Horizontal redistribution:
Finanzausgleich (2)

- The equalization yardstick is compared with the effective financial situation of each state, and the gap is equalized according to a formula.
- States below the average receive a compensation. This compensation is carried, in progressive steps, by the states above the average.
- The scheme is a complete clearing mechanism.
- The formula (or ”tariff“) of the redistribution scheme reflects the degree of interregional solidarity among states. It is extremely progressive.
The horizontal redistribution formula

- 100 per cent
- 75 per cent
- 50 per cent
- 0 per cent
- -50 per cent
- -75 per cent
- -100 per cent

Are the rich being exploited?

Horizontal Equalization

Rich state

Effectiveness of Finanzausgleich

Per capita revenue before and after Finanzausgleich relative to average

<table>
<thead>
<tr>
<th>Category</th>
<th>Before Finanzausgleich</th>
<th>After Finanzausgleich</th>
</tr>
</thead>
<tbody>
<tr>
<td>BE</td>
<td></td>
<td></td>
</tr>
<tr>
<td>HB</td>
<td></td>
<td></td>
</tr>
<tr>
<td>M-V</td>
<td></td>
<td></td>
</tr>
<tr>
<td>THUE</td>
<td></td>
<td></td>
</tr>
<tr>
<td>SACH</td>
<td></td>
<td></td>
</tr>
<tr>
<td>S-A</td>
<td></td>
<td></td>
</tr>
<tr>
<td>BRG</td>
<td></td>
<td></td>
</tr>
<tr>
<td>SAAR</td>
<td></td>
<td></td>
</tr>
<tr>
<td>NDS</td>
<td></td>
<td></td>
</tr>
<tr>
<td>RP</td>
<td></td>
<td></td>
</tr>
<tr>
<td>SH</td>
<td></td>
<td></td>
</tr>
<tr>
<td>NRW</td>
<td></td>
<td></td>
</tr>
<tr>
<td>HH</td>
<td></td>
<td></td>
</tr>
<tr>
<td>BAY</td>
<td></td>
<td></td>
</tr>
<tr>
<td>BW</td>
<td></td>
<td></td>
</tr>
<tr>
<td>HE</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Asymmetrical federal grants

- Moreover, there are asymmetrical vertical federal grants: so-called "supplementary grants".
- States receiving such grants are considered "weak in the provision of services".
- In particular, factual "gap-filling grants" are used to guarantee at least 99.5 percent of the average fiscal ability for all states.
- Moreover, 9 states out of 16 receive grants to relieve their costs of "political management".
- The Eastern states (and some Western peers) receive federal grants for "special burdens".
Effects of equalization before unification

The redistributive effects of three stages of equalization

"Effectiveness" of federal grants

Inefficiencies

- A high degree of interjurisdictional solidarity entails inefficiencies and waste.
- States below the guaranteed per-capita minimum have no interest to enlarge their tax bases, because any increase in tax revenue would reduce their grants conformingly.
- Federal grants designed to cover state budget deficits encourage fiscal irresponsibility and waste of public resources.
Marginal burden on own state revenue

Does the system foster moral hazard?

What remains from one € revenue:

State indebtedness for two groups of states
A challenge of the Constitution

- Three states challenged the Constitution arguing that the scheme overstressed solidarity; and was inefficient.
- The Constitutional Court criticized the Law to be not sufficiently transparent as to
  - the vertical distribution criteria;
  - alterations of the population criterion for horizontal equalization
- to exaggerate the degree of equalization (violation of rank!)

Solidarity Pact II (from 2005-2019)

- Solidarity Pact II has reformed the following elements of Germany's fiscal federalism:
  - the allocation of the respective VAT share to the states;
  - the fiscal equalization among the states (narrow definition);
  - the allocation of additional funds by the central government; and
  - the "German Unity" fund.

Solidarity Pact II: Finanzausgleich

- Abolition of port charges for Bremen, Hamburg, etc.
- Increase from 50% to 64% of municipal taxes in calculating the state’s financial strength
- The weighing of inhabitants by 1.35 will persist for the city-states; thinly populated states will also be taken into account when assessing municipal taxes.
- Mecklenburg-West Pomerania and Brandenburg are allowed to multiply their municipal tax requirements by 1.05; and
- Saxony-Anhalt is allowed a factor of 1.02.
- The current municipal weighing of inhabitants, graded according to the size of the municipality and the density of its inhabitants, will be scrapped

Contractual federalism in Germany?

- Where there are interjurisdictional spillovers, contractual forms of federalism could significantly improve the quality of public service delivery.
- Financial flows corresponding to the service provided could correspond, more or less, to *quid pro quo* transactions, and any partner dissatisfied with the quality of the service could exit the market.
- The cooperative machinery of German federalism is prone to dealing with interjurisdictional spillovers, but it would require more flexible contractual arrangements among authorities.
Interjurisdictional solidarity in Germany

- Interjurisdictional solidarity is firmly established and will prevail in Germany. Horizontal and asymmetrical forms of equalization will continue to be used to achieve it.
- However, the Constitutional Court has limited the degree of equalization.
- Federal grants will have to be limited to exceptional cases.
- They will also typically have to be phased out over time.

Solidarity and economic efficiency

- Interjurisdictional contracts could lead to redesigning intergovernmental resource flows. Taking such flows into account renders equalization more efficient.
- In particular negative financial incentives could be eliminated by allowing the states to generate some own revenue that is subject to legislation and control of regional authorities.
- Marginal revenue must be protected against interregional redistribution to preserve the incentives.
- Such protection of marginal revenue must not necessarily jeopardize solidarity among governments.

Is Germany prepared for competitive federalism?

- The concept of competitive federalism is contrary to the German perception of solidarity and uniformity in the provision of public services.
- However, the states have begun to compete through service delivery and there are demands to allow some limited taxing autonomy for the states as well.
- Competition among regions of the EU and globalizing trends will ultimately determine the pace of developments, but Germany's corporatist approach appears to be ready to resist such trends.

Can the German system be reformed?

- The irony of the German system is that its basic philosophies and actual fiscal arrangements can be interpreted to foster a modernization of its intergovernmental cooperative machinery, as institutionalized cooperation could be considered to be an archetype of contractual federalism.
- However the need for consensus, reluctance to compete, and a partisan-driven emphasis on strong regional solidarity may ultimately prevent this modernization of German federalism to materialize.
Thank you for your attention.