PRESENTATION BY HANS-PETER SCHNEIDER

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German Institute for Federal Studies, Hannover
Director: Prof. Dr. Dr. Hans-Peter Schneider

**COMPANIES AND GOVERNMENT**
**BETWEEN FEDERALISM AND FISCAL FEDERALISM.**
**The German Example**

**Paper**
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**on**
***"MARKET LEADERS AND SCENARIOS FOR THE 21st CENTURY"***
**at Cernobbio, Villa D'Este,**
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## Content

## I. Introduction

- Federalism means a combination of „self rule“ and „shared rule“
- Federal systems have two basic features:
  1. division of sovereignty between two or more territorially organised political bodies enjoying autonomy and self-government in certain political areas of all three branches of state functions (legislative, executive, judicial powers)
  2. co-operation
     a) of the decentralised bodies with the central government (vertical co-operation) and
     b) among the decentralised bodies themselves (horizontal co-operation)

## II. General Remarks on German Federalism

- Consisting of the Federation (*Bund*) and 16 States (*Länder*)
- Municipalities are parts of the States (only administrative bodies, not a third tier of government)
- 90 % of the legislative powers belong to the Federation
- The States are (more or less) administrative bodies executing not only State law, but also federal law under the oversight of the Federation
- The German system is characterised as a kind of “executive federalism” by two reasons:
  a) the executive branches of the Federation and the States dominate the day to day policies
  b) the Federal Council (*Bundesrat*) represents the State governments, not the legislatures
- Despite the general division of powers in federal systems, the German Constitution provides for joint tasks and joint taxes

## III. Fiscal Rules and Principles in the Federal Constitution

- The *Länder* as independent constituent States need
  a) adequate financial resources to perform their functions
  b) free and full control over these resources and their use
- The Constitution (*"Basic Law"*) contains in Chapter X some general rules on the division of the financial powers and resources
  a) between the Federation and all States together (vertical relations), and
  b) among the States themselves (horizontal relations)
- The vertical relations are governed by the principles
  a) of "separation" of tasks and expenditures of the Federation and the States
  b) of "connexity" and "equivalence" between tasks and resources of each level of government
- The horizontal relations are governed by the principles
  a) of "equality" of living conditions throughout the country
  b) of "solidarity" amongst the different levels of government

## IV. Allocation of Tax Revenues

- Major taxes are "joint" taxes (more than 80 %)
  a) Income and corporation tax: **Federation** 42,5 %, **States** 42,2 % and **Municipalities** 15 % (per capita)
  b) VAT (flexible and negotiable): **Federation** 50,5 %, **States** 43,5 % and **Municipalities** 6 %
- Minor taxes (less than 20 %) are allocated to the
  a) **Federation**: consumption of goods, excise duties, capital transactions, highway fright, tobacco, insurance
  b) **States**: property, inheritance, motor vehicles, gambling, beer (Bavaria)
  c) **Municipalities**: rates, local trade

## V. Redistribution of Tax Revenues (Equalisation Scheme)

DIF

- Principle of “local yield”
  (each level gets and keeps the allocated taxes)
- Modifications of the “local yield”-principle (in four steps)
  (1) Income tax (distributed per capita): citizens of the City States are “upgraded” to 135 %
  VAT (collected at the main location or seat of a company): redistributed to all States with a place of business (“yield splitting)
  (2) Up to 25 % of the yield of VAT as a supplementary portion to States with lower tax revenues than the overall average per capita
  (3) Direct “horizontal” payments of 5 “richer” donor States to 11 “poorer” receiver States
  (4) Supplementary federal grants for the “poorer” States
  a) unconditioned (to the general budget)
  b) conditioned (for special programmes and purposes)

Equalising effects (as a % of the average financial capacity per inhabitant):

DIF

| Financial capacity per inhabitant <u>before</u> financial equalisation among the States | Financial capacity per inhabitant <u>after</u> financial equalisation among the States | Financial capacity per inhabitant <u>after</u> financial equalisation among the States <u>and general federal grants</u> |
|---|---|---|
| 70 (or less) | 90 | 97,5 |
| 80 | 93,5 | 98 |
| 90 | 96 | 98,5 |
| 100 | 100 | 100 |
| 110 | 104 | 104 |
| 120 | 106,5 | 106,5 |
| 130 (or more) | 109 | 109 |

## VI. The 2008 Corporate Tax Reform

DIF

- Corporation tax (like income tax) is a direct tax on the profits of juristic persons (corporations, associations, companies)
- Tax burden is lowered by 9 % to below 30 %
- Smaller enterprises are qualified for investment deductions up to € 200,000 per year
- Smaller enterprises profit from a tax allowance of € 100,000 for the limitation on the deductibility of interest costs in connection with the local trade tax
- Immediate write-off of the cost of acquisition or production of low-cost assets is lowered to € 150; for assets with acquisition costs from € 150 to € 1,000 only 20 % are deductable each year
- Philosophy behind: “lower tax rates – broaden the tax base”

## VII. Advantages and Disadvantages of Fiscal Federalism in Germany

DIF

### 1. Advantages:

- Stability (because of the guaranties in the Constitution)
- Transparency (because of the Financial Equalisation Act)
- Acceptability (because of the consent of the Federal Council)
- Equality of living conditions throughout the country
- No centre/periphery-frictions
- No tax dumping
- Decentralised political responsibility for the use of financial resources

## 2. Disadvantages:

- States have no legislative powers on taxes
- No tax competition (“poor is beautiful”)
- No incentives to raise more revenues or to collect more taxes
- No space for taxing (new taxes or surtaxes) by decisions of State governments
- Bad policies in the States might be honoured by the equalisation scheme
- Federal grants bear the danger of the “golden lead” by conditions of the federal government
- Federal grants can be misused as a “hammock” for regional or local inactivity

## VIII. Modernisation of German Federalism and the Fiscal Relations between the Federation and the States

*1. Phase I:*

- Establishing a 1st Joint Commission of the Federal Diet and the Federal Council in 2003
- Aims:
  a) Reducing the number of bills which need the consent of the Federal Council
  b) Transferring substantive legislative powers to the States
  c) Separating the entangled relations between the States and the Federation in administrative and fiscal matters
  d) Strengthening the influence of the Federation in the bodies of the European Union in matters of State concern
- The reforms came into effect on September 1, 2006

*2. Phase II:*

- Establishing the 2nd Joint Commission of the Federal Diet and the Federal Council in 2007
- Aims:
  a) Reducing debts and deficit spending of all levels of government
  b) Establishing mechanisms to avoid cases of “financial emergency” of States and municipalities
  c) Creating new “debt brakes” for all levels of government according to the European Stability Pact
  d) Co-ordinating different systems of IT-government of the Federation and the States
- Results: a strong and binding constitutional obligation to achieve balanced budgets
  a) for the Federation until 2016 (afterwards borrowing up to 3,5 % of the GDP is allowed)
  b) for the States until 2020 (afterwards no borrowing is allowed anymore)