Federalism Commission II – Recent Reforms of Federal-Länder Financial Relations in Germany

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Introduction

- Stage I of Reform of German Federalism in 2006
  - Disentangling assignment of competencies: Spending side.
  - Higher autonomy of the federal level and the Laender.
- Stage II of Reform of German Federalism in 2009 (intention)
  - New fiscal constitution
  - Higher tax autonomy of the Laender?
  - Debt problem?

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Outline of the Presentation

- The Problems to Be Solved
- Germany's Fiscal Constitution
- The Contents of Stage II of Reform
- Criticism
- Towards More Tax Autonomy

Table 1: Public indebtedness in Germany

Year	Aggregate Debt	Federal	Laender	Local	Debt to GDP Ratio
	Mio. DM (West Germany)				
1970	125,890	57,808	27,784	40,295	18.6
1980	468,612	235,600	137,804	95,208	31.7
1989	928,837	497,604	309,860	121,374	41.8
	Mio. DM (Germany)				
1990	1,053,490	599,101	328,787	125,602	X
1998	2,280,154	1,457,750	623,572	198,833	60.9
	Mio. Euro (Germany)				
1999	1,199,975	770,331	327,407	102,237	61.2
2000	1,211,455	774,646	338,143	98,462	60.2
2005	1,489,029	901,320	471,375	116,033	67.7
2006	1,533,697	933,467	481,850	118,380	67.6
2007	1,539,500	935,599	484,117	115,295	65.1

The Problems to Be Solved 2

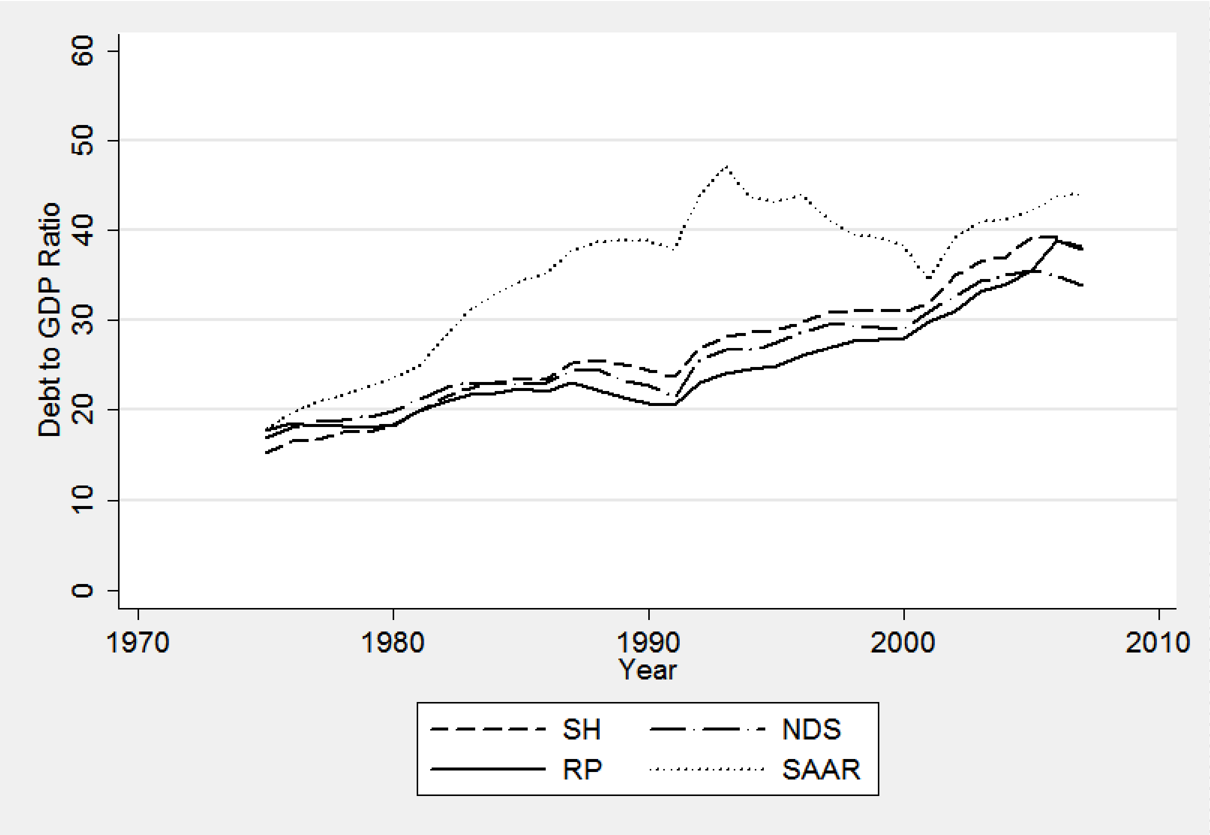

Figure 1a: Debt to GDP ratio (in % of GDP) of fiscally weak West-German states (including communities), 1975 – 2007

The Problems to Be Solved 3

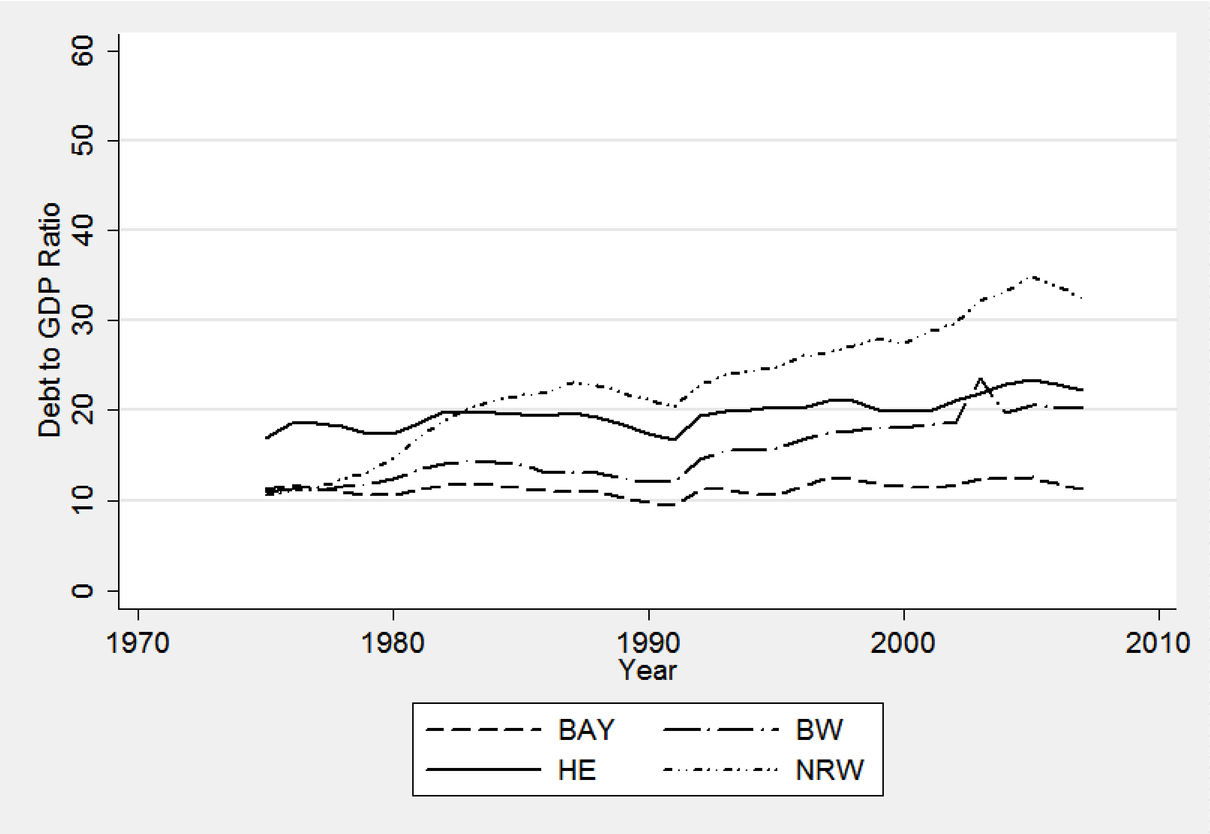

Figure 1b: Debt to GDP ratio (in % of GDP) of fiscally strong West-German states (including communities), 1975 – 2007

The Problems to Be Solved 4

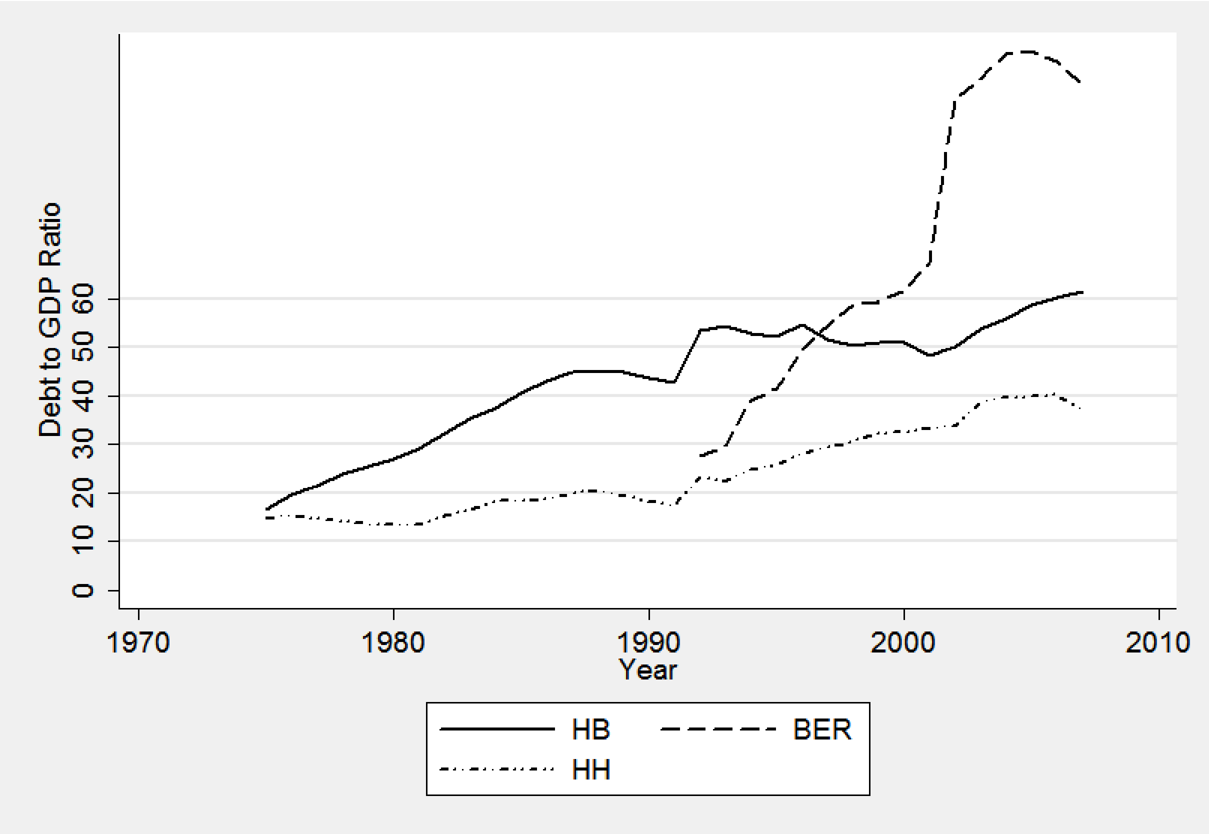

Figure 1c: Debt to GDP ratio (in % of GDP) of city-states, 1975 – 2007

The Problems to Be Solved 5

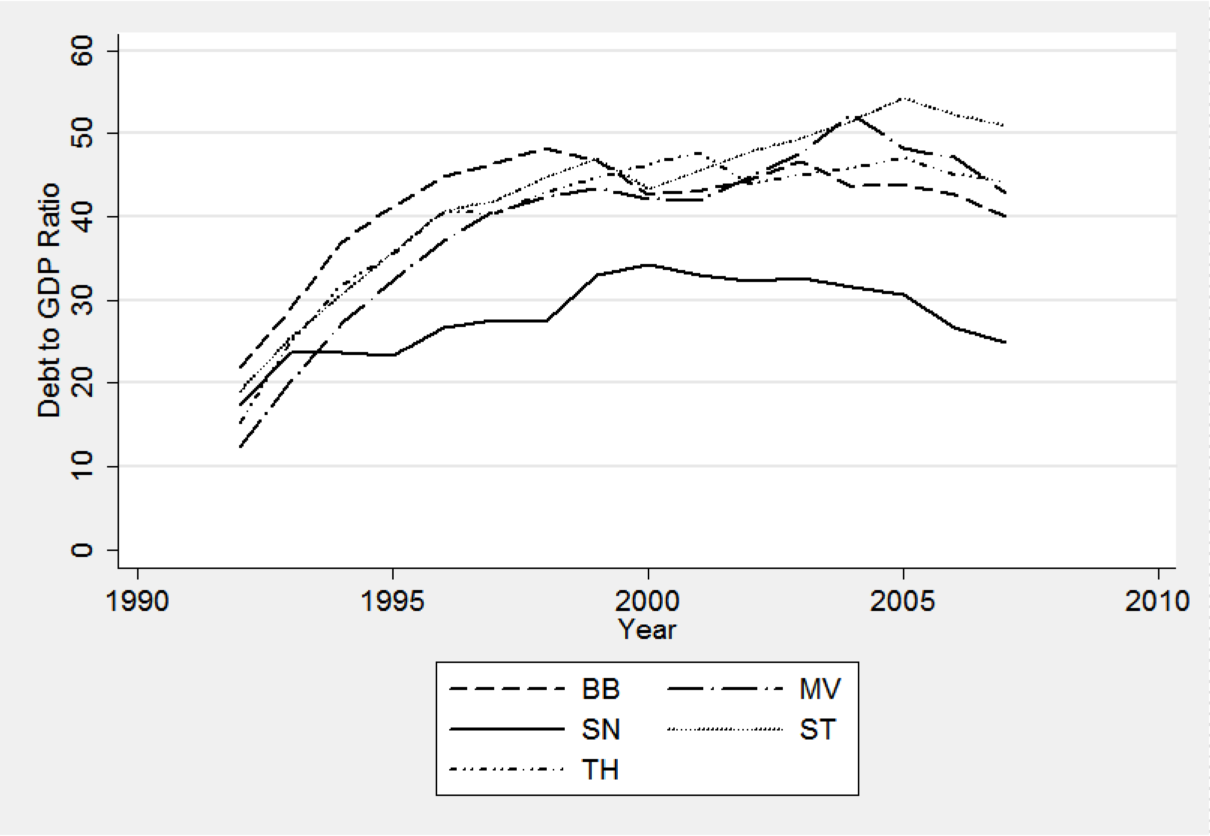

Figure 1d: Debt to GDP ratio (in % of GDP) of East-German states (including communities), 1992 – 2007

The Problems to Be Solved 6

- Current expectations after the financial crisis
  - EU-Commission: Deficits of 3.9 percent in 2009 and 5.9 percent in 2010
  - Federal Government: Debt to GDP ratios
    - 2008: 65.5 percent,
    - 2009: 68.5 percent,
    - 2010: 70.5 percent,
    - 2011: 71.5 percent,
    - 2012: 72.5 percent.
  - Too optimistic: Rather 85 percent in 2013.

The Problems to Be Solved 7

- Problems run deeper:
  - Incentive problems of the German fiscal constitution.
    - No incentives for sound fiscal policies.
    - Fiscal equalization provides no incentives to attract additional tax revenue.
    - Bailout provides incentives for excessive debt.
  - Fiscal commons problems are aggravated by this fiscal constitution.

Germany‵s Fiscal Constitution 1

- Revenue assignment
  - Most important tax sources are joint taxes (personal and corporate income tax and VAT): Decided jointly by Bundestag (Federal Govt.) and Bundesrat (States)
  - States‵ own taxes are almost exclusively fixed by federal law: (Almost) no tax rate or base autonomy.
  - Local jurisdictions: Autonomy to set rates of local business and property taxes.
- Spending assignment
  - States have more autonomy with respect to spending.
  - But: Federal mandates heavily restrict them.

Germany‵s Fiscal Constitution 2

- Fiscal equalization
  - First step: Shared taxes are distributed 75 percent according to accrual and 25 percent in equalization terms.
  - Second step: Differences in fiscal capacity of Laender equalized by transfers from fiscally strong to fiscally weak states to between 90 and 95 percent.
  - Third step: Vertical transfers to the fiscally weak states.

Germany‘s Fiscal Constitution 3

- Explicit bail-out guarantee for excessively indebted jurisdictions (ruling of the Constitutional Court)
- Incentives:
  - The implied marginal contribution rates to the fiscal equalization system vary between 60 and 100 percent.
  - The last step in the fiscal equalization system can change the revenue rank of states such that those with an initial revenue above average are falling behind those with initial revenue below average.
  - Empirical evidence that fiscal equalization and bail-out lead to higher borrowing and spending.

Solutions

- More tax autonomy of the Laender:
  - He who has the nice task to spend the money should have the nasty task to collect it.
- More debt responsibility:
  - No bail-out clause with clear default provisions.
- Formal fiscal restraints: Debt Brake.
  - Old rule: Art. 115 GG.
  - Investment and business cycle.

Contents of Stage II of Reform 1

- New debt brake for the federal government:
  - Balanced budget over the business cycle („close to balance‟);
  - Procedure for cyclical adjustment;
  - Special account to synchronize budget planning and implementation;
  - Extraordinary deficits decided by a qualified majority of the members of parliament;
  - Fully implemented from 2016 onwards.

Contents of Stage II of Reform 2

- New debt brake for the Laender:
  - Balanced budget in budgetary planning with some adjustment in implementation.
- Prevention provisions for excessive debt
  - Stability council.
- Bail-out for highly indebted states.
- Fully implemented as of 2020.

Criticism 1

- Time dimension
  - Adjustment is useful (financial crisis).
  - But: More ambition of the Laender.
- Exceptions to the normal debt brake
  - Simple majority of all members of parliament (already called „qualified“ as all must be present).
  - Requirement of approval by the Bundesrat?

Criticism 2

- Definition of the public sector
  - Federal: also social security.
  - Laender: also communities.
  - Art. 109 Abs. 3 GG (n.F.): only balanced budget for federal level and Laender.
  - Off-budget activities
  - Loans and guarantees
- Preventing excessive debt
  - Stability council
  - Sanctioning.

Criticism 3

- Bail-out
  - Which states and how much???
  - Restrictions by the stability council are insufficient.
- Tax autonomy is lacking
  - Most serious shortcoming of the reform
- Next step of federalism reform must go towards more tax autonomy
  - Laender have virtually no revenue autonomy after the 2009 reform.

Towards More Tax Autonomy

- Loopholes in the federal debt brake
  - Off-budget activities
  - Loans and guarantees
- Change in budget laws
  - Towards top down budgeting (Sweden)
- Next step of federalism reform must go towards more tax autonomy
  - Laender have virtually no revenue autonomy after the 2009 reform.