

Regional Financing in Germany and Spain: Comparative Reform Perspectives

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2. The structure of the German and Spanish regional financing systems

Basic elements of a regional financing system:

- Allocation of tax revenues, fiscal legislative powers and tax collection responsibilities among the different tiers of government and across territories: determines each administration's potential tax revenues or *fiscal capacity* and its degree of revenue autonomy.
- A formula for determining *spending needs* or equalization targets, possibly cast in terms of an adjusted population variable
- A set of horizontal and/or vertical transfers that equalize the resources available to territories with different levels of tax revenue.

Table 1: Division of tax revenues and tax responsibilities (without the local level)

	<i>Spain</i>	<i>Germany</i>
<i>Shared taxes</i>	Personal income tax ^R : <i>Resid</i> VAT: <i>Cons</i> Excise Taxes: <i>Cons</i>	Personal income tax ^C : <i>Resid</i> VAT ^C : <i>Pop/Redist</i> Corporate Tax ^C : <i>Resid</i>
<i>Federal Taxes</i>	Corporate tax	Excise Taxes (except beer) Vehicle matriculation
<i>Regional taxes</i>	Inheritance tax ^{R,C} : <i>Resid</i> Wealth tax ^{R,C} : <i>Resid</i> Property transmission ^{R,C} : <i>Cons</i> Gambling taxes ^{R,C} : <i>Cons</i> Vehicle matriculation ^R : <i>Cons</i> Retail fuel sales ^R : <i>Cons</i>	Inheritance tax ^C : <i>Resid</i> Property transmission ^{R,C} : <i>Cons</i> Gambling taxes ^{R,C} : <i>Cons</i> Beer tax: <i>Cons</i>

Key:
- *Superscripts: R, C* = regulated, collected by the regions; the default is the Federation
- *Criterion for the allocation of revenues across regions: Resid* = by residence or place of business; *Cons* = by location of consumption or transaction; *Pop* = by population; *Redist* = with a redistributive criterion.

- Allocation of taxes is quite similar (excise vs. corporation)
- Tax autonomy: much more in Spain than in Germany, where most rates are set centrally.
- Tax collection: German Länder play a much greater role than the Spanish regions, but acting largely as an agent of the Bund.
- German system generates incentive problems.

Exceedingly high “leakage rates” because of a highly redistributive system

and no use of a standardized revenue measure that avoids disincentive effects of equalization.

The calculation of expenditure needs or adjusted populations

In both countries, regional populations are adjusted to take account of cost differences across regions in the setting of equalisation targets.

- *Germany*: system is very much *ad-hoc*: the population of the city states (Hamburg, Bremen and Berlin) is multiplied by 1.35 to compensate high (?) costs of big agglomerations.
- *Spain*: simple formula takes into account the main demographic and geographical factors that affect the demand for the public services managed by the regions and their unit costs.

2.1. Equalisation in Germany

- *The allocation of VAT across the Länder:* The bulk of *Länder* VAT revenue is allocated in proportion to population. Up to 25% is reserved for states with below average fiscal capacity per head.
- *Horizontal transfers across regions (financial compensation):* States with above-average fiscal capacity per adjusted head transfer resources to the rest.
- *Federal transfers for equalisation and special needs.* Top up grants to *Länder* that are still below 99.5% of average financing per adjusted head and supplementary transfers for “special needs”

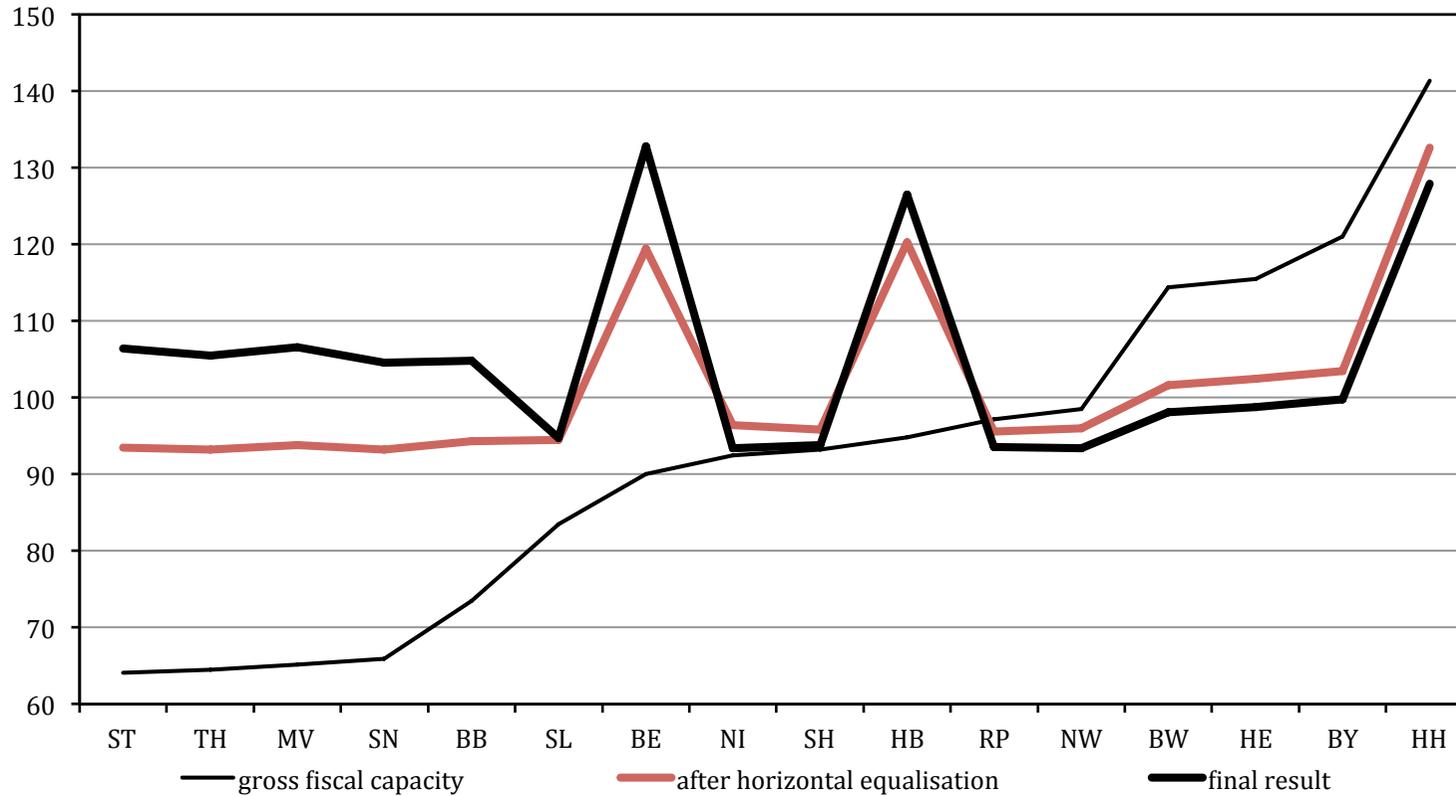
Some grants are scheduled to decline over time.

2.2. Equalisation in Spain

- *Horizontal Equalisation: the Guarantee Fund.* Fed by 75% of standardized regional revenues and a minor central contribution, distributed in proportion to expenditure needs or adjusted populations. Represents around 80% of the system's total ordinary resources.
- *Vertical Transfers: there is* a jumbled set of vertical transfers from/to the Central Government. These transfers are distributed across regions according to a large number of often conflicting criteria. The dominant one is the preservation of the *status quo*.

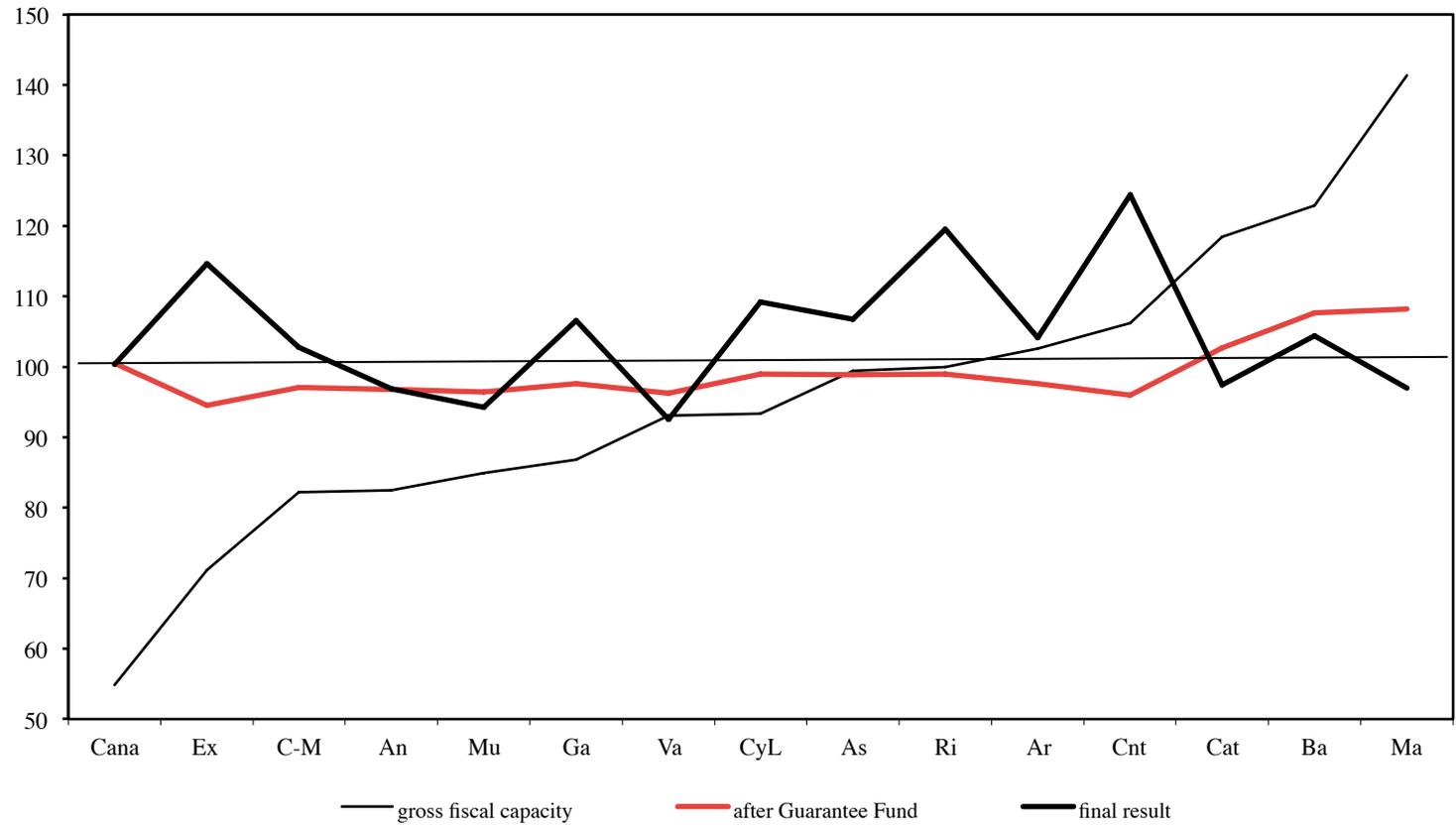
3. The financial results of the German and Spanish systems

Figure 1: Allocation of resources per capita at various stages in the application of the German financing system (includes homogenized local taxes. 2013 data)



- Overall, the German system reduces inequality by around one half and significantly changes the ranking of the *Länder* in favour of the former East Germany and the three city states.
- VAT pre-equalisation eliminates nearly half the initial disparities
- The dispersion of financing per head is further reduced, though to a much lesser extent, by the horizontal equalisation transfers
- and slightly increased by vertical transfers which concentrate on the Eastern *Länder*, taking them to the upper tail of the distribution.
- The special treatment accorded to the city-states of Hamburg, Bremen and Berlin introduces a large distortion.

Figure 2: Financing per adjusted head at homogeneous competences after the application of the different elements of the Spanish system



- The Spanish system also reduce inequality approximately by one half and significantly changes the ranking of the regions, but not in a systematic way.
- The Guarantee Fund dramatically reduces financing disparities across regions (the dispersion indicator drops from 20.6 to 3.9) while roughly respecting the initial ordering of the regions in terms of their gross fiscal capacity.
- The vertical transfers, however, sharply increase the dispersion of financing per adjusted capita (from 3.9 to 8.9) and completely alter the ordering of the autonomous communities, leaving a final distribution of resources that has very little to do with the original distribution of tax revenues.

Table 2: Some comparative statistics on the two systems

	[1] gross fiscal capacity	[2] financing after allocation of VAT	[3] after horizontal transfers	[4] after standard vertical transfers	[5] after special vertical transfers
Germany 2014					
<i>Std. deviation</i>	22.0	12.8	11.5	12.5	12.5
<i>Inequality index</i>	100.0	57.9	52.4	56.8	56.8
<i>corr with [1]</i>	1.000	0.943	0.646	0.503	0.122
Spain 2013					
<i>Std. deviation</i>	20.6		3.9		8.9
<i>Inequality index</i>	100.0		19.0		43.2
<i>corr with [1]</i>	1.000		0.700		-0.027
<i>Note:</i>					
Germany 2008					
<i>Std. deviation</i>	27.6	15.6	12.2	13.0	14.7
<i>Inequality index</i>	100.0	56.5	44.3	47.0	53.2
<i>corr with [1]</i>	1.000	0.945	0.692	0.545	-0.132

- Starting from similar levels of inequality, both systems achieve very significant reductions in initial disparities in tax revenues per capita and introduce important changes in the regional ranking in terms of resources per capita (or adjusted capita).
- The main source of arbitrariness in Germany is the ad-hoc population adjustment enjoyed by the city states. In Spain, the main problem is that the allocation of vertical grants follows no clear logic beyond the preservation of the *statu quo*.
- The changes in the regional ranking are important in both countries and generate a final distribution of resources that has very little to do with the original distribution of tax revenues across regions. In Germany, things have improved over time with the gradual phasing out of some grants.

6. Conclusions

For Spain: the main advantage of the German system is that vertical transfers are made on a comprehensible and reasonable basis, while in Spain these funds are allocated according to highly diverse and sometimes contradictory criteria. This is what wrecks the rest of the system. Sorting this out should be a major aim of the reforms.

Another important lesson is that long phasing-out periods for special allocations that may be temporarily justified are preferable to the permanent freezing of distributive patterns that the Spanish system tends to generate.

For Germany

The Spanish method of tying fiscal needs to indicators linked to the demand for the main regional public services could be useful in Germany.

German Länder suffer from too little tax and expenditure autonomy.