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**Fiscal Federalism in Germany**

Yannick Bury und Lars P. Feld

20/4

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Institut für allgemeine Wirtschaftsforschung  
**Abteilung Wirtschaftspolitik und  
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Albert-Ludwigs-Universität Freiburg



## Fiscal Federalism in Germany<sup>1</sup>

Yannick Bury and Lars P. Feld

From the year 2020 onwards, major constitutional changes have inverted former principles of German fiscal federalism and have led to further vertical fiscal imbalances. The latest reform of Germany's fiscal federalism strengthens the federal level in general and the executive branches at the federal and state (Laender) tiers of government in particular at the expense of the Laender and their parliaments, respectively. The autonomy of German Laender continues to decline, while their executives will keep an already substantial influence on federal policies. From the early years of the German constitution (*Grundgesetz*), Germany has been characterized as a unitary federal state<sup>2</sup>. Even though there have been attempts by some Laender to obtain higher tax autonomy since, the majority of the Laender has favored comprehensive fiscal equalization to provide every Land with the financial resources to meet its legal obligations and related spending needs. As a result, the Laender have not returned to the tax autonomy they had in the pre-war Weimar constitution<sup>3</sup>. The Laender executives, however, have kept the influence on tax laws via the second chamber of parliament, the *Bundesrat*, an influence that had been ensured by the intervention of the allies. Under constitutional law, this legislative power on tax policy resulted from administrative responsibilities of the Laender rather than from actual tax setting competencies<sup>4</sup>.

On this constitutional basis, an increasing degree of cooperation and centralization in fiscal powers has evolved after 1949. After the federal level exerted major influence in the fields of public housing and culture, which the *Grundgesetz* assigns exclusively to the Laender, the Laender demanded a fundamental reorganization of fiscal competencies<sup>5</sup>. This was followed by the Fiscal Reform Act of 1969, aiming at relocating powers between the Laender and the federal level. In addition to this reorganization of competencies, the Fiscal Reform Act also established a new fiscal equalization scheme between the Laender and thus effectively raised

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<sup>1</sup> This article is an updated and supplemented version of Feld, L.P. and J. von Hagen. 2007. "Federal Republic of Germany." In A. Shah (eds.), *The Practice of Fiscal Federalism: Comparative Perspectives*. Montreal & Kingston / London / Ithaca: McGill-Queen's University Press. – We thank Lars Other and Mustafa Yeter, both from the staff of the German Council of Economic Experts, for very valuable research assistance and comments.

<sup>2</sup> See Hesse, K. 1962. *Der unitarische Bundesstaat*. Karlsruhe: C.F. Müller.

<sup>3</sup> See Oeter, S. 1998. *Integration und Subsidiarität im deutschen Bundesstaatsrecht*. Tübingen: Mohr Siebeck.

<sup>4</sup> See Feld, L.P. and J. von Hagen. 2007. "Federal Republic of Germany." In A. Shah (eds.), *The Practice of Fiscal Federalism: Comparative Perspectives*. Montreal & Kingston / London / Ithaca: McGill-Queen's University Press.

<sup>5</sup> See Blankart, C.B. 2017. *Öffentliche Finanzen in der Demokratie*. Munich: Franz Vahlen.

fiscal cooperation to an even higher level. These core characteristics of this fiscal equalization system remained unchanged until 2019.

After the reform act of 1969, several attempts to reform this system took place, some of them triggered by decisions of the Constitutional Court. Two decisions in 1986 and 1992, e.g., resulted in bailouts of the Laender Bremen and Saarland<sup>6</sup>. After unification in 1990, the five East German states were integrated into the system in 1995. After another ruling by the Constitutional Court in 1999 and in the light of growing concerns about resulting disincentives of the system, a Commission for the Modernization of the Federal Order was created in 2003. It was supposed to be the starting point of a major revision of German federalism.

After the grand coalition, elected in 2005, re-entered the reform process of the federal system, a first reform step of Germany's fiscal federalism succeeded in 2006. The major achievement of the Reform Act of 2006 was a disentanglement of federal and Land responsibilities. As the assignment of constitutional tasks to the different levels of government is prerogative for the fiscal constitution, this disentanglement of tasks was key to reform Germany's *fiscal* federalism. Subsequently, the reform of federalism continued in a second step with a strengthening of sub-national fiscal responsibility in 2009, as a debt brake for the Laender was introduced to limit their ability to compensate the lack of tax autonomy through indebting themselves in order to finance political projects. While the expenditure side of fiscal federalism was thus reformed, there was almost no progress on the revenue side.

Instead of introducing more tax autonomy, the federal level and the Laender agreed on a major reform of Germany's fiscal federalism in 2017, which has the dimension of the Fiscal Reform Act of 1969 and has been criticized for fundamentally undermining Germany's (fiscal) federalism<sup>7</sup>. The reform act, which came into force in 2020, did not only largely rescind the disentanglements of the 2006 reform, it also revokes essential parts of the 1969 Fiscal Reform Act and the basic principle that the Laender themselves are the signors of the equalization scheme and Germany's cooperative fiscal federalism.

In view of this development of fiscal federalism in Germany, this chapter provides an overview of the components of fiscal federalism in Germany. After providing a brief characterization of the country, we discuss the division of fiscal powers, the possibilities for the different levels of government to generate revenues, and the system of intergovernmental transfers. Besides

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<sup>6</sup> See Ruling of the Constitutional Court, "BVerfGE 86, 148 – Finanzausgleich II", 27.05.1992.

<sup>7</sup> See German Council of Economic Experts. 2017. *Towards a Forward-Looking Economic Policy: Annual Report 2017/2018*. Wiesbaden: Federal Statistical Office, <https://www.sachverstaendigenrat-wirtschaft.de/jahresgutachten-2017-2018.html?&L=1>.

describing the current situation, we discuss how the latest reform act will change these dimensions of fiscal federalism from 2020 onwards.

### **Section 1: Overview of the Country**

The Federal Republic of Germany is a representative parliamentary democracy with a population of 83.0 million in 2019 and an area of 375,050 square kilometers. In 2019, 10.9 million people, which corresponds to 12% of the population, were foreigners. With 1.48 million people, immigrants from Turkey make up the largest group of foreigners living in Germany, followed by 869,145 immigrants from Poland. In 2019, 1.68 million refugees were registered in Germany, which corresponds to 2 percent of the total population. Of these refugees, 53% were firstly registered in the years 2015 and 2016. With 698,950 persons, immigrants from Syria represent the largest part of the refugees and the third largest part of all immigrant groups. The majority of the German population has a Christian religious background, however most of them are not practicing. 23.6 million people are Roman Catholics and 21.9 million people are Protestants. There are 1.2 million people of Orthodox faith and 300,000 free church followers. About 4.7 million Muslims and 99,000 Jews live in Germany.

The German constitution stipulates two layers of government that possess sovereignty. One is the state level, the *Laender*. The *Laender* in their entirety form the federal level, the *Bund*, which is the second tier of government. As the *Laender* constitute the federal level, their existence is guaranteed by the Grundgesetz<sup>8</sup>. The Grundgesetz allows for territorial changes of the *Laender* and of Germany with three important cases in German post-war history<sup>9</sup>. The first case was the creation of Baden-Wuerttemberg through a merger of the former *Laender* Baden, Württemberg-Baden, and Wuerttemberg-Hohenzollern. The second case was Saarland's accession to the Federal Republic and the third case, of course, was unification.

The constitutional barriers for such changes in the territorial boundaries of the *Laender* are high, as only there the Grundgesetz stipulates mandatory and binding referenda in those *Laender*, which are involved in possible territorial changes, so that a merger requires the majority of the citizens in every Land involved<sup>10</sup>. In 1996, the planned merger of the *Laender* Berlin and Brandenburg failed, because only the majority of the citizens of Berlin, but not of the citizens

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<sup>8</sup> See Grundgesetz, art. 20, abs. 1.

<sup>9</sup> There has also been the interesting case of Schaumburg-Lippe. Despite a majority in a referendum on January 19, 1975 aiming at a re-establishment of the Land of Schaumburg-Lippe according to art. 29 of the Grundgesetz, the federal government rejected this territorial change.

<sup>10</sup> See Grundgesetz, art. 29.

of Brandenburg, voted for the merger. The Grundgesetz confers severity on the sovereignty of the citizens of the Laender and thus of the Laender themselves<sup>11</sup>.

**Table 1: Basic political and geographic indicator**

Official name	Bundesrepublik Deutschland (Federal Republic of Germany)
Population (31.12.2019):	82,885,000
Area (square kilometres):	357,400
GDP per capita in USD (2018):	45,578.57 <sup>1</sup>
Constitution:	1949, written
Orders of government:	Representative Democracy
Constitutional status of local government:	Strong
Official language:	German
Number and types of constituent units:	Three levels of government: federal ( <i>bund</i> ) states ( <i>laender</i> ) local ( <i>gemeinden</i> )
Number of Laender	Before Reunification: 8 Laender and 2 City States  After Reunification: 16 Laender (5 new Laender) and 3 City States (1 new City State)
Population, area, and per capita GDP in USD of the <i>largest</i> constituent unit	Northrhine-Westphalia population (2018): 17,932,651 area: 34,112.31 sq. km. per captia GDP (2018): USD 45,721.70 <sup>1</sup>
Population, area, and per capita GDP in USD of the <i>smallest</i> constituent unit	Bremen population (2018): 682,986 area: 419.36 sq. km., per capita GDP (2017): USD 56,720.6 <sup>1</sup>

Source: Federal Statistical Office (2020)

<sup>1</sup> Exchange rate: 1 EUR = 1.18 USD (ECB reference rate 2018).

Before 1990, the Federal Republic of Germany consisted of eight Laender and the cities of Hamburg and Bremen, which hold the legal status of a Land. Unification in 1990 increased the number of Laender to 16, when five East German Laender and the city state of Berlin entered the Federal Republic. The largest Land is North-Rhine-Westphalia with a population of 17.9

<sup>11</sup> See Feld, L.P. and J. von Hagen. 2007. "Federal Republic of Germany." In A. Shah (eds.), *The Practice of Fiscal Federalism: Comparative Perspectives*. Montreal & Kingston / London / Ithaca: McGill-Queen's University Press.

million and an area of 34,083 square kilometers. The smallest Land is the city state of Bremen with 568,006 inhabitants living on 325 square kilometers. Economically, the Laender show considerable differences. While Germany as a whole recorded an annual GDP per capita of 47,535 USD in 2018, Hamburg recorded a significantly higher figure of 76,208 USD, followed by 53,829 USD in Hesse, and 55,646 USD in Bavaria. The three Laender with the lowest GDP per capita are the East German Laender Mecklenburg-West Pommern with 32,753 USD, Brandenburg with 33,776 USD, and Saxony-Anhalt with 33,001 USD<sup>12</sup>.

Local government does not enjoy the constitutional status of sovereignty. Instead, the municipalities are part of the Laender with their exact legal status determined by each Land's constitution. This leads to varying rights and obligations of the local level across the Laender. Nevertheless, the Grundgesetz protects local government. In particular, the Grundgesetz obliges the Laender to guarantee the principle of municipal self-administration, which means that local governments must be enabled to offer voluntary services in addition to mandatory services they have to provide as delegates of the Laender<sup>13</sup>. This constitutional guarantee obliges the Laender to endow their municipalities with sufficient funds to fulfill their mandatory tasks and to give them financial leeway to offer additional voluntary services.

The number of municipalities has declined considerably since the 1970s. The first wave of municipal mergers took place in the 1970s, during which the number of independent municipalities was reduced by 64%<sup>14</sup>. The second wave coincided with unification, with the number of municipalities in East Germany falling by around 38%, mainly because of municipal mergers there. Since 1991, the number of municipalities has been further reduced by another 33%, resulting in 10,848 politically independent municipalities in 2019.

There are two major differences between German federalism and other, particularly older, federations<sup>15</sup>. First, most of the Laender were newly created and comprised after the Second World War, following the boundaries of the allied occupation zones instead of the historical German states and principalities. The only exceptions are Bavaria, Saxony and the city states Bremen and Hamburg. The second peculiarity of German federalism is that it mainly focuses on separating executive tasks rather than legislative competencies across different layers of

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<sup>12</sup> GDP and population numbers taken from Federal Statistics Office. 2020.

<sup>13</sup> See Grundgesetz, art. 28 abs. 2.

<sup>14</sup> See Fritz, B. and L.P. Feld. 2020. "Common Pool Effects and Local Public Debt in Amalgamated Municipalities." *Public Choice*, 183: 69-99 for more details and for an analysis of the effects of these mergers in the state of Baden-Wuerttemberg.

<sup>15</sup> See Feld, L.P. and J. von Hagen. 2007. "Federal Republic of Germany." In A. Shah (eds.), *The Practice of Fiscal Federalism: Comparative Perspectives*. Montreal & Kingston / London / Ithaca: McGill-Queen's University Press.

government<sup>16</sup>. This special understanding of federalism assigns a particularly important role to the executive branches of government. The historical reason for this distinctive kind of federalism can be found in the way Germany was created in the 19<sup>th</sup> century<sup>17</sup>. As Germany emerged from numerous formerly sovereign principalities under Prussian hegemony, federalism was regarded as a mechanism to ensure the influence of the local princes on the newly created federal level. The aim was to decide jointly on a number of policy fields at the federal level and to leave implementation at the level of the principalities. To date, the Grundgesetz still lays down the principle that the Laender must execute (commonly set) federal law within their own responsibility, which leaves them with considerable executive leeway.

Additionally, the focus of German federalism on executive functions can be seen in the composition of the Bundesrat as the second chamber of parliament. Instead of consisting of elected state-representatives, it is an assembly of the Laender's executives. Only cabinet members of the the state government can be appointed as members of the Bundesrat<sup>18</sup>. Thus, the members of the Bundesrat are the Prime Ministers and senior ministers of the Laender. Note that it is the state cabinets that decide which cabinet members represent the Land in the Bundesrat, while the state parliaments play no role in the formal appointment process. Each member of the Bundesrat carries one vote. The number of members a Land is entitled to appoint, is constitutionally set and should (non-proportionally) reflect the differences in the Laender's population. The members of the Bundesrat have to follow an imperative mandate of the state government they represent. Only if all delegates of one Land vote unanimously a Land's votes are counted. If no consensus can be reached within a state government, the respective Land has to abstain entirely from the conflicted vote. Besides the orderly members of the Bundesrat each line-minister of a Land represents their Land in the committees of the Bundesrat, no matter whether they are a member of the Bundesrat itself or not.

German politics is organized as a parliamentary democracy with proportional representation both on the federal and state levels. Federal and Laender executives are elected by their respective parliaments. Between elections, executives need the ongoing trust of the majority of their parliaments to govern. This offers a strong role to political parties. The role of the parliaments manifests itself also in the fact that there are no elements of direct democracy on the federal level and only very narrowly limited elements of direct democracy on the level of the Laender. The only exception to the parliamentary system is the local level as mayors are

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<sup>16</sup> See Renzsch, W. 2015. "Bundesstaatlicher Finanzausgleich: Fiskalischer Föderalismus oder funktionale Aufgabenteilung des Grundgesetzes?" In M. Junkernheinrich, S. Koriath, T. Lenk, H. Scheller and M. Woisin (eds.), *Jahrbuch für öffentliche Finanzen*. Berlin: Berliner Wissenschafts-Verlag.

<sup>17</sup> See Oeter, S. 1998. *Integration und Subsidiarität im deutschen Bundesstaatsrecht*. Tübingen: Mohr Siebeck.

<sup>18</sup> See Grundgesetz, art. 51 abs 1.



directly elected, such that they play a strong role on the local level against the local (militia) assemblies. Moreover, there are possibilities to hold referenda on local policy issues on the local level. However, on both, the state and the municipal level, decisions affecting public revenues are strictly excluded from direct democratic decision-making. Elections are held in a four-year term on the federal and in five-year terms on the Laender level. As electoral terms overlap, a year without any municipal, state, or federal election is the exception, which holds governments accountable to voters on an ongoing basis.

Given the strong role of political parties, representatives are heavily dependent on their party to pursue political careers. Candidates depend on their party to put them on a secure position on the party list or to nominate them in a constituency the party is likely to win. Thus, parties can discipline their representatives in parliament. The parties themselves are deeply rooted in German federalism<sup>19</sup>. Their structures follow the federal layers and it is usually the local and Laender party branches that decide on the composition of the party lists as well as the candidates in the constituencies. Talented politicians can make it from the local level directly to the federal level or via the state level to the federal level, but usually the Laender level plays a key role in interlinking all levels within the parties. Conversely, federal policymakers changing to state governments or becoming mayors of large cities is also common. This applies to both the legislative as well as the executive branches of government. A side effect of these recruitment mechanisms and the permeability across federal levels within parties is that politicians pursue a more cooperative than competitively oriented path of federalism. However, this cooperative prevalence of federalism within parties usually collapses when conflicts of interest arise between the Laender and the federal level. In such cases, the political lines of conflict do usually not follow party lines, but rather the lines of the tiers of government across all parties. The most recent examples for this are the Federal Reform Acts of 2017 and 2019, in which representatives of the Laender across all parties opposed representatives of the federal level across all parties on the issue of state funding.

Since the Second World War, these lines of the German political system have led to stable governments across all levels of government, usually with two-party coalitions in parliament, led by one of the two main parties, CDU/CSU and SPD. Although parties are very influential, their strong role is challenged in recent times due to two factors. First, the fragmentation of the German party system has increased recently. While the vote shares of the two main parties have declined considerably, left- and right-wing parties have been able to establish themselves,

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<sup>19</sup> See Feld, L.P. and J. von Hagen. 2007. "Federal Republic of Germany." In A. Shah (eds.), *The Practice of Fiscal Federalism: Comparative Perspectives*. Montreal & Kingston / London / Ithaca: McGill-Queen's University Press.

making grand-coalitions or coalitions with more than two parties the rule, and turning formerly secure party lists as well as constituencies into more open races. Second, a strong civil society with an influential NGO landscape increasingly engages in political debate and questions the parties' role as dominant political actors.

While the separation of powers between the legislative and the executive is not very strong due to the parliamentary system, a strong and independent judiciary restricts representatives in parliaments and government. This is, on the one hand, due to the strong role of the constitutional court, which enjoys a high reputation among the population. On the other hand, Germany's civil law system, especially its distinct constitutional and administrative law, effectively restricts policymakers. A second restriction is provided by the federal system and the formation of the Bundesrat as representation of the Laender governments. Since the Bundesrat has to approve most of federal lawmaking and majority conflicts often arise in the Bundestag and the Bundesrat with the parties in opposition in the Bundestag holding the majority in the Bundesrat, i.e., a form of divided government, pronounced checks and balances are provided via the Laender governments.

## **Section 2: The Division of Fiscal Powers**

In light of the functional nature of German federalism, spending responsibilities for each level of government follow the assignment of tasks at these levels<sup>20</sup>. Basically, the Laender are responsible for all fields of politics as long as the Grundgesetz does not explicitly assign a specific responsibility to the federal level<sup>21</sup>. Conversely, this means that the Grundgesetz conclusively defines the fields for which the federal level is exclusively responsible, while everything else lies in the responsibility of the Laender<sup>22</sup>. By this means, the constitution explicitly assigns competencies to the various layers of government.

Besides this explicit assignment, there is an implicit assignment of competencies<sup>23</sup> occurring through concurrent legislation of the federal level and the Laender. The Grundgesetz defines policy areas in which legislative power is assigned to the Laender and to the federal level<sup>24</sup>. If both layers use their legislative powers in these policy areas, federal legislation is superior to

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<sup>20</sup> See Grundgesetz art. 104a abs. 1.

<sup>21</sup> See Grundgesetz art. 70 abs. 1.

<sup>22</sup> See Grundgesetz art. 73.

<sup>23</sup> See Feld, L.P. and J. von Hagen. 2007. "Federal Republic of Germany." In A. Shah (eds.), *The Practice of Fiscal Federalism: Comparative Perspectives*. Montreal & Kingston / London / Ithaca: McGill-Queen's University Press.

<sup>24</sup> See Grundgesetz art. 74.

**Table 2: Rearrangement of (former concurring) Legislative Competencies 2006**

<i>Area of Government</i>	<i>Competency before 2006</i>	<i>Competency after 2006</i>
Legislation on Citizen's Registration and ID	Concurring	Federal Level
Defense against terrorism	Concurring	Federal Level
Legislation on Arms and Explosives	Concurring	Federal Level
Legislation on the usage and security of Nuclear Energy	Concurring	Federal Level
Protection of Cultural Goods against outflux to foreign countries	Concurring	Federal Level
Support for Veterans	Concurring	Federal Level
Legislation on tenure, salaries and pensions of local civil servants and judges	Concurring	Land
Correction and Correction Facilities	Concurring	Land
Social Housing	Concurring	Land
Shop-closing times	Concurring	Land
Right of Assembly	Concurring	Land
Legislation on restaurants and pubs	Concurring	Land
Legislation on general provisions for Universities	Concurring	Land
Legislation on general provisions for the Press	Concurring	Land
Legislation on Gambling	Concurring	Land
Legislation on Retirement-Homes	Concurring	Land
Legislation on land consolidations	Concurring	Land
Noise abatement (except of noise from traffic)	Concurring	Land
Legislation on Hunting and Fishing	Concurring	Concurring (Land legislation superior)
Environmental Protection	Concurring	Concurring (Land legislation superior)
General Legislation on Regional development	Concurring	Concurring (Land legislation superior)

**Table 2: cont.**

<i>Area of Government</i>	<i>Competency before 2006</i>	<i>Competency after 2006</i>
General legislation and water supply	Concurring	Concurring (Land legislation superior)
University admission	Concurring	Concurring (Land legislation superior)

*Source:* Report of the Scientific Service of the German Bundestag 2009, Auswirkungen der Föderalismusreform I.

legislation by the Laender. The degree to which the federal level uses its legislative powers then implicitly determines the remaining powers of the Laender.

Throughout the Reform Act of 2006 and the associated disentanglement of competencies, the fields of concurrent legislation were reduced. The most important, formerly concurrent, fields in which the Federal Level attained exclusive legislative powers were defense against terrorism, legislation on citizens registration as well as legislation on the usage and security of nuclear energy. The Laender attained exclusive legislative competencies in the fields of salaries and pensions of local civil servants, shop-closing times, and assembly rights. Moreover, the Reform Act of 2006 made legislation by the Laender superior to federal legislation in specific areas of concurrent legislation<sup>25</sup>. The most important areas in which legislation of the Laender now outweighs that of the Federal Level are environmental protection, legislation on hunting and fishing as well as on university admissions. Table 2 provides a list of the disentanglement of formerly concurrent legislation throughout the Reform Act of 2006. Although the reform generally strengthened the legislative role of the Laender against the Federal Level, the general superiority of federal legislation against Laender legislation has remained<sup>26</sup>.

Generally, the political fields explicitly and exclusively assigned to the federal level are foreign affairs and defense policy, immigration and border control, citizenship, aviation, railways, highways and large parts of traffic regulation, postal services and communication. In addition, the federal level is solely responsible for payments and pensions of public servants employed at the federal level. In all of these fields, the Laender are not involved in federal decision-making via the Bundesrat. Other competencies at the federal level are the unity of law, labor market regulations, social security including healthcare, research policy and parts of environmental policy, in particular nuclear safety. In these fields, the Laender executives are involved in the decision-making through the Bundesrat.

<sup>25</sup> See Grundgesetz art. 72 abs. 3; art. 84 abs. 1.

<sup>26</sup> See Grundgesetz art. 72 abs. 1.

In principle, the Laender are responsible for all remaining fields of policy. However, due to a strong emphasis on equivalent living conditions in connection with skepticism towards competition among states, the only relevant fields of policy that remain at the Laender level are education, police services and, to a lesser extent, regional planning and hospital supply. Moreover, since the Reform Act of 2006, salaries and pensions of state public servants fall into the exclusive responsibility of the Laender. This is of particular importance as 76 percent of all public servants are employed by the Laender (and 11 percent by the municipalities)<sup>27</sup>. This number is an indicator for another important role of the Laender. The Laender provide public administration, which does not necessarily give them legislative but ample administrative powers. Only the federal employment agency is provided by the federal level. With the Reform Act of 2017, however, the federal level assumes additional administrative competencies on the legislative design of online-administrative services for all levels of government<sup>28</sup>.

Although the Reform Act of 2006 strengthened the regulatory powers of the Laender, the Laender deliberately coordinate themselves in almost all fields in which they possess autonomy. At regular meetings of the state ministers, the Laender mostly agree to adhere to common standards. These standards exert similar effects as legislation at the federal level. Therefore, even in those fields in which the Laender could act autonomously, they mostly decide to act uniformly<sup>29</sup>. The most prominent examples are the regular conferences of the state ministers for education and the interior, the two main areas of state autonomy.

Deviating from the principle that funding responsibilities follow the assignment of tasks, the Grundgesetz defines regional economic promotion, agricultural development and coastal protection as shared tasks of the federal level and the Laender<sup>30</sup>. Both layers of government are generally obliged to provide fifty percent of economic promotion funding. For agricultural development and coastal protection, the federal level has to provide *at least* fifty percent<sup>31</sup>. Until the Reform Act of 2006, the construction of university buildings, research promotion, educational planning, local public transport and public housing have been shared tasks, too. With the Reform Act of 2006 these fields have been assigned exclusively to the Laender. In order to compensate for the increased financial obligations of the Laender following the assumption of exclusive responsibility for these areas, the federal level granted so-called

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<sup>27</sup> See Federal Statistical Office. “Personal des öffentlichen Dienstes“ Series 14/6.

<sup>28</sup> See Federal Ministry of Finance. 2017. “Die Neuordnung der Bund-Länder-Finanzbeziehungen” *Monthly Report of the Federal Ministry of Finance*, 8. Berlin.

<sup>29</sup> See Zimmermann, H. 2018. “Deutschland – auf dem Weg zum unitarischen Bundesstaat?” In M. Junkernheinrich, S. Koriath, T. Lenk, H. Scheller and M. Woisin (eds.), *Jahrbuch für öffentliche Finanzen*, 2018-1. Berlin: Berliner WissenschaftsVerlag.

<sup>30</sup> See Grundgesetz art. 91a abs. 1.

<sup>31</sup> See Grundgesetz art. 91a abs. 3.

disentanglement aid for the period from 2009 to 2019. These transfers are de jure earmarked. However, there is no monitoring of whether the Laender have actually used these funds for the newly assigned competencies.

Besides the constitutionally set shared tasks and financial interlinkages that result from former shared tasks, there are three other areas in which fiscal powers are interwoven across federal levels. First, the federal level provides grants for large investment projects that are carried out by the state or municipal level<sup>32</sup>. In cases where municipalities are the beneficiaries, grants are allocated and administratively executed by the state administrations. During the last years, these grants have been widely extended. With the Federal Reform Act of 2017, federal grants for the subsidization of school infrastructure expenditure of financially weak municipalities were established<sup>33</sup>. In 2019, the federal level and the Laender agreed on additional constitutional changes that establish federal grants to the Laender to support Laender and municipalities in funding digital school equipment and to financially assist the Laender in providing public housing<sup>34</sup>. These latest reforms not only invert some of the disentanglements of the Reform Act of 2006. For the first time, the federal level assumes funding responsibility for educational spending, thus creating a new interweaving in a policy area that used to be the exclusive responsibility of the Laender.

Second, federal legislation often influences sub-federal spending. A recent example is federal legislation that established legal entitlements for childcare. While legislation is passed on to the federal level, the Laender and municipalities must provide childcare capacities locally. Third, the Laender often administer federal tasks without receiving financial compensation from the federal level. This was the case with highway construction, which fell into the responsibility of the federal level but was carried out administratively by the Laender. The latter changed in 2020, when a newly established federal highway agency became responsible not only for construction but also for the administration of highways.

All of this indicates a strong influence of the federal level on state and local policies and thus on state and local fiscal decisions. The flipside is a high degree of participation by the Laender in federal decision-making processes. Every time a federal law affects the administrative competencies of the Laender or concerns the Laender or municipalities financially, the approval of the Bundesrat is required. This provides the Laender with a strong position to counterbalance the federal level, especially when the Laender act jointly. This leads to a situation where on the

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<sup>32</sup> See Grundgesetz art. 104b.

<sup>33</sup> See Grundgesetz art. 104c.

<sup>34</sup> See Grundgesetz art. 104d.

one hand the Laender are strongly bound by federal legislation, but on the other hand the federal level cannot decide much without the consent of the majority of the Laender executives<sup>35</sup>.

**Table 3: Legislative responsibility and actual provision of services by different spheres of government**

<i>Legislative responsibility (de jure)</i>	<i>Public service</i>	<i>Executive responsibility</i>
EU	Monetary policy	EU
EU	Customs	EU
Federal	Defense	Federal
Federal	Foreign affairs	Federal
Federal	Citizenship	Federal
Federal	Customs	Federal
Federal	Rail and air transport	Federal
Federal	Post and telecommunication	Federal
Federal	Social security	Federal/Land
Federal	Health including health insurance and local health facilities	Federal/Land/Local
Federal	Social assistance (supplementary welfare)	Federal/Land/Local
Federal	Waste disposal	Local
Federal/land joint task	Regional economic policy	Land
Federal/land joint task	Coastline preservation	Land
Federal/land joint task	Agricultural promotion	Land
Federal/land	Digital School Equipment	Federal/Land/Local
Federal/land	Environmental protection	Land
Federal/land	Water supply	Local

<sup>35</sup> See Feld, L.P. and J. von Hagen. 2007. "Federal Republic of Germany." In A. Shah (eds.), *The Practice of Fiscal Federalism: Comparative Perspectives*. Montreal & Kingston / London / Ithaca: McGill-Queen's University Press.

**Table 3: cont.**

<i>Legislative responsibility (de jure)</i>	<i>Public service</i>	<i>Executive responsibility</i>
Federal/land	Sewerage	Local
Land	Law and order	Land
Land	Culture	Land
Land	Schools and education	Land
Land	Universities	Land
Local	Local roads	Local
Local	Sports and recreation	Local
Local	School construction	Local
Local	Public housing	Local

*Source:* Authors' collection on the basis of legal documents.

As local governments are part of the Laender, their concrete responsibilities differ across states and depend on specific regulations in the states' own constitutions. In all states, municipalities are responsible for services of general interest such as sewerage, waste disposal, school buildings, urban construction, childcare services, or sports and recreation. Moreover, municipalities are free to provide additional public services on their own as long as they do not violate state or federal legislation. Besides these competencies, municipalities take on administrative tasks on behalf of the states or the federal government. The most important are the registration of citizens and permits for buildings and social services. Thus, there is a high level of administrative vertical integration across all layers of government, which is why Germany is referred to as a typical example of executive federalism<sup>36</sup>.

<sup>36</sup> See Zimmermann, H. 2018. "Deutschland – auf dem Weg zum unitarischen Bundesstaat?" In M. Junkernheinrich, S. Koriath, T. Lenk, H. Scheller and M. Woisin (eds.), *Jahrbuch für öffentliche Finanzen*, 2018-1. Berlin: Berliner Wissenschafts-Verlag.; Rensch, W. 2015. "Bundesstaatlicher Finanzausgleich: Fiskalischer Föderalismus oder funktionale Aufgabenteilung des Grundgesetzes?" In M. Junkernheinrich, S. Koriath, T. Lenk, H. Scheller and M. Woisin (eds.), *Jahrbuch für öffentliche Finanzen*. Berlin: Berliner Wissenschafts-Verlag.



**Table 4: Direct expenditures by function and sphere of government**

<b>Function</b>	<b>Federal</b>	<b>Land</b>	<b>Local</b>	<b>All</b>
Defence	100%	0%	0%	100%
Debt servicing <sup>1</sup>	58%	35%	7%	100%
General administration	14%	27%	59%	100%
Law and order	13%	57%	30%	100%
Schools	0%	81%	19%	100%
Universities	13%	87%	0%	100%
Promotion of pupils, students	37%	35%	28%	100%
Other education	30%	47%	23%	100%
Science and research	74%	23%	3%	96%
Social security	65%	12%	23%	99%
Health, environment, sports, and recreation	9%	40%	51%	100%
Housing, urban development, regional planning	17%	32%	51%	100%
Local public services I <sup>2</sup>	0%	3%	97%	100%
Subsidies	33%	53%	14%	100%
Traffic and communication	45%	20%	35%	100%
Public enterprises	63%	11%	26%	100%
<b>Total</b>	<b>47%</b>	<b>36%</b>	<b>17%</b>	<b>100%</b>
Local public services II <sup>3</sup>	5%	60%	35%	100%

*Source:* Federal Statistics Office, Fachserie 14/Reihe 3.1, Finanzen und Steuern, 2011.

<sup>1</sup>“Zinsausgaben am Kreditmarkt”

<sup>2</sup> According to Federal Statistical Office definition, including street lights, sewerage, waste collection, and street cleaning.

<sup>3</sup> According to the Forum of Federations definition, approximated as mean of law and order, schools, other education, health environment, sports and recreation, housing, urban development and regional planning, and local public services I.

Table 3 shows the differences in legislative and executive responsibilities of the German federal system. We include the EU, to indicate the responsibilities that the national level has delegated to the EU. It becomes obvious how responsibilities are shared, especially in the execution of

public services. This task sharing across layers creates a high opacity for citizens as to which of the three layers of government is de facto responsible for which part of a particular public service. While the Reform Act of 2006 disentangled some of these legislative and executive competencies, the Reform Acts of 2017 and 2019 have rolled back some of these increases in responsibility and transparency, creating a new interweaving especially in the areas of school construction, school equipment and public housing.

Since the allocation of tasks is prerogative for the spending responsibilities, the spending shares of the different governmental tasks are correspondingly interwoven. This is depicted in Table 4. Defense is the only government function that falls into the exclusive fiscal responsibility of a single (the federal) tier of government, while Local Public Services I is the only category in which the federal level has no spending obligations. On the contrary, apart from defense spending, universities are the only governmental function where the local level has no (at least administrative) spending responsibilities. With the exception of defense, the Laender have spending responsibilities for all other governmental functions, which can be explained by their role as the general provider of public administration services.

Overall, the federal level plays the predominant role in financing public services, accounting for 47% of overall public expenditures, while the Laender account for 36%, and the local level for 17%. The most important driver for this role of the federal level is its main responsibility for social security spending. However, as discussed above, the actual fiscal influence of the federal level is much higher, as its legislation often has a decisive impact on state and local spending. With these allocations and interweaving of governmental tasks and, as a result, fiscal obligations and competencies across the three layers of government, Germany can be characterized as a *unitary* federal state<sup>37</sup>. The federal level has the possibility to protrude into competencies of Laender and municipalities, while the Laender are compensated for this with increased influence on the federal level for their executives. Even though they are not formally involved in decision-making processes on the federal level or on the level of the Laender, municipalities, through their umbrella-organizations, which are important, albeit informal, actors in the political arena on the Laender and federal levels, have a strong voice on all issues that affect them. While the tendencies to further intervene in tasks and decisions across government tiers have been ceased somewhat through the Reform Act of 2006 and the associated disentanglements of legislative and executive competencies, they accelerated again with the Reform Acts of 2017 and 2019. As a result, the decision-making system, with its tendencies to shift decisions to higher levels, often contradicts the subsidiarity principle. This

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<sup>37</sup> See Hesse, K. 1962. *Der unitarische Bundesstaat*. Karlsruhe: C.F. Müller.

applies especially to the interplay between the federal and the state level. Due to the strong role of the executives against the legislatures on all governmental layers, which has increased as a result of the latest Reform Acts, Germany's federal system can not only be described as a unitary, but also as *executive* federalism, that often lacks parliamentary oversight over federal fiscal relations, especially on the level of the Laender.

While the expenditure side of the public budget is highly intertwined and rigid, this is all the more true for public revenues. The three main revenue sources of the public budget are the income, corporate and value-added taxes. These three taxes are the so-called shared taxes. The federal level and (via the Bundesrat) the executives of the Laender jointly decide on the bases and rates of these taxes. Tax revenues are divided between the federal level, the Laender and, to a lesser extent, the municipalities<sup>38</sup>.

Large, but still limited, exclusive tax autonomy is assigned to the federal level, which has the exclusive right to determine tariffs and some indirect taxes<sup>39</sup>. However, the authority to set tariffs was conveyed to the European Union, which reduces the de facto exclusive tax autonomy of the federal level to indirect taxes. The Laender possess even less exclusive tax autonomy. They only have full rate autonomy on the real estate purchase tax and, since 2020, the right to determine the tax base of the local property tax autonomously. For the remaining state taxes, tax bases and tax rates are set uniformly and jointly on the federal level by the Bundestag and the executives of the Laender in the Bundesrat as a result of concurrent legislation<sup>40</sup>. Although the Laender have almost no revenue-raising autonomy, they are responsible for collecting federal, state, and joint taxes due to their role as general providers of public administration services<sup>41</sup>. This offers them de facto a slightly stronger role in revenue collection than the de jure tax competencies would suggest<sup>42</sup>. However, the Reform Act of 2017 reduced the autonomy of the Laender to collect taxes from 2020 onwards. While each Land had exclusive autonomy over legislation concerning its tax administration until 2019, new legislative possibilities allow the federal level, with consent of the Bundesrat, to establish administrative standards for the collection of taxes which are applicable to all Laender.

The largest exclusive tax-setting power is assigned to the municipal level. Municipalities are allowed to set the tax rates of local business and property taxes, which are both major revenue

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<sup>38</sup> See Grundgesetz art. 106 abs. 3.

<sup>39</sup> See Grundgesetz art. 106 abs. 1.

<sup>40</sup> See Grundgesetz art. 105 abs. 2.

<sup>41</sup> See Grundgesetz art. 108 abs. 2.

<sup>42</sup> See Bönke, T., B. Jochimsen and C. Schröder. 2017. "Fiscal Equalization and Tax Enforcement." *German Economic Review*, 18: 377-409.

sources for the local authorities<sup>43</sup>. Until 2020, the tax bases have been jointly determined by the Bundestag and the Laender executives in the Bundesrat at the federal level. Since 2020, the Laender also have the right to set the tax base of the local property tax autonomously.

These tax-raising competencies lead to a situation where the own-source revenues of the state and municipal levels fall short of their constitutionally assigned tasks and thus their actual spending needs. Therefore, there are distinct, complex, and quantitatively important systems of revenue redistribution between the federal level and the Laender and between the Laender and the municipalities, which assign revenues to all layers according to their respective tasks. Moreover, the distribution of revenues across layers of government is, most notably for the Laender, also used to compensate for differences in local revenues among the jurisdictions of the same layer. After the allocation of the respective tax shares of the joint taxes, which follows tax occurrence and redistribution aims, a redistribution-scheme among the Laender sets in to increase revenues of all states to approximately 90 percent of per capita average state revenues. After that, further vertical transfers from the federal level ensure that every Land receives at least 97.5 percent of average per capita state revenues. All these transfers are de facto unconditional and impose a highly egalitarian revenue situation on all Laender. Even though municipalities enjoy more tax autonomy than the Laender, their own-source revenues also fall short of their spending responsibilities. As municipalities are part of the Laender, it falls into the responsibility of the Laender to endow them with sufficient resources to execute their tasks. Therefore, all states established municipal equalization schemes. In addition to the equalization scheme among the Laender until 2020, the local equalization schemes are primarily vertical systems with horizontal redistribution effects. Only a few Laender have amended their municipal equalization scheme with horizontal components. All of this can be attributed to the general emphasis of German politics and the electorate on an egalitarian rather than efficient distribution of revenues. This is even rooted in the Grundgesetz, where the establishment of equivalent living conditions is defined as a constitutional obligation<sup>44</sup>.

Throughout the Reform Act of 2006 and as a result of the increases in public debt and the insufficiency of the formerly “golden rule” debt constraint, which stated that the federal and the state governments are entitled to issue debt for themselves in the amount of their annual net investment expenditures, a close-to-balanced budget rule has been introduced for the federal level since 2016. Since 2020 the Laender face a strict balanced budget rule. Although the precise formulation of the budget rules of the Laender fall within the competencies of the

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<sup>43</sup> See Grundgesetz art. 106 abs. 6.

<sup>44</sup> See Grundgesetz art. 72 abs. 2.

Laender legislatures, the strict borrowing banning obligations of the Grundgesetz are prerogative to possibly shortcoming rules of the Laender<sup>45</sup>. Local governments were already confronted with budget rules before the Reform Act of 2006. As the Laender are constitutionally obliged to guarantee the financial capacity of their municipalities, and since it remains at least unclear whether the Laender would have to bail-out municipalities in the case of a municipal default, they restrict municipal budgetary activities, especially with respect to local borrowing and deficits, and control the fiscal activities of their municipalities. Apart from the Laender, that are exposed to credible fiscal rules since 2020 only, German municipalities have never been allowed to run structural deficits. However, the intensity and credibility of restrictions for municipal debt and their surveillance differ considerably across Laender. While the budgets of municipalities in, e.g., Baden-Wuerttemberg are tightly regulated by state legislation, municipalities in North-Rhine Westphalia enjoy much greater discretion<sup>46</sup>. Overall, the Reform Act of 2006 introduced credible restrictions on federal borrowing and borrowing of the Laender, while municipalities face debt restrictions ever since. Moreover, Germany as a whole remains restricted not only by its own fiscal rules, but also by the EU Stability and Growth Pact and the Fiscal Compact.

### **Section 3: Fiscal Federalism and Macroeconomic Management**

Since the foundation of the European Monetary Union (EMU), monetary policy is exclusively assigned to the European Central Bank (ECB) and thus to the European level. According to the European treaties, the ECB was created based on the model of the Deutsche Bundesbank. The ECB enjoys strong independence, but in a hierarchical mandate it has the primary task to ensure price stability. While the ECB is bound by its mandate, the central bank enjoys instrumental independence, with the exception that state funding and monetization of public debt are strictly prohibited. While monetary policy is delegated to the European level, fiscal policy remains in the national sphere. The only European institutions that affect national fiscal policy are the Stability and Growth Pact (SGP) and the Fiscal Compact, the first one limiting the overall annual deficit of all layers of government to 3 percent of its GDP and the overall debt burden to 60 percent of GDP, the latter limiting structural deficits to 0.5 percent of GDP. However, the

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<sup>45</sup> See Burret, H.T. and L.P. Feld. 2013. "Fiscal Institutions in Germany." *Swiss Journal of Economics and Statistics*, 149: 249-290.

<sup>46</sup> See Bury, Y. and L.P. Feld. 2018. "Die Heterogenität der kommunalen Haushalts- und Aufsichtsregeln als Herausforderung im vertikalisierten Fiskalföderalismus." In M. Junkernheinrich, S. Koriotoh, T. Lenk, H. Scheller and M. Woisin (eds.), *Jahrbuch für öffentliche Finanzen*, 2018-2. Berlin: Berliner Wissenschafts-Verlag.

credibility of the SGP and its enforcement has been put into question several times since its establishment because of many special permissions and loopholes.<sup>47</sup>

On the national level, the Grundgesetz establishes general economic equilibrium as constitutional obligation for the federal level and the Laender<sup>48</sup>. This became instrumental with the Stability and Growth Law of 1967, which obliges the federal government and the Laender to conduct macroeconomic policies such that price stability, high employment, external balance and adequate economic growth are achieved<sup>49</sup>. Thus, all governmental layers are responsible for macroeconomic stabilization.

The lack of tax autonomy of the Laender, combined with rigid spending obligations, led the Laender to increasingly rely on transfers and borrowing to meet their spending needs and to finance the state governments' individual political purposes. The consequence is high indebtedness in some Laender. This development culminated in a ruling of the Constitutional Court in 1992, according to which the federal level and the other Laender had to bailout the most highly indebted Laender Bremen and Saarland<sup>50</sup>. However, the Constitutional Court defined strict requirements for such federal bailouts. The most important of these requirements is that there must be a federal state of emergency. This would only be the case if the continued existence of the Land, which seeks bailout, and thus of the federal territory as it stands, is at risk. The Constitutional Court appeared to be strict in the application of this requirement, as it rejected a bailout lawsuit of the highly indebted city state of Berlin in 2006<sup>51</sup>.

Nevertheless, there are reasons to suspect that a soft budget constraint for the Laender resulted from the Bremen/Saarland ruling<sup>52</sup>. In case of a soft budget constraint, the marginal benefits of additional spending exceed their marginal costs, as the possibility for state policy arises to externalize some of the taxation needed to fund additional spending to taxpayers outside their own Land<sup>53</sup>. This may incentivize state policy to conduct excessive spending and to increase

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<sup>47</sup> See Christofzik, D.I., L.P. Feld, W.H. Reuter and M. Yeter. 2018. "Uniting European Fiscal Rules: How to Strengthen the Fiscal Framework." Working Paper 04/2018, German Council of Economic Experts, Wiesbaden.

<sup>48</sup> See Grundgesetz, art. 109 abs. 2.

<sup>49</sup> See Stability and Growth Law, paragraph 1.

<sup>50</sup> See Ruling of the Constitutional Court, „BVerfGE 86, 148 – Finanzausgleich II“, 27.05.1992.

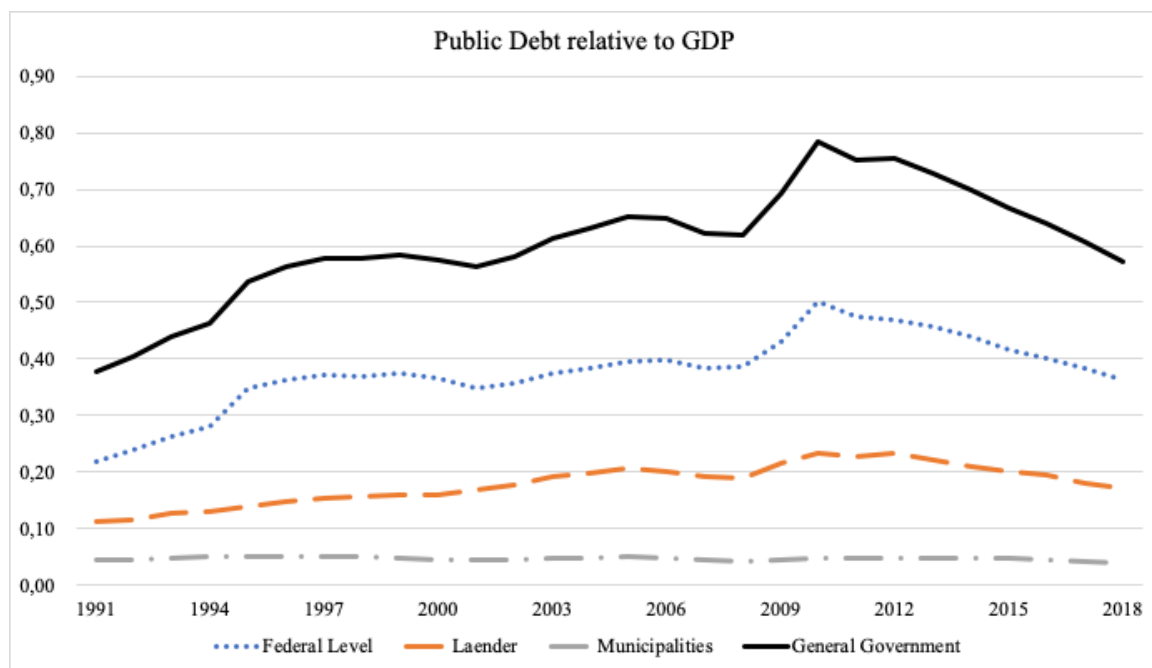
<sup>51</sup> See Ruling of the Constitutional Court, „2 BVF 3/03“, 19.10.2006.

<sup>52</sup> See Feld, L.P. and J. von Hagen. 2007. "Federal Republic of Germany." In A. Shah (eds.), *The Practice of Fiscal Federalism: Comparative Perspectives*. Montreal & Kingston / London / Ithaca: McGill-Queen's University Press; Seitz, H. 1999. "Subnational Bailouts in Germany." ZEI Working Paper B20. Bonn; Rodden, J. 2005. "And the Last Shall be First: Federalism and Fiscal Outcomes in Germany." Department of Political Science, MIT. Cambridge. Mimeo.

<sup>53</sup> See Feld, L.P. and J. von Hagen. 2007. "Federal Republic of Germany." In A. Shah (eds.), *The Practice of Fiscal Federalism: Comparative Perspectives*. Montreal & Kingston / London / Ithaca: McGill-Queen's University Press.

deficits<sup>54</sup>. These tendencies are intensified as all Laender benefit from the favorable credit conditions of the German federal government. Empirical analyses indicate unsustainable debt levels in most Laender<sup>55</sup>. Moreover, the numbers of state debt are likely to increase sharply once demographics will affect pension liabilities of the Laender<sup>56</sup>. The overall debt to GDP ratio was 59.8 percent in 2019<sup>57</sup>. At about 60 percent of overall public debt, the federal level bears the largest share, followed by the Laender with 30 percent of public debt in 2019. While the overall public debt burden quadrupled since 1990, subnational debt tripled.

**Figure 1: Public Debt relative to GDP (1991-2018)**



Source: Federal Statistical Office, own calculations.

The development of the public debt stock since reunification is depicted in Figure 1. Although fiscal sustainability of individual Laender can be put into question<sup>58</sup>, the credible bail-out claim

<sup>54</sup> See Hagen, J. von and M. Dahlberg. 2004. "Swedish Local Government: Is There a Bailout Problem?" In P. Molander (ed.), *Fiscal Federalism in Unitary States*. New York: Kluwer/Springer.

<sup>55</sup> See Burret, H.T., L.P. Feld and E.A. Koehler. 2016. "(Un-)Sustainability of Public Finances in German Laender: A Panel Time Series Approach." *Economic Modelling*, 53: 254-265; Burret, H.T., L.P. Feld and E.A. Koehler. 2017. "Fiscal Sustainability of the German Laender: Time Series Evidence." *Finanzarchiv / Public Finance Analysis*, 73: 103-132; Feld, L.P., E.A. Koehler and J. Wolfinger. 2020. "Modeling Fiscal Sustainability in Dynamic Macro-Panels with Heterogeneous Effects: Evidence from German Federal States." *International Tax and Public Finance*, 27: 215-239.

<sup>56</sup> See Feld, L.P. and J. von Hagen. 2007. "Federal Republic of Germany." In A. Shah (eds.), *The Practice of Fiscal Federalism: Comparative Perspectives*. Montreal & Kingston / London / Ithaca: McGill-Queen's University Press.

<sup>57</sup> Data according to Eurostat.

<sup>58</sup> See Burret, H.T., L.P. Feld and E.A. Koehler. 2016. "(Un-)Sustainability of Public Finances in German Laender: A Panel Time Series Approach." *Economic Modelling*, 53: 254-265.

of the federation against the Laender prevented individual Laender from falling into sovereign debt crises. This credible bail-out claim also prevented the Laender from falling into debt crises in situations of particular fiscal stress as, e.g., in the financial crises of 2008/2009. However, the increase in general government debt during the financial crisis triggered the debate on sustainability of public finances in Germany.

As a reaction to this debate and to counteract the imbalances of increasing spending needs and almost no revenue-raising possibilities on the state level and the associated unfavorable incentives, the federal level and the Laender agreed to implement a fiscal rule into the Grundgesetz in 2009<sup>59</sup>. This fiscal rule states that, since 2016, the federal government is not allowed to run a structural deficit that exceeds 0.35% of GDP. The respective cyclical adjustments have to be symmetric. They enable broader deficit limits in times of economic downturns, but require surpluses in booms<sup>60</sup>. In addition to automatic cyclical adjustments, an escape clause is provided. The Bundestag may approve additional credit lines in case of natural disasters, severe economic downturns or other events that are beyond the control of the government. In such cases, an amortization plan of the additionally approved deficits must be provided<sup>61</sup>.

While Article 109 of the Grundgesetz allows the federal level to run a close-to-balanced budget, the Laender are subject to a strict balanced budget rule since 2020. As on the federal level, deviations from a balanced budget through cyclical adjustments and escape clauses are allowed for. The detailed design and implementation of the fiscal rule for each Land is submitted to the Laender. However, the provisions that apply to the fiscal rule on the federal level have to hold for the fiscal rules of the Laender simultaneously. In particular, even on the state level, only *symmetric* cyclical components are legitimate. Moreover, amortization plans are also required at the Laender level if a state parliament approves higher credit lines in the event of natural disasters or other exceptional events. If the fiscal rule of a Land did not meet the requirements of the Grundgesetz, the Land's own fiscal rule would be overruled by the Grundgesetz. In this case, the Land would not be allowed net borrowing in any case without exception.

While giving considerable scope for fiscal policy to react to macroeconomic shocks, the design of the German debt brake should limit excessive public borrowing on both federal and Laender levels. Due to cyclically high revenues and low interest payments, the federal government faced

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<sup>59</sup> See Burret, H.T. 2013. "Die deutsche Schuldenbremse als Allheilmittel - eine Analyse im historischen Kontext." *Journal für Generationengerechtigkeit*, 13: 48-65.

<sup>60</sup> See Burret, H.T. and L.P. Feld. 2013. "Fiscal Institutions in Germany." *Swiss Journal of Economics and Statistics*, 149: 249-290.

<sup>61</sup> See Federal Ministry of Finance. 2012. *Compendium on the Federation's Budget Rule as set out in Article 115 of the Basic Law*. Berlin.



no difficulties in meeting the requirements of the fiscal rule since 2016. To enable the highly indebted Laender Berlin, Bremen, Saarland, Saxony-Anhalt, and Schleswig-Holstein to meet the requirements of the fiscal rule from 2020 onwards, the federal government and the other Laender provided consolidation assistances of 800 million Euro (862 million USD) annually to these Laender between 2011 and 2019. Within the framework of the Federal Reform Act of 2017, the federal level and the Laender agreed that the payment of consolidation assistances will continue beyond 2019. Since 2020, however, the federal level bears the consolidation assistances alone, while the other Laender will no longer have to contribute any funds<sup>62</sup>.

By the Reform Act of 2009, a Stability Council was established consisting of the federal ministers of finance and economic affairs, and the state ministers of finance<sup>63</sup>. This council has to monitor the compliance of all tiers of government with the fiscal provisions of the Grundgesetz and the federal law of public budgeting. Since 2020, the Council is mandated to monitor compliance of the Laender with the fiscal rules and is allowed to set uniform standards for the cyclical adjustment of budgetary data<sup>64</sup>. Moreover, the Stability Council has to ensure that all layers of government comply with European fiscal provisions. The Stability Council must provide recommendations if the federal government or a Land fails to comply with the legal provisions. In case of fiscal stress of a particular Land, the Stability Council has to detect and declare a fiscal state of emergency and agree on adjustment measures for the respective Land. It may impose sanctions if a Land does not comply with its adjustment plan. However, these sanctions are limited to a cut in consolidation assistances that are part of the adjustment plan itself. The council is complemented by an independent advisory board.

While strict fiscal rules for the federal level and the Laender were established by the Reform Act of 2009, German municipalities have never been allowed to run structural deficits. Instead, municipal borrowing is restricted to the amount of public investment expenditures. However, as the Laender are responsible for monitoring municipal finances, compliance with this rule varies considerably across states. Especially, Saarland, Rhineland-Palatinate, Hesse, and North-Rhine Westphalia allowed their municipalities to use short-term liquidity loans to fund current expenditures and to accumulate deficits over a period of years<sup>65</sup>. Hesse launched a debt relief

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<sup>62</sup> See Federal Ministry of Finance. 2017. “Die Neuordnung der Bund-Länder-Finanzbeziehungen” *Monthly Report of the Federal Ministry of Finance*, 8. Berlin.

<sup>63</sup> See Grundgesetz, art. 111.

<sup>64</sup> See Federal Ministry of Finance. 2017. “Die Neuordnung der Bund-Länder-Finanzbeziehungen” *Monthly Report of the Federal Ministry of Finance*, 8. Berlin.

<sup>65</sup> See Bury, Y. and L.P. Feld. 2018. “Die Heterogenität der kommunalen Haushalts- und Aufsichtsregeln als Herausforderung im vertikalisierten Fiskalföderalismus.” In M. Junkernheinrich, S. Koriath, T. Lenk, H. Scheller and M. Woisin (eds.), *Jahrbuch für öffentliche Finanzen*, 2018-2. Berlin: Berliner Wissenschafts-Verlag; Heinemann, F., L.P. Feld, B. Geys, C. Gröpl, S. Hauptmeier and A. Kalb. 2009. *Der kommunale Kassenkredit zwischen Liquiditätssicherung und Missbrauchsgefahr*. Baden-Baden: Nomos.

program with which the state and local governments could redeem debt burdens caused by liquidity loans and thus reflecting deficits resulting from current expenditures. Since late 2019 there are ongoing debates whether the federal government should redeem municipal debt burdens in other states without leading to conclusive results.

#### **Section 4: (Fiscal) Federalism during the COVID-19 pandemic**

The COVID-19 pandemic of 2020 is a litmus test for macroeconomic management in Germany's system of fiscal federalism in the situation of an extraordinary economic and societal shock. In addition, it has put the effectiveness of Germany's executive and cooperatively entangled federalism in times of crises to the test.

Despite the strong role of the Laender executives in German federalism, situations are rare in which a wider public takes notice of the crucial role the Grundgesetz assigns to the Laender. The outbreak of the COVID-19 pandemic in 2020 marked such an, also in this regard, exceptional event. There are two reasons that are important to understand the central role the Laender have played during the COVID-19 pandemic. First, times of crises are usually times in which the executive branches of government is central. As discussed above, in German federalism the core executers of public services are the Laender executives. Second, the Laender constitute the federation and delegate (large) parts of their sovereignty to the federal level. However, policies that may interfere with fundamental personal rights have largely been kept within the sphere of the Laender. Therefore, the federal state of defense constitutes the only case in which the federal level is allowed to universally restrict the right of assembly or free movement of people. By this means, the Grundgesetz uses the assignment of competencies to establish pronounced checks and balances to secure fundamental rights. Establishing the state of emergency<sup>66</sup> or inducing measures that restrict the freedom of assembly or free movement in the case of natural disasters falls into the exclusive competency of the Laender, which are responsible for all policies of civil protection and disaster management.

According to this separation of competencies, it has been the Laender that were responsible for all emergency measures during the COVID-19 pandemic. In the course of the pandemic, all Laender imposed the closures of schools, shops and restaurants and enacted directives to prohibit all assemblies and meetings of more than three persons. A formal quarantine was, however, not prescribed by any Land. The sequence of inducing these measures differentiated

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<sup>66</sup> Most of the Laender did not formally establish a state of emergency during the COVID-19 pandemic, but imposed directives to restrict the freedom of movement and assembly.

distinctly between the Laender. Bavaria and Saarland, followed by Baden-Wuerttemberg and Hesse, were the first to implement far-reaching measures to reduce personal contacts between people. Bavaria and Saarland have also been the two only Laender that formally established a state of emergency. This aimed at giving the state governments additional policy tools at hand, i.e., using health care equipment of the armed forces. Thus, instead of sticking to the usually practiced cooperative approach, Germany's federalism showed competitive elements between the Laender during the COVID-19 pandemic.

Besides the Laender, municipal governments played the most important role in implementing emergency measures. In accordance with their state constitutions municipal governments are entitled to implement measures that restrict personal freedom in case of natural disasters that particularly affect respective municipalities. As emergency measures of the state governments evolved gradually, municipalities that were exposed to particular epidemiological risks often imposed emergency measures such as curfews and restrictions to the right of assembly before the respective state governments took up containment measures. For these municipalities, the directives of the state governments did then outweigh the measures already imposed by the municipality. However, each municipality was still entitled to implement measures that went beyond the scope of the state directives if there was a local epidemiological necessity to do so. In addition to civil protection measures, the Laender had two other important functions during the pandemic. These functions came along with their constitutionally assigned tasks of public health protection in general as well as their roles as providers of general public administration services and of hospital supply in particular. Within the Laender's role as provider of the general public administration, public health offices as well as police and emergency forces are part of the state administrations. Thus, not only the emergency measures by themselves, but also the enforcement of these (de jure often identical across states) measures, differed between the states. Within the Laender's role to administer hospital care, the state level was responsible to organize the allocation of patients to hospitals, the safety regulations of hospitals as well as for the supply of hospitals with medical equipment. Also in these regards, the concrete policies of the Laender differed from each other.

Coordinating the emergency measures of the Laender fell into the competency of the federal level. The most important field of coordination was the supply of medical equipment. The federal ministry of health newly organized centralized procurement mechanisms for medical equipment and its distribution to the state governments<sup>67</sup>. While this technical coordination was well perceived by all Laender, an attempt to transform the individual emergency measures of

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<sup>67</sup> The distribution to individual hospitals was then organized by the state governments.

the Laender into a coherent acting of all Laender caused conflicts. The attempt to transform state-individual policies into one coherent policy of all states was initiated by the federal government and triggered by some state prime ministers, but encountered sharp resistance by most of the Laender that faced higher epidemiological risks and subsequently already took up stricter containment measures than the rest of the Laender. Thus, the differing reactions of the state governments to the COVID-19 pandemic was one of the rare examples in which the otherwise usual urge of German Laender to cooperate and agree to pursue coherent policies failed. The Laender also declined an attempt of the federal level to change the Federal Infection Protection Act. This attempt aimed at shifting far-reaching additional competencies in the case of pandemics from the state to the federal level<sup>68</sup>.

While the implementation of emergency and health care measures fell into the responsibility of the Laender, the federal level had two explicit competencies to execute. First, the federal government was within its tasks of foreign affairs and border protection responsible for international coordination of emergency measures as well as border protection and closures<sup>69</sup>. The most important role the federal level assumed during the pandemic, however, have been economic emergency measures. The central economic emergency measure has been the provisions for short-time work, which is a wage assistance from the federal employment agency for workers, that enables companies to keep them on the job during a crisis without bearing the costs of employment. Via tax moratoriums, liquidity assistance<sup>70</sup>, and liquidity loans the federal level provided an additional 415.8 billion Euro (447.2 bn. USD) of public funds. This economic emergency response aimed at counteracting liquidity shortages of businesses during the economic shutdown period. Within few days after the first shutdown measures were imposed by state governments, these funds became effective. Moreover, the federal government provided guarantees over 819.7 billion Euro (884 bn. USD) for liquidity loans for companies. To finance these measures, Bundestag and Bundesrat used the escape clause that the fiscal rule of the Grundgesetz foresees and was authorized to take up 217.8 billion Euro (238.7 bn. USD) of new debt. According to the provisions of the fiscal rule an amortization table was passed together with the activation of the escape clause. The amortization table states that the newly

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<sup>68</sup> The Infection Protection Act was changed during the COVID-19 pandemic, however in a distinctly smaller extent than it was intended by the federal government.

<sup>69</sup> The latter caused discussions between some state governments and the federal government, as, e.g., Saarland, Bayern and Baden-Wuerttemberg closed parts of their borders to France and Austria before the federal government officially announced the general closure of borders.

<sup>70</sup> These assistances were designed as direct and non-refundable payments for small and medium sized businesses.

issued debt will be redeemed within 20 years with an annual debt service of 5 billion Euro, starting in the year 2024.

The payout of the liquidity assistances was implemented via the state governments that individually designed the applications and approving procedures for companies to receive funds. Besides the economic emergency measures of the federal level, most Laender set up own state funds to provide liquidity assistances and liquidity loans to businesses within their state. Some states implemented their own funds proactively, before the economic stabilization measures of the federal level were implemented.

Table 5 provides an overview on the federal and state individual economic emergency measures during the COVID-19 pandemic. In addition to the economic emergency funds, some of the Laender established funds to support the municipalities within their states with additional transfers.

These transfers aimed at covering the increased costs of local public services during the pandemic. As of July 31, 2020, all Laender except Thuringia and the city state of Bremen passed supplementary budgets. In line with the federal level, the Laender parliaments had to activate the escape clauses of their state-level fiscal rules to take up new debt to fund their economic emergency measures.

Additional borrowing of the Laender is also depicted in Table 5. Although the federal level and most of the Laender indebted themselves to mobilize substantial funds, sustainability of public finances of the federal government and the Laender is not expected to change. The reason for this are the amortization schedules for newly issued debt, which the Laender had to resolve in the course of enacting the escape clauses of their fiscal rules (see Table 5). According to these schedules, the Laender will have to use substantial amounts out of their budgets in the subsequent years to service the debt they took up during the COVID-19 pandemic. As the Laender have almost no possibilities to raise additional revenues (see next section), servicing the debt of the COVID-19 emergency measures out of their running budgets will substantially reduce fiscal space of the German Laender in the years after the pandemic.

**Table 5: Economic Emergency Measures of the Laender during the COVID-19 pandemic**

<i>Land</i>	<i>Economic Emergency Measures</i>	<i>Borrowing necessary to fund measures</i>	<i>Amortization Table</i>
Federal Level	<ul style="list-style-type: none"> <li>• Direct Payments for SME, self-employed and liberal professions</li> <li>• Liquidity Loans</li> <li>• Economic stimulus package</li> </ul>	217.8 bn. Euro (255.84 bn USD) <sup>1</sup>	Amortization over 20 years, beginning in 2023.
Baden-Wuerttemberg	<ul style="list-style-type: none"> <li>• Direct Payments for SME, non-profit organizations, self-employed, liberal professions and artists</li> <li>• Liquidity Loans</li> <li>• Direct payments to municipalities to compensate for shortfall in receipts and additional expenditures</li> </ul>	5 bn. Euro (5.87 bn USD)	Amortization over 10 years, beginning in 2024 with annual redemptions of 500 million Euro.
Bavaria	<ul style="list-style-type: none"> <li>• Direct Payments for SME and self-employed members of the liberal professions and artists</li> <li>• Liquidity Loans and guarantees</li> </ul>	10 bn Euro (10.96 bn USD)	Amortization beginning in 2024 with annual redemptions of 1/20 of the liabilities.
Berlin	<ul style="list-style-type: none"> <li>• Liquidity Loans and guarantees</li> <li>• Direct Payments for SME, self-employed, liberal professions and artists</li> </ul>	6 bn. Euro (7.05 bn USD)	Amortization beginning in 2023 with annual redemptions of 1/27 of the liabilities
Brandenburg	<ul style="list-style-type: none"> <li>• Direct Payments for SME, self-employed and liberal professions</li> <li>• Liquidity loans and guarantees</li> <li>• Direct payments to municipalities to compensate for shortfall in receipts and additional expenditures</li> </ul>	2 bn Euro (2.35 bn USD)	Amortization beginning in 2022 with annual redemptions of at least 3.3 per cent.
Bremen	<ul style="list-style-type: none"> <li>• Direct Payments for SME and artists</li> <li>• Liquidity Loans</li> </ul>	0.89 bn Euro (1.06 bn USD)	Amortization beginning in 2024 with annual redemptions of 29.6 Mio Euro for 29 years.

**Table 5: cont.**

<i>Land</i>	<i>Economic Emergency Measures</i>	<i>Borrowing necessary to fund measures</i>	<i>Amortization Table</i>
Hamburg	<ul style="list-style-type: none"> <li>• Direct Payments for SME, self-employed, liberal professions and artists</li> <li>• Liquidity Loans</li> </ul>	1.5 bn Euro (1.76 bn USD)	Amortization beginning in 2025, equally within 20 years.
Hesse	<ul style="list-style-type: none"> <li>• Direct Payments for SME, non-profit organizations, self-employed, liberal professions and artists</li> <li>• Liquidity Loans</li> <li>• Direct payments to municipalities to compensate for shortfall in receipts</li> <li>• Economic growth package</li> </ul>	1.7 bn Euro (2 bn USD)	Amortization over 7 years, according to the difference between the the net borrowing allowed and the actual net borrowing during the financial year 2020 required net borrowing.
Mecklenburg-Western Pommerania	<ul style="list-style-type: none"> <li>• Direct Payments for SME, non-profit organizations, self-employed, liberal professions and artists</li> <li>• Liquidity Loans</li> </ul>	0.7 bn Euro (0.82 bn USD)	Amortization over 10 years, beginning in 2024 with annual redemptions of 10 per cent.
Lower Saxony	<ul style="list-style-type: none"> <li>• Direct Payments for SME, self-employed and liberal professions</li> <li>• Liquidity Loans</li> </ul>	8.78 bn Euro (10.3 bn USD)	Amortization beginning in 2024 within 25 years.
North Rhine-Westphalia	<ul style="list-style-type: none"> <li>• Direct Payments for SME, non-profit organizations, self-employed, liberal professions and artists</li> <li>• Liquidity Loans</li> </ul>	25 bn Euro (29.4 bn USD)	Amortization over 50 years, in line with economic situation.
Rhineland-Palatinate	<ul style="list-style-type: none"> <li>• Liquidity Loans</li> </ul>	0.57 bn Euro (0.67 bn USD)	Amortization beginning in 2024, with positive business cycle component 15 per cent, with negative business cycle component 5 per cent.

**Table 5: cont.**

<i>Land</i>	<i>Economic Emergency Measures</i>	<i>Borrowing necessary to fund measures</i>	<i>Amortization Table</i>
Saarland	<ul style="list-style-type: none"> <li>• Liquidity Loans</li> <li>• Direct Payments for SME, self-employed, liberal professions and artists</li> <li>• Support for municipalities</li> </ul>	1.2 bn Euro (1.41 bn USD)	Amortization over 30 years.
Saxony	<ul style="list-style-type: none"> <li>• Liquidity Loans</li> </ul>	6 bn Euro (7.01 bn USD)	Amortization within 8 years specified in the constitution, Actual amortization over 6 years (beginning 2025) with annual redemptions of 1/6 of the liabilities.
Saxony-Anhalt	<ul style="list-style-type: none"> <li>• Direct Payments for SME, self-employed, liberal professions and artists</li> <li>• Liquidity Loans</li> </ul>	0.259 bn Euro (0.305 bn USD)	Amortization in financial years 2022 and 2023 100 million euro each and approximately 59 million euro remaining in 2024.
Schleswig-Holstein	<ul style="list-style-type: none"> <li>• Liquidity Loans</li> </ul>	1 bn Euro (1.17 bn USD)	Amortization beginning from 2021, within 20 years.
Thuringia	<ul style="list-style-type: none"> <li>• Direct Payments for SME, self-employed and liberal professions</li> </ul>	Decision on borrowing not yet taken at the 28 <sup>th</sup> July 2020.	Decision on borrowing not yet taken at the 28 <sup>th</sup> July 2020.

*Source:* Authors collection. The Table depicts the policy measures resolved until the 28<sup>th</sup> July 2020.

<sup>1</sup> Exchange Rate: US dollar (USD): EUR 1 = USD 1.1760 (ECB euro reference exchange rate: 27<sup>th</sup> July 2020).



Eventually, Germany's (fiscal) federalism, with the strong role it assigns to the state executives, proved to provide resilient structures to react to an outstanding exogenous shock such as the COVID-19 pandemic. The decentralized decision-making on the municipal and state levels mostly provided healthcare and fiscal policy responses that have been effective and locally suited for the specific regional needs. Moreover, the Laender resisted to use the pandemic as an occasion to shift competencies to the federal level thereby protecting the federal structure in a situation in which it was exposed to intense stress.

### **Section 5: Revenue Raising Responsibilities**

The German fiscal constitution provides almost no competencies to generate revenues for subnational units. Tax bases and rates, with minor exceptions for the latter, are set at the federal level. While the Laender have almost no autonomy to set taxes exclusively, their executives play an important role in tax setting decisions on the federal level via the Bundesrat. Table 6 summarizes the tax setting powers and the allocation of revenues from the various taxes. In the fiscal year of 2018, 46 percent of all shared, federal and state tax revenues were assigned to the federal level.

The most important revenue sources in quantitative terms are the shared taxes (*Gemeinschaftssteuern*), i.e., income tax, corporate tax, value added tax and flat-rate withholding tax. Revenues from these taxes are shared between the federal level, Laender, and municipalities<sup>71</sup>. Tax bases and rates are determined at the federal level, whereby a majority of the Bundesrat and thus the approval of the executives of the Laender is required. The shared taxes are the quantitatively most important revenue sources for the federal level. Revenues from these taxes accounted for 80 percent of federal tax revenues and 66 percent of total federal revenues in 2018. The VAT alone accounts for 35 percent of tax revenues at the federal level. For the Laender, the shared taxes are an even more important source of tax revenue. In 2018, shared taxes made up 86 percent of state tax revenues and 63 percent of total state revenues.

While the shared taxes are quantitatively the most important, there are taxes that are exclusively assigned to the federal, state or local levels. Taxes on insurance, tobacco, coffee, spirits, sparkling wine, intermediate goods, energy, electricity, car and air-traffic fall under the sole responsibility of the federal government (*Bundessteuern*)<sup>72</sup>. Within the Reform Act of 2006, the previously state vehicle tax became a federal tax.

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<sup>71</sup> See Grundgesetz art. 106 abs. 3.

<sup>72</sup> See Grundgesetz art. 106 abs. 1.

**Table 6: Tax assignment for various orders of government**

Determination of			Tax collection and administration	Shares in Revenue (%)			
Base	Rate			Federal	Land	Local	All orders
<b><i>Federal</i></b>							
Mineral oil tax	Federal	Federal	Federal	100%	0%	0%	100%
Tobacco tax	Federal	Federal	Federal	100%	0%	0%	100%
Spirits tax	Federal	Federal	Federal	100%	0%	0%	100%
Sparkling wine tax	Federal	Federal	Federal	100%	0%	0%	100%
Intermediate good tax	Federal	Federal	Federal	100%	0%	0%	100%
Coffee tax	Federal	Federal	Federal	100%	0%	0%	100%
Insurance tax	Federal	Federal	Federal	100%	0%	0%	100%
Electricity tax	Federal	Federal	Federal	100%	0%	0%	100%
Solidarity levy	Federal	Federal	Land	100%	0%	0%	100%
Motor Vehicle Tax (since 2009 federal)	Federal	Federal	Federal	100%	0%	0%	100%
Air Traffic Tax	Federal	Federal	Federal	100%	0%	0%	100%
<b><i>State or provincial</i></b>							
Property (wealth) tax	Joint Federal/land	Joint Federal/land	Land	0%	100%	0%	100%
Inheritance tax	Joint Federal/land	Joint Federal/land	Land	0%	100%	0%	100%
Real estate purchase tax	Joint Federal/land	Land	Land	0%	100%	0%	100%
Betting and lottery tax	Joint Federal/land	Joint Federal/land	Land	0%	100%	0%	100%
Fire protection tax	Joint Federal/land	Joint Federal/land	Land	0%	100%	0%	100%
Beer tax	Joint Federal/land	Joint Federal/land	Federal	0%	100%	0%	100%

Table 6: cont.

	Determination of		Tax collection and administration	Shares in Revenue (%)			
	Base	Rate		Federal	Land	Local	All orders
<b>Local</b>							
Business tax	Joint Federal/land	Local	Land/Local	3,7% (2017)	13,9% (2017)	82,4% (2017)	100%
Real estate taxes	Joint Federal/land (from 2020 land may deviate)	Local	Land/Local	0%	0%	100%	100%
Dog Tax	Local	Local	Land/Local	0%	0%	100%	100%
Hunting and fishing tax	Land	Land	Local	0%	0%	100%	100%
secondary residence tax	Land/Local	Land/Local	Local	0%	0%	100%	100%
beverage tax	Local	Local	Local	0%	0%	100%	100%
<b>Shared taxes</b>							
Personal income tax	Joint Federal/land	Joint Federal/land	Land	42.50%	42.50%	15%	100%
Flat rate withholding tax	Joint Federal/land	Joint Federal/land	Land	44%	44%	12%	100%
Corporate income tax	Joint Federal/land	Joint Federal/land	Land	50%	50%	0%	100%
VAT	Joint Federal/land	Joint Federal/land	Land	50,2% (2018)	46,6% (2018)	3,2% (2018)	100%

Source: Federal Ministry of Finance, Steuern von A bis Z.

Federal Ministry of Finance, Bund-Länder-Finanzbeziehungen auf Grundlage der Finanzverfassung 2018.

The Bundestag has the authority to autonomously determine the bases and rates of these taxes. The revenues from these taxes fall exclusively on the federal level. However, of these taxes, only the energy, tobacco and, to a lesser extent, the insurance and car tax generate notable revenue.

The taxes whose revenues exclusively flow to the Laender (*Laendersteuern*) are the transaction tax, the beer tax, lottery, amusement, inheritance and gift taxes. Even though these are state taxes, the bases and rates of these taxes are jointly set on the federal level by the Bundestag and the Laender executives in the Bundesrat. Since 2006, the only tax for which the Laender have the power to set the tax rate autonomously is the real estate purchase tax. Its tax base is determined jointly on the federal level. Thus, tax policy of the federal and Laender levels is almost completely harmonized. Actual state taxes accounted for only 8 percent of the states' tax revenues. The remaining 6 percent of the states' tax revenues are federal tax payments to compensate the Laender for the conversion of the car tax into a federal tax and for taking on further responsibilities of local public transport services. Notably, the real estate purchase tax, which is the only tax where the Laender have the competence to set the tax rate autonomously, accounts for only 4 percent of the states' tax revenues.

Other than the Laender, the municipalities have the power to set surcharges on the local business and property tax rates (*Gemeindesteuern*), both of which are important revenue sources for the local jurisdictions. However, there are ceilings for minimum and maximum surcharges. For the local business tax, the tax base is jointly determined on the federal level by the Bundestag and the executives of the Laender in the Bundesrat. Therefore, although municipalities can set surcharges, the tax system is also strongly harmonized on the local level.

Since the year 2020 this changed for the property tax. Following a ruling of the Constitutional Court, the determination of the local property tax base had to be reformed. In June 2019, the federal level and the Laender agreed to a new definition of the property tax base, which is set on the federal level. First and foremost, the reform will confer legislative power over the property tax on the federal level. At the insistence of Bavaria and Baden-Wuerttemberg, however, an opening clause was introduced in accordance with Article 72.3 of the Grundgesetz. This opening clause gives the Laender the right to voluntarily deviate from the federal definition of the property tax base and to set the property tax base autonomously according to their own definition. Both, Bavaria and Baden-Wuerttemberg made use of this new competency. Thus, the reform of the property tax increases the tax autonomy of the Laender and enables minor tax competition not only between the municipalities that set the property tax rate, but also between the Laender that can autonomously define the property tax base since 2020.

On the municipal level, with 50 percent of all municipal tax revenues in 2018, the local business tax is the most important tax revenue source. Local property taxes account for 12.5 percent of local tax revenues and thus also play an important role in municipal funding. The remaining 37.5 percent of municipal tax revenues come from the municipal shares in joint taxes. However, local tax revenues account for only 41 percent of total local revenues, while the remaining 59 percent are transfers from the Laender, fee revenues, and other revenues, such as property sales or dividends from municipal holdings<sup>73</sup>. Even though tax revenues are not the only important revenue source of German municipalities, local governments actively use their autonomy to set surcharges on tax rates. Therefore, in Germany's highly interwoven system of fiscal federalism, the municipal level is the only sphere where tax competition between jurisdictions arises<sup>74</sup>.

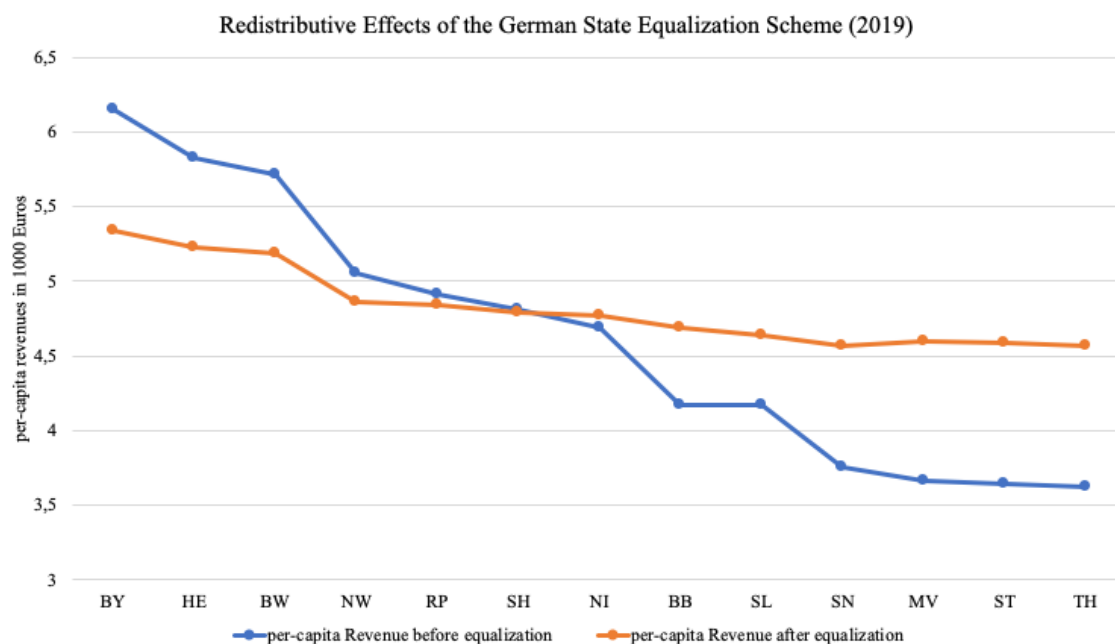
### **Section 6: Intergovernmental Fiscal Transfers**

Germany has an elaborated fiscal equalization system, which arranges fiscal relations among the Laender as well as between the federal level and the Laender. The equalization scheme effectively levels out disparities in per capita revenues of the Laender. The effects of the equalization scheme on fiscal disparities between the Laender for the fiscal year 2019 are depicted in Figure 2. Without the equalization scheme in place, the Laender would have faced distinct fiscal disparities. Before equalization, per capita tax revenues of Bavaria as the financially strongest Land yielded 172% of the per capita tax revenues of the financially weakest Land Thuringia. The equalization scheme considerably closes these disparities and reduces the gaps in per capita revenues at a rate of up to 70%. The equalization system that was in force until 2019 was established in 1969 as part of the Fiscal Reform Act. The fundamental principle of this equalization system was to put the Laender in the position of the signors of fiscal equalization. Therefore, the system was originally designed as a horizontal equalization system, supplemented by vertical transfers. This principle changed 2020, when fiscal relations among the Laender and between the Laender and the federal level have been transformed into an entirely vertical equalization system managed by the federal level.

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<sup>73</sup> See Federal Statistical Office. 2018. *Kassenmäßige Steuereinnahmen vor Steuerverteilung*.

<sup>74</sup> See Buettner, T. 2003. "Tax Base Effects and Fiscal Externalities of Local Capital Taxation: Evidence from a Panel of German Jurisdictions." *Journal of Urban Economics*, 54:110-128.

**Figure 2: Redistributive Effects of the German State Equalization Scheme (2019)**

*Source:* Federal Ministry of Finance, own calculations.

The system in place since 1970 and until 2019 consisted of four steps. First, tax revenues were distributed between the federal level and the Laender according to the distribution of shared taxes in Table 6. Second, the state shares of the income and corporate taxes and revenues from state taxes were assigned to each Land. This assignment followed population in the case of the income tax, residency in the case of the corporate tax, and occurrence in the case of the state taxes. Moreover, 25 percent of the VAT revenues were distributed according to the financial strength of the Laender, with the aim to increase the revenue capacity of the poorest Laender. The remaining 75 percent of VAT revenue was then distributed according to the number of inhabitants. As VAT revenues have been redistributed among the Laender in this way, this step is referred to as primary horizontal equalization.

Third, the secondary horizontal equalization set in. This step was the core of fiscal equalization system until 2019. Laender with above average adjusted per capita revenues contributed to the system, while Laender with below average adjusted per capita revenues received payments from the system. State tax revenues were adjusted in two different ways. On the one hand, 64 percent of local revenues was included into the revenues of the Land. On the other hand, 12 percent of the more than proportional increase of state revenues compared to the average of all Laender has been deducted from a Land's revenue. The latter aimed at limiting the absorption of additional tax revenues and thus possible disincentives of the equalization system.

The fiscal gap of Laender receiving payments and the fiscal excess of the Laender contributing to the system was calculated as the difference between a Land's adjusted per capita revenue and the average adjusted per capita revenues of all Laender. Redistribution then took place according to a symmetric progressive formulary schedule that raised the marginal transfers to the receiving Laender to fill up 44 to 75 percent of the calculated fiscal gap. The exact rate at which the fiscal gap filled up depended on a Land's relative per capita revenue strength. On the contrary, the fiscal excess of the contributing Laender was skimmed by 44 to 75 percent, again depending on a Land's individual relative per capita revenue strength<sup>75</sup>.

The fourth step in revenue distribution were vertical transfers from the federal level to those Laender, which still had an adjusted revenue capacity of less than 99.5 percent of the adjusted average per capita revenues of all Laender. These vertical transfers filled the gap between a Land's relative revenue and 99.5 percent of the average per capita revenues of all Laender at a rate of 77.5 percent. Moreover, the federal level provided transfers to those Laender for which special spending needs were identified politically. On this basis, the Laender in East Germany received additional vertical transfers to deal with high structural unemployment as a consequence of the separation of Germany before 1990. Furthermore, ten small Laender received compensation for costs of their political administration.

At the end of these four steps, every Land had revenues that amounted to at least 97.5 percent of the average per capita revenues of all Laender, such that the equalization system among the Laender was highly egalitarian. This highly egalitarian system induced high rates of marginal contribution, which for some recipient states came close to a full absorption of additional tax revenue throughout the equalization scheme<sup>76</sup>. There is also evidence that the system created incentives for excessive borrowing and spending by the Laender<sup>77</sup>. Although some of the vertical transfers had been justified by specific spending needs, all transfers in this system were unconditional. Despite these problems of the system between the federal level and the Laender,

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<sup>75</sup> At which concrete rate between 45% and 75% the fiscal gap (excess) was filled up (skimmed) depended on the relative per capita revenue strength of each Land compared to the average per capita revenue strength of all Laender. The lower (higher) the relative per capita revenue strength, the higher was the rate of compensation (skimming). For a detailed description and explanation of the exact tariff formula see Burret. H.T., Y. Bury and L.P Feld. 2018. "Grenzabschöpfungsraten im deutschen Finanzausgleich." *List Forum für Wirtschafts- und Finanzpolitik*, 44: 1-22.

<sup>76</sup> See Burret. H.T., Y. Bury and L.P Feld. 2018. "Grenzabschöpfungsraten im deutschen Finanzausgleich." *List Forum für Wirtschafts- und Finanzpolitik*, 44: 1-22; Baretti, C., 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: 631-649.

<sup>77</sup> See Feld, L.P. and T. Baskaran. 2010. "Federalism, Budget Deficits and Public Debt: On the Reform of Germany's Fiscal Constitution." *Review of Law and Economics*, 6: 365-393; Feld, L.P. and J. Schnellenbach. 2013. "Verzerrungen im bundesstaatlichen Finanzausgleich." Report for the Laender Bavaria and Hesse. Freiburg.

Table 7 shows that the system closed fiscal gaps and eased the cost of social security, as these costs are primarily borne by the federal level.

**Table 7: Vertical fiscal gaps**

	Total revenue collected	Total revenue available, including net transfers for that level of government	Expenditures
	<i>(2018) Mill. USD</i>	<i>(2018) Mill. USD</i>	<i>(2018) Mill. USD</i>
National	412,298.34	228,927.81	215,045.19
Subnational			
<i>Land</i>	363,035.81	318,334.26	295,769.27
<i>Local</i>	131,194.91	223,514.45	212,605.15
EU	30,710.70	30,710.70	30,710.70
Social security	319,326.12	447,935.96	435,492.58
All levels	1,256,565.88	1,256,565.88	1,189,622.89

*Source:* Federal Statistical Office, Fachserie 14 Reihe 2.

As of 2020, this system, which has shaped fiscal relations among the German Laender for more than 50 years, has been changed fundamentally. The new system breaks the principle of horizontality in fiscal relations among the Laender, as all financial relations are verticalized. Since 2020, the two steps of horizontal redistribution have been eliminated completely, reducing fiscal equalization to a three-step system. After the first step of allocating tax revenues of income, corporate, and state taxes to the federal and the Laender levels and among the Laender according to the same principles as in the old system, the entire redistribution, which took place horizontally, is converted into the vertical VAT distribution to the Laender by means of surcharges and deductions. The newly designed vertical VAT redistribution forms the new second step of equalization. It is designed to not only entirely replace the volume of the formerly horizontal funds. The volume of equalization will instead be increased by 4.7 billion USD to meet the increased redistributive goals of the new system. Note, however, that this *increase* in equalization funds comes at the cost of the federal level and not at that of the other Laender. However, this increased federal funding will not remove horizontal redistributive effects. The reason for this is that, in order to replace the horizontal funds, the redistribution formula of VAT revenues changes: Before 2020, fiscal gaps and fiscal excess were calculated as the difference between adjusted per capita revenues of each land and the average adjusted per capita revenue of all Laender. The adjustment of revenues have changed slightly, as local revenues are now included in the calculation of state revenues with a factor of 75 percent instead of 64 percent. The schedule to determine VAT surcharges and deductions that replace the formerly



horizontal funds is now linear, filling up (skimming) 63 percent of the fiscal gap (fiscal excess). Thus, the Laender with above-average per capita VAT revenues are still effectively contributing to the equalization scheme via VAT deductions. In fact, the former explicit horizontal redistribution effects are neither abolished nor substantially reduced, but converted into implicit ones<sup>78</sup>.

Increased additional vertical transfers from the federal level to the Laender form the new third step of the equalization system. The vertical transfers to close remaining fiscal gaps have been expanded, as the upper ceiling of the remaining fiscal gap was increased to 99.75 percent of the average per capita revenues of all Laender. Also, the rate at which this gap is filled was increased from 77.5 to 80 percent. Thus, the standard of equalization was not lowered through the removal of the horizontal component. Instead, it has been slightly increased. The politically identified fiscal needs, that constitute further vertical transfers, have also been expanded. The vertical transfers to compensate the Laender for the cost of high unemployment remain, while the vertical transfers intended to compensate small Laender for the costs of their political administration have been increased. In addition to these vertical transfers, two new areas of additional fiscal needs have been identified. Laender with financially weak municipalities receive additional vertical transfers from the federal level. Furthermore, Laender with a poor research performance receive additional vertical transfers, which should enable them to build up better research capacities<sup>79</sup>. As before, all transfers paid within the new equalization system remain unconditional.

There is a broad consensus that the reform of the fiscal relations between the federal level and the Laender will not improve the incentives of the German fiscal equalization scheme. Instead, there is reason to expect a worsening of the problems of the old system as well as new problems. In particular, there are three points that cause concerns<sup>80</sup>. Firstly, the reform is not able to reduce the disincentives arising from the high marginal contribution rates<sup>81</sup>. Even though the new linear equalization schedule should be associated with reduced marginal contributions, the

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<sup>78</sup> Only horizontal redistribution effects at the top are slightly reduced. This reduction is, however, not induced through the removal of the horizontal transfer scheme, but through the change of the redistribution tariff from a linear-progressive tariff in the former horizontal scheme to a proportional tariff according to which the VAT deductions are calculated.

<sup>79</sup> Poor research performance is defined as the (negative) difference between the per capita research grants a Land receives from the federal level and the average per capita research grants received by all Laender. If the amount of per capita federal research grants received by a Land meets 95% or less of the average per capita research grants of all Laender, the Land is entitled to receive additional transfers out of the equalization scheme. Note that federal research grants are assigned to the Laender based on individual grant applications for specific research projects.

<sup>80</sup> See Feld, L.P., C. Fuest, J. Haucap, H. Schweitzer, V. Wieland and B.U. Wigger. 2016. *Für eine echte Reform der Bund-Länder-Finanzbeziehungen*. Kronberger Kreis Study No. 62. Berlin: Stiftung Marktwirtschaft.

<sup>81</sup> See Burret, H.T., Y. Bury and L.P. Feld. 2018. "Grenzabschöpfungsraten im deutschen Finanzausgleich." *List Forum für Wirtschafts- und Finanzpolitik*, 44: 1-22.

increased rate at which local revenues will be included in the calculation of state revenues will counteract this effect. Thus, the reform is not expected to reduce the disincentives of revenue equalization.

Secondly, the transparency of fiscal relations and fiscal accountability declined further through the elimination of the horizontal elements of the redistribution scheme. This loss of accountability and transparency can be seen as a main driver why both, the Laender that formerly contributed horizontal transfers as well as the Laender that received horizontal payments, pushed for the removal of the horizontal component of fiscal equalization. Before the reform, distributional conflicts between contributing and receiving Laender regularly caused tensions between both groups. With the removal of the horizontal scheme, these formerly horizontal distributional conflicts between the Laender are converted into vertical conflicts between the entirety of all Laender and the federal level. Now, both groups of Laender can accuse the federal level instead of each other if they face insufficient fiscal resources to pursue their spending projects. Moreover, due to the loss of transparency, the formerly transfer-receiving Laender lose their stigma of conducting bad fiscal policies, while the formerly contributing Laender cannot be accused for lacking solidarity anymore.

Thirdly, as redistribution is fully integrated into the vertical distribution of VAT revenue, parliamentary oversight of fiscal relations is almost completely eliminated. With the horizontal component in place, horizontal transfer payments between the Laender were part of the budgets of the Laender and thus part of the parliamentary budgetary processes and votes in all Laender. While the state parliaments had no possibility to reject the payment of (constitutionally determined) equalization transfers, this process established transparency over the redistribution of revenues across the Laender. The distribution of VAT revenues is however determined before the actual state budget processes start. Thus, with horizontal redistribution being integrated into the vertical distribution of VAT revenues, state parliaments will no longer debate nor vote on the redistributive effects of the equalization scheme. Instead, it will be the executives of the Laender and the Federal Ministry of Finance that have full oversight over the redistributive effects of the equalization scheme now.

Besides the transfers resulting from the fiscal equalization system, the federal level may grant financial aid to the Laender if certain conditions are met. These additional vertical transfers have become increasingly important throughout the last years as the federal level and the Laender agreed to expand the fields where the federal government may provide such grants. The most prominent examples are newly established federal transfers to the Laender so that

they can endow their municipalities with sufficient funds to improve school equipment in all municipalities and school infrastructure in financially weak municipalities.

The increased and highly rigid fiscal obligations of the federal level against the Laender lower the fiscal space of the federal level itself. However, due to the strong fiscal position of the German federal government these new obligations as well as possible future financial claims of the Laender against the federal government are not expected to put fiscal sustainability of the federal government at risk.

As compensation for granting additional funds, the federal level received extended control over the use of federal financial aid. As a result of the Reform Act of 2017, the Laender lost their autonomy in designing transfer programs that are partly funded by federal transfers, as they now require the consent of the federal level for the design of these programs. Thus, federal influence and the interweaving of federal and Land policy increased due to the Reform Acts of 2017 and 2019. Furthermore, the control rights of the Federal Court of Audit against the Laender have been extended, as the Court is now allowed to conduct inquiries directly at the level of the Laender and municipalities if they receive federal funds.

Fiscal relations and fiscal transfers between the federal level and the Laender are a regular part of the public debate. However, fiscal transfers between the state and the local levels are quantitatively much more important, as transfer revenues make up for 50 percent of municipal revenues. Unlike the federal level and the Laender, there are unconditional *and* conditional grants from the Laender to their municipalities. Conditional grants to municipalities usually serve to support municipal investment projects. Only to a lesser extent conditional grants aim to subsidize current expenditures. Conditional grants to municipalities are usually designed as matching grants. Unconditional grants, which aim at closing the fiscal gap between Laender and municipalities, play the most important role in transfer relations between the two subnational layers of government. All Laender are obliged to ensure that their municipalities are adequately endowed so that they can fulfill their compulsory tasks and have fiscal leeway to provide a minimum amount of additional voluntary services on which local councils decide autonomously. The transfer systems between Laender and municipalities differ in design. Basically, there are two types of systems for unconditional transfers to close municipal fiscal gaps. Most Laender use a system that assigns a specific share of aggregated tax revenue of the Land and municipalities to the municipal level. Some Laender, mainly as a result of rulings by their state courts, changed the system to a needs-based system that requires the determination of the specific fiscal needs of every municipality. All transfer systems between Laender and

municipalities are predominantly vertical systems with horizontal redistribution effects. Only some Laender amended their transfer systems with actual horizontal redistribution schemes. There is evidence that municipal equalization can induce adverse incentives on municipalities. For example, Buettner and Wildasin find that grants to municipalities in the state of Baden-Wuerttemberg have a significant effect on spending and borrowing<sup>82</sup>. Similar spending effects are found for municipalities in other states<sup>83</sup>. Beyond flypaper effects, marginal contribution rates are also an issue within municipal transfer systems. This is shown, e.g., by Hauptmeier, who finds that increased contributions rates to the system are associated with lower productive spending of the municipalities in Baden-Wuerttemberg<sup>84</sup>.

### Section 7: The Way Forward

Given these institutional arrangements, Germany can be characterized as a cooperative<sup>85</sup>, unitary, and executive federal system. All layers enjoy autonomy on the expenditure side of the public budget. However, fiscal responsibilities follow the constitutionally assigned tasks. As these tasks are often influenced by legislation of higher levels, spending decisions are partly predetermined and rigid for subnational levels. While these legislative influences induce minimum spending levels for certain political areas, there are, however, no restrictions that would impose limits for maximum spending. The only exceptions for the latter arise indirectly through deficit rules for municipalities and, since 2020, for the Laender.

While the spending side is somewhat restricted, this is all the more true for the revenue side. In order to decide on all quantitatively relevant tax bases and rates, the federal level requires the approval of the Laender executives through the Bundesrat. The Laender themselves have almost no autonomy in raising own revenues or setting taxes. The only minor exception is the real estate purchase tax, which is quantitatively negligible. The local level enjoys the widest autonomy in raising revenues, since municipalities decide on surcharges on the local business and property taxes.

This institutional framework not only underlines the *cooperative* nature of German federalism, but also its characterization as a *unitary* federal state, that predominately divides the fulfillment of tasks across layers of government instead of assigning areas of policy entirely to single

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<sup>82</sup> See Buettner, T. and D. Wildasin. 2006. "The Dynamics of Municipal Fiscal Adjustment." *Journal of Public Economics*, 90: 1105-1132.

<sup>83</sup> See Baskaran, T. 2016. "Intergovernmental Transfers, Local Fiscal Policy and the Flypaper Effect: Evidence from a German State." *FinanzArchiv / Public Finance Analysis*, 72:1-40.

<sup>84</sup> See Hauptmeier, S. 2007. "The Impact of Fiscal Equalization on Local Expenditure Policies: Theory and Evidence from Germany." ZEW Discussion Paper No. 07-006. Mannheim.

<sup>85</sup> See Scharpf, F.W., B. Reissert, and F. Schnabl. 1976. *Politikverflechtung: Theorie und Empirie des kooperativen Föderalismus in der Bundesrepublik*. Kronberg/Ts: Scriptor.

governmental layers. One consequence of this is the historically rooted, particular power that executives have at all layers of government. Cooperation across layers takes place between the executive branches of governments. Especially at the level of the Laender, the parliaments play no considerable role in German federalism. Therefore, the third characterization of Germany's federal system is to be an *executive* federal system.

These federal arrangements entail a number of problems and create adverse incentives for the fiscal performance of subnational entities. The most important one is that the fulfillment of governmental tasks and the fiscal responsibilities associated with it are not transparent. As a consequence, it becomes hard to hold individual tiers of government accountable. This has an impact on the fiscal performance of subnational entities. As it is hard to hold subnational policy fiscally accountable, inhibitions to increase spending are low in some states and municipalities. While at the same time borrowing is the only real autonomous revenue raising possibility of the Laender, some of them have run excessive deficits. The federal bailouts that were provided for two of them accelerated the soft budget constraint problem.

The 2006 and 2009 Reform Acts aimed at tackling these problems in two ways. First, excessive state borrowing and the soft budget constraint problem are limited through the implementation of fiscal rules for the federal level and, since 2020, for the Laender. Second, transparency and accountability of the different levels of government ought to be strengthened by a disentanglement of tasks and their fulfillment. While these reform steps went into the right direction, they only focused on the spending side of the public budget. The consequent third step towards achieving the goals of the federal reform commissions of 2006 and 2009 of establishing a fiscal constitution that is transparent and that ascribes clear and conceivable accountabilities to all levels of government, would have been to rearrange the revenue side of the budget. Granting more tax autonomy to all layers of government would have been a possibility to bring Germany's fiscal constitution closer to the ideas of Oates' laboratory federalism<sup>86</sup> and to increase the advantages of decentralization in Germany.

Instead, the reforms agreed between the federal level and the Laender in 2017 and 2019 after protracted negotiations rescinded most of the disentanglements of the 2006 reform. It even created new entanglements, with the federal level assuming responsibilities for educational funding, which was the last area of exclusive state autonomy and accountability. While the situation on the expenditure side becomes increasingly intertwined, the same applies to public revenues. Instead of unravelling the revenue side and ascribing revenue raising and tax setting autonomy to the Laender, the revenue side has become even more verticalized and thus rigid

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<sup>86</sup> See Oates, W.E. 1999. "An Essay on Fiscal Federalism". *Journal of Economic Literature*, 37: 1120-1149.

for the Laender. First, all horizontal elements of the fiscal equalization scheme have been replaced by vertical transfers. Second, the formerly existing vertical transfers from the federal level to the Laender within and outside the equalization scheme have been expanded. Third, the federal level has for the first time assumed funding responsibilities for the local level. Apart from these unfavorable steps, there are also positive aspects of the Reform Act. First, assigning the competencies of highway construction and maintenance solely to the federal level ended the situation in which the Laender had to bear the administrative costs of federal decisions in this area. Second, the strengthening of the Stability Council should lead to a more credible implementation of the fiscal rules for the Laender.

Although there are minor positive aspects to the latest reforms of the federal system, the overall repercussions of the reform remain worrying. Most of the reform steps that took effect in 2020 accelerate unitarianism and a predominant role of the executives in the German federal system. With the recent reforms of German federalism, the Laender degrade themselves and become more and more administrative provinces instead of real federal states. It is noteworthy that it was the Laender that pushed for this design of the latest reform, and not the federal level, although the power of the latter will increase as a result of the reform. Given the complicated negotiation procedures of the German federal system, which are driven by conflicting interests of federal and Laender officials, further reform towards more transparent and accountable arrangements of tasks, revenues, and transfers is unlikely in the near future. What will remain for the time being is an increasingly unitary state within the institutional mantle of federalism.

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