Future
Social Market Economy

Bertelsmann Stiftung

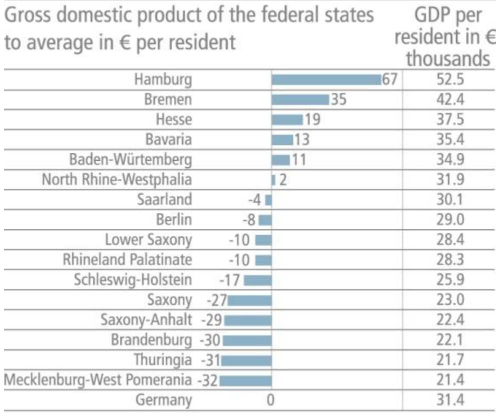
Policy Brief # 2012/07

Sustainability and solidarity – basic ideas of new financial structures

Federal financial structures which include fiscal equalization between the states are and will remain to be indispensable. Such structures are required to equalize the significant regional economic differences which exist within the federal republic and to ensure sufficient funding for the responsibilities of the public sector across the nation. The current federal financial structures have a number of structural flaws which regard both the criteria for tax distribution, the design of the debt brake and the role of municipalities. The financial structures will have to be revised beginning in 2020. The objective is to consolidate in the long term the budgets of federation, state and municipal governments and to safeguard a modern welfare state.

Focus

Fig. 1: Gross domestic product (GDP) of the federal states in relation to the overall German average in € per resident in 2011 and absolute GDP per resident in € thousands



Source: Own research based on data published by the State Statistical Offices

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The currently applicable financial structures of the Federal Republic of Germany were drawn up in 1969. They are no longer able to meet the demands of today's parameters and require a fundamental reform. Against this backdrop, 2020 becomes a decisive year: The debt brake will come into effect for the federal states, while the fiscal equalization between the states and the solidarity pact for the former East Germany will expire. The next few years offer a window which must be used for amendment.

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Basic features of the fiscal equalization between federal states

The active fiscal equalization system between the federal government and the states comprises a primary and secondary fiscal equalization. It includes vertical and horizontal elements. Fiscal equalization is a four-step procedure executed in a specific order (see Wendt, 2012). As a result of the technical complexity and against the backdrop of the interests involved, there are no "simple" or "non-political" approaches.

Primary fiscal equalization (tax assignment):

I Tax revenue from all tax types is split among the federal, state and municipal government levels according to the separate and compound system.

II Federal and municipal governments are allowed various deductions at source from the revenue arising from value added tax. After that, the remaining amounts are distributed by roughly half to the federal and municipal governments. At least 75 percent of the state government's share of value added tax is then distributed according to the number of residents. Up to 25 percent is distributed to supplement financially weak states.

Secondary fiscal equalization (Tax redistribution):

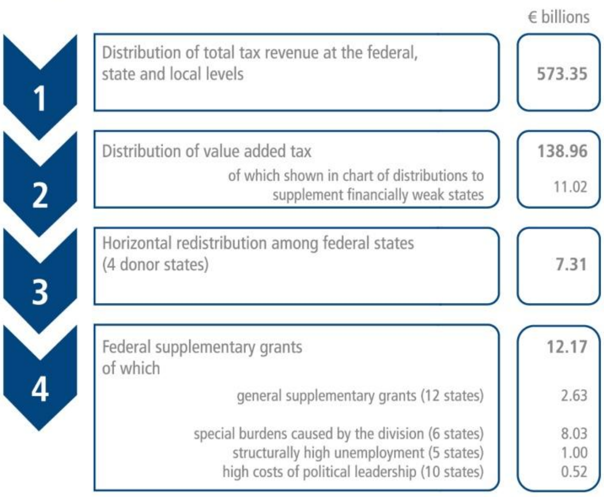
III Strictly speaking, fiscal equalization among federal states consists of redistribution by means of equalization payments by financially strong states to financially weak states.

IV Finally, the federal government can provide financially weak states with additional funding (federal supplementary grants).

The term "financial structures" refers to section X of the Basic Law. Among other things, this section includes provisions for tax collection and distribution, borrowing and accounting. Fiscal equalization is one part of these financial structures.

1. Structural weaknesses of applicable federal financial structures

Fig. 2: Stages of fiscal equalization between federal states



Source: Own research based on data published by the Federal Ministry of Finance. | BertelsmannStiftung

The German financial structures were drawn up more than forty years ago. At that time, there was less variance in economic and fiscal strengths across states, debt was immaterial, unemployment low, and the economy and demographics were characterized by growth. The real structures in Germany are entirely different today (see fig. 1).

To date, the financial structures do not yet reflect the defining historical changes of the reunification and the European integration.

The financial consequences of the reunification were managed without revising the financial structures but at the cost of growing national debt, the expansion of state fiscal equalization and federal supplementary grants. These developments cannot be sustained on a permanent basis. After 1990, the necessary restructuring of state financial relationships was simply postponed.

The EU Fiscal Stability Treaty signed in March 2012 impacts the financial structures as does the European Stability Mechanism (ESM), for instance, strengthening the former Maastricht criteria and EU intervention rights. Domestic implementation is unsatisfactory.

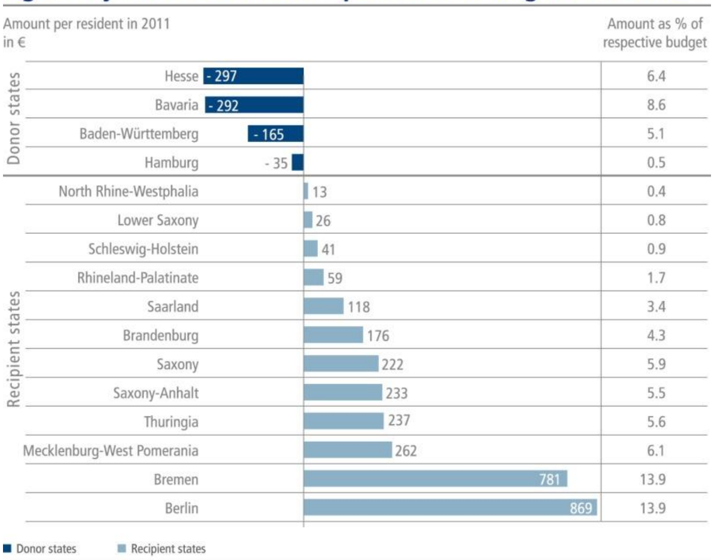
Primary financial distribution is mainly aligned with municipal tax revenue and the number of residents. This distribution is questionable in a welfare state, since revenue and need for funding diverge regionally. Even payment-specific structural differences (for example, assistance to meet costs of living, child and youth welfare, housing allowance, assistance under the Federal Law concerning the Promotion of Education or Training) are not taken into consideration.

The expansion of the welfare state is based on federal laws but is essentially borne by the states and municipalities. The resulting burden of expenditure is not currently reflected in the funding of the administrative levels. Because the federal laws must be executed uniformly in all states, in relative terms, they burden financially weak states (and municipalities) more than financially strong ones. Responsibilities assigned by the federal government therefore limit the ability of states and their municipalities to take action.

Federal fiscal equalization has become increasingly complex over the course of the past years due to varied changes at the detail level (see Woisin 2008). At the same time, there are financial flows even outside of regular fiscal equalization which have redistributional effects. Ultimately only experts, not citizens and politicians, can comprehend the distribution of tax receipts and funding for public-sector services.

Fiscal equalization among the federal states is at the center of the public debate. Regardless of the fact that its volume is disproportionate to the controversial debate, it does have structural flaws as well. One such flaw is that there is little incentive for either the donor or the recipient state to tap the full potential of their own tax base, since only a small part of the additional tax collected will flow to the

Fig. 3: Payments under fiscal equalization among federal states



Source: Research from data of the Federal Statistical Office and state budgets | BertelsmannStiftung state's own budget. The entry of the new states resulted in the immense growth of the redistribution volume. The increasing criticism relates to the heavy burden carried by a few states (see fig. 3).

2. Flaws in Basic Law debt brake

Legislators incorporated the debt brake into the Basic Law in 2009. It mandates that federal and state budgets shall be balanced without borrowing. Indirectly, the debt brake is an essential part of the federal financial structure and must be seen in the context of the fiscal equalization between federal states. It is a necessary step in creating fiscal sustainability, but it also gives cause for criticism.

Drawing on past experience, there is reason to doubt that regulations founded on the financial structures are suitable for effectively impacting national debt. In addition, the Basic Law is not the right legal framework for putting them into operation. In practical terms, effective implementation of the debt rule is hardly possible, particularly without sanctions.

The debt brake would be taken more seriously if it were to take effect immediately and if the step-by-step reduction of the deficits were defined by law. For the majority of states, compliance with the debt brakes on their own seems hardly achievable despite consolidation assistance and a ten-year transition period. The debt brake covers only part of the overall public-sector budget. It does not include the municipalities and social insurance providers.

The debt brake foresees stricter limits for the states than at the federal level. Since there is hardly any flexibility in terms of expenditures or income for the states, the states will be extremely limited in terms of their (financial) independence and run the risk of degenerating into administrative units of the federal government.

The debt rule ignores the problem of debt accrued in the past and the interest burden resulting from this. Despite historically low interest rates, interest payments on massive amounts of debt currently place a significant burden on the ability of some states to take action.

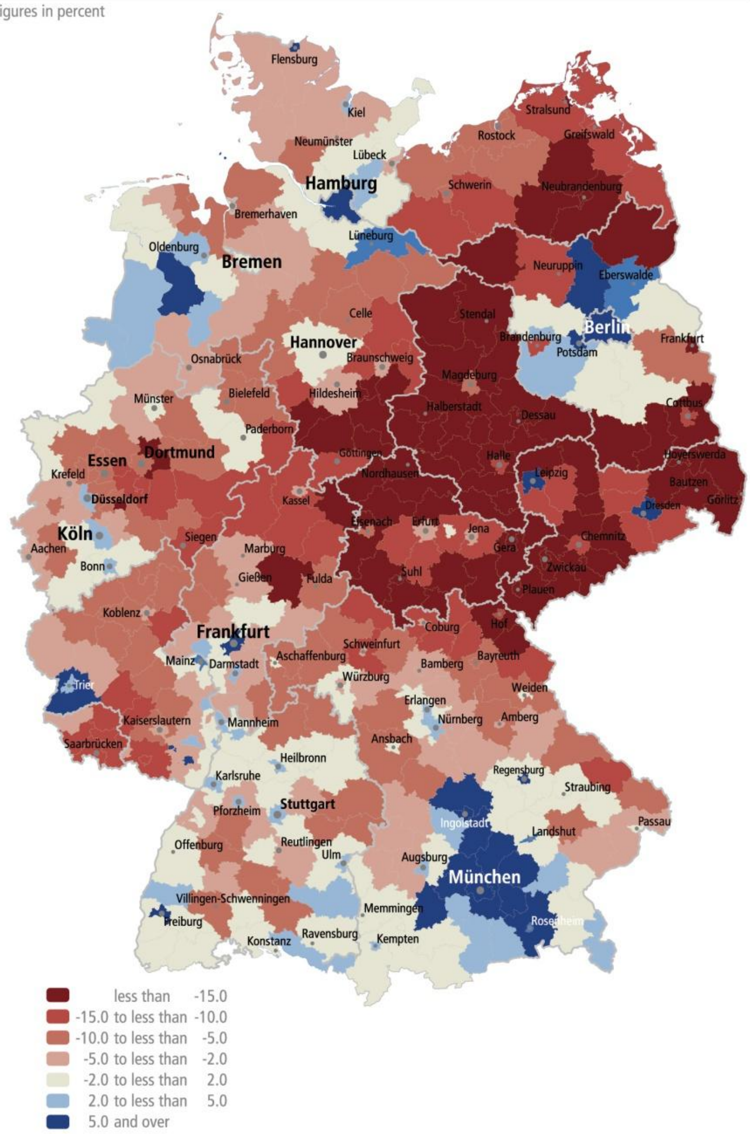
The debt brake is also not adjusted to the demographic developments which arise as a result of an aging population and migration. These developments differ widely between regions (see fig. 4), leading to severe distortions in receipts and expenditures.

This can result in a downward spiral of increasing expenditures and falling receipts. Migration movements within a state lead to adverse redistribution of funds burdening the shrinking and financially weak regions (see Seitz 2007). In particular, this problem occurs in the states which used to belong to the former East Germany.

Currently, the debt brake and EU Fiscal Stability Treaty have not yet been coordinated and must be seen side by side. In several respects, the Fiscal Stability Treaty is more comprehensive and stricter. The regulatory structure of the debt brake should therefore be reviewed and amended in order to compliment the European Fiscal Stability Treaty.

Fig. 4: Population development from 2009 to 2030 in administrative districts and independent districts

Figures in percent



Source: Bertelsmann Stiftung, Wegweiser Kommune (Community Guide). | BertelsmannStiftung

The Basic Law provides that municipalities have the right to self-government but offers no guarantee of sufficient funding.

The inadequate constitutional position is reflected particularly in the area of welfare spending. In the past, it was possible for the federal government to delegate social responsibilities to the municipalities which, however, did not have the right to request reimbursement. Over the decades, this led to an unhealthy shift of the municipal budget structure (see fig. 5) and to an increase in cash lending of just under €1 billion in 1990 to almost €45 billion in 2011.

The municipalities are not included in the debt brake of the Basic Law. This provides the states with an incentive to shift the burdens in their budgets.

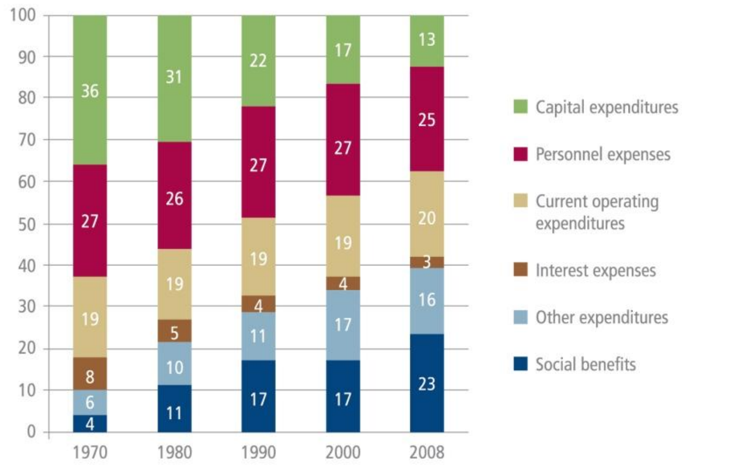
3. Effects on municipalities

Municipalities are only mentioned indirectly in the system of state financial structures. The Basic Law views the municipalities as a part of the federal states. This poses the risk of a budget policy at the expense of third parties, the municipalities.

At the same time, the municipalities are also not represented in the stability council. The tasks of this council, however, such as the coordination of a budgetary policy for the states as a whole, indebtedness or rebuilding the former East Germany, can hardly be managed without the municipalities.

Fig. 5: Development of municipal budget spending structure

Figures in percent



Source: Anton and Diement 2009:25. | BertelsmannStiftung

4. Basic features of modern financial structures

The following descriptions point out essential priorities to be considered during a reform of applicable financial structures.

To the extent that the goal is to strive for equivalent living conditions in all parts of Germany, state funding must also be equivalent. Under these conditions, fiscal equalization among federal states is indispensable. In doing so, equalization payments should be aligned with needs as dictated by the responsibilities.

Considering the weaknesses of the calculation based on municipal revenue and population figures, a new primary financial distribution between the federal and state governments should be introduced. In this new system, the federation should allocate funds directly, based on spending for specific purposes as dictated by the responsibilities stipulated by federal law. In this way, it could be guaranteed that funding is linked to actual responsibilities and that each level has access to the necessary funds. Complicated and opaque secondary rounds of (re)distribution will be drastically reduced.

This paradigm shift becomes especially clear when looking at the example of social welfare. Up until now, federal lawmakers in the Bundestag and the federal states in the Bundesrat have distributed “sociopolitical benefits” without having to come up with the financial means to cover ensuing expenses. In particular with regard to cash benefit legislation, the funding burden of states and municipalities should be taken over by the federal level.

In light of the legislative powers in tax law or public-sector responsibilities, there is little point in completely eliminating fiscal equalization among federal states. The federal government should however guarantee the states a significantly higher amount of funding which should be linked to their responsibilities by means of direct allocations, thus equalizing regional differences in terms of their funding and benefits. That way, the volume of fiscal equalization among federal states could be significantly lowered, and the criticism of the donor states along with it.

Negative incentives, like not fully utilizing the state’s own tax potential, should be avoided when designing both vertical and horizontal equalization payments. Financial structures must be designed as incentives, and the states should be left at least half of their additional structural receipts.

The amount of the national debt poses a fundamental problem for any future financial structure. One solution could be the step-by-step transfer – subject to certain terms – of debts from the federal, state and municipal levels to a common fund, which should be financed from additional tax receipts. A prerequisite for such a step would be appropriate funding at all levels of government and compliance with the debt brake.

An effective controlling system and an objective budgeting process are indispensable in order to identify unfavorable developments in budgets at the state or federal level in a timely manner, so that countermeasures can be introduced. Initial steps in this direction include establishing a stability council to avoid budget emergencies and a double-entry budgetary reform at the municipal level.

Funding for local government at the municipal level must also be guaranteed under Basic Law. In addition, it is necessary to enable direct financial relationships between the federal and municipal governments so as to equalize any responsibilities that the federal government has imposed or will impose on the municipal governments.

Liabilities of municipal governments should be assigned to the respective states in order to avoid any incentives from shifting burdens and only apparent compliance with the debt brake.

The desired level of public-sector services and stable funding at the federal, state and municipal levels over the long term requires structurally higher tax receipts. In an international comparison, taxation of capital in the Federal Republic in particular is more moderate than on average in the EU (see Eurostat 2012: 28 et seq.).

The Federal Republic is based on the principle of cooperative federalism. This basic government principle is widely accepted and favors economic and social development. A competitive federalism between the states does not represent the history of the Federal Republic, the economic structure of the states and the will of the population (see Wintermann and Petersen 2008).

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Policy Brief 2012/05: Maastricht 2.0

The European Union's regulations governing sovereign debt are based on the principle of equal treatment of all member states. The recommendations we make here concerning changes in EU sovereign-debt reduction rules take account of national particularities. According to our calculations, such reformed regulations would do far more to promote economic growth than would be the case under the Fiscal Compact's European debt brake. By 2030, real gains in growth will amount to more than 450 billion Euros.

Policy Brief 2012/06: Euro-exit in Southern Europe

While Greece defaulting on its sovereign debt and leaving the European Monetary Union would have relatively little effect on the world economy, such a move could, however, lead to contagion in Portugal, Spain and Italy, thus provoking not only a sovereign default in those states as well, but also a severe worldwide recession. Economic growth would be reduced by a total of 17.2 trillion Euros in the world's 42 largest economies in the lead-up to 2020. Hence, political actors are well advised to prevent Greece from a sovereign default as well as leaving the euro, and the domino effect that this event could induce.

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ISSN-Nummer: 2191-2467

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