THE FEDERAL FINANCIAL EQUALISATION SYSTEM IN GERMANY

Evaluation of Reform Strategies

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Agenda

1. **Introduction**
2. **Modelling the Public Sector**
3. **Evaluation of Reform Strategies – The Case of the Solidarity Surcharge**
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1. Introduction

- Background
- Analysis of Public Revenues

Background

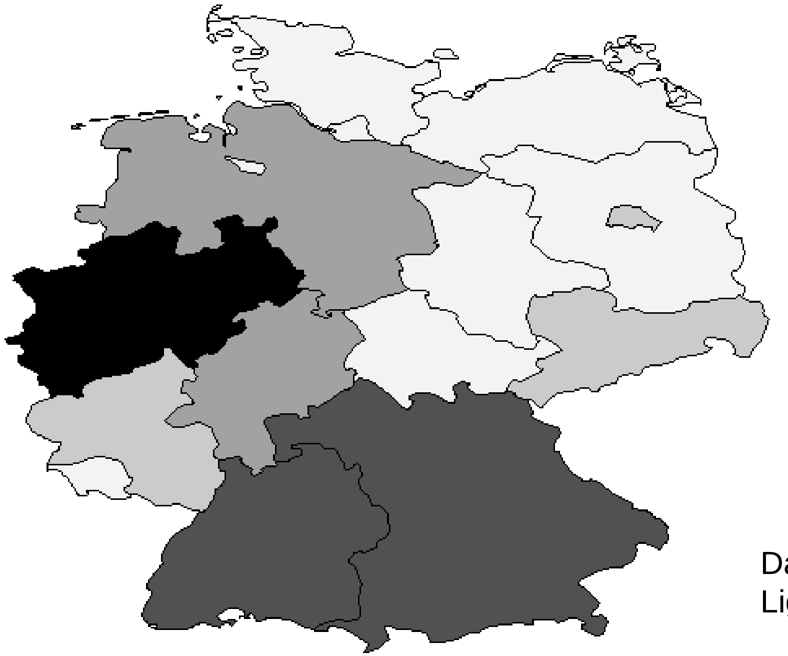
- Title of PhD thesis: „Modelling the Public Budget at the Level of Federal States“
  - ⇨ Targets:
    - Analysing the Federal Financial Equalisation System (FFES) in Germany
    - Developing a public sector model for evaluation of reform strategies
  - ⇨ Challenges:
    - Analysing monetary flows within the public sector
    - Developing a model that is capable of performing detailed scenario analysis of reform strategies
    - Integration into the German model INFORGE

Background

- Germany comprises of 16 federal states (FS)
- Local states (LS) belong to FS
- All governmental levels (GL) have their rights and obligations assigned to them under the constitution
- GL need adequate financial resources to fulfill their *functions*
  - ⇨ Federation: e. g. defense
  - ⇨ FS: e. g. education
  - ⇨ LS: e. g. culture
  - ⇨ Social Security System (SSS): social security (pensions, unemployment fees etc.)

Background

- Financial distribution is specified in constitutional law §§106-107 and law on financial equalisation
- FS are heterogenous with respect to population and economic structure → influences expenditures and revenues



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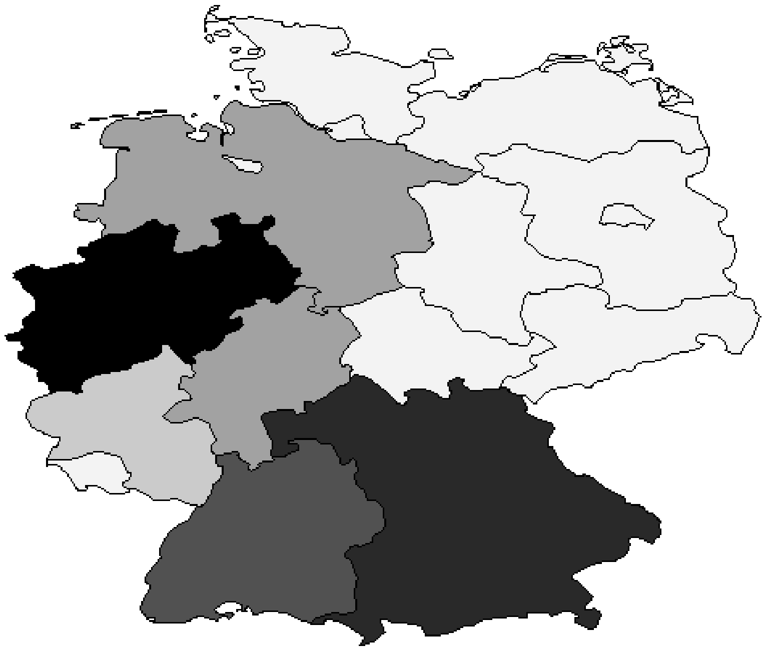


Population

GDP

Background

- *Overall target* for allotting the revenues of the FS: create and maintain equal living conditions troughout Germany
- Distributive rules are part of the FFES
  - ⇨ Law on Financial Equalisation (LFE) ends in December 2019
  - ⇨ Need for reform
    - High level of reallocation of tax revenues
    - Up to 4 FS support the remaining 12 FS
    - Negative incentives to increase the tax base
    - Solidarity surcharge
  - ⇨ Part of coalition agreement: commission of representatives from the federation, FS and LS should prepare a proposal for reform strategies

Analysis of Public Revenues

- Main part of public revenues is based on
  - Social constributions and tax revenues (75 %, ~1.100 bln. €)
  - Other current transfers and capital transfers (18 %), in particular reallocation of tax revenues among and within federation, FS and LS
- Social contributions are entitled to SSS
- Federation, FS, LS receive total amount of tax revenues
  - Constitution regulates tax distribution and guarantees appropriate funding for all governmental levels
  - 4 step approach according to LFE

Analysis of Public Revenues

- I. Step:
  - ⇨ Federation: e. g. energy taxes, solidarity surcharge (~ 100 bln. €)
  - ⇨ FS: e. g. beer tax, inheritance tax (~ 16 bln. €)
  - ⇨ LS: e. g. trade and property tax (~ 57 bln. €)
- II. Step:
  - ⇨ Distribution of joint taxes (~443 bln. €) to governmental levels, …

	Income Tax	Cooperation Tax	VAT
Federation	42.5 %	50 %	~53 %
FS	42.5 %	50 %	~45 %
LS	15 %	0	~2 %

Analysis of Public Revenues

- ⇨ …and 16 FS
  - Basically by territory (principle of local revenue) but corrected by special regulations (valid for income and cooperation tax)
  - At least 75 % of VAT are allocated according to the number of inhabitants (~76 bln. €); At max. 25 % of VAT goes as supplementary portion to fiscally weak FS (~ 11 bln. €)

- III. Step:
  - ⇨ Fiscally strong FS support weaker FS
  - ⇨ Revenue and demand indicator of each FS are compared
  - ⇨ Result: each FS is classified either as donoring or receiving country
  - ⇨ Certain share (44 % to 73 %) of difference is compensated applying a linear-progressive tariff
  - ⇨ Equalisation grants are equal to the amount of compensation

Analysis of Public Revenues

- III. Step (cont.):
  - ⇨ Exact amount of adjustment payments depends on the differences of the *average* revenues indicator p. c. compared to the *individually* revenue indicator p. c.
  - ⇨ 2013 ~8 bln. €
- IV. Step:
  - ⇨ Supplementary grants (~ 11 bln. €) from the federation to still financially weak FS or FS with special needs (e. g. high unemployment, poor infrastructure)

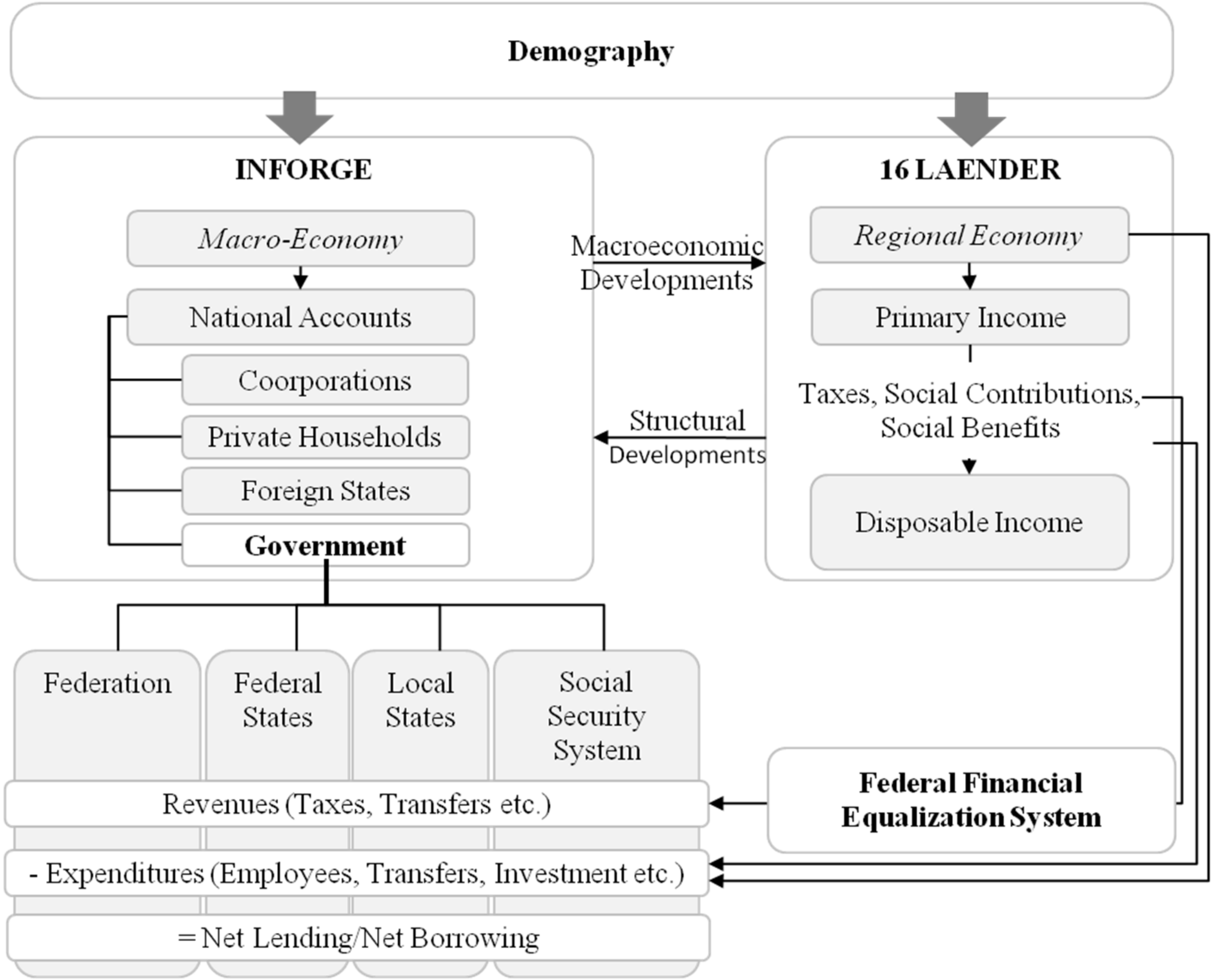
2. Modelling the Public Sector

- Requirements
- Implementation

Modelling the Public Sector

- Requirements derived from comparison of other public sector models
  - ⇨ Depicting all governmental levels (federation, FS, LS, SSS)
  - ⇨ Showing structure of revenues and expenditures
  - ⇨ Modelling FFES
  - ⇨ Integration of public sector into a macro-econometric model including regions
  - ⇨ Link to population
- Public sector is part of INFORGE but
  - ⇨ Only distinguishing between the SSS and rest of public sector
  - ⇨ FFES is not included
  - ⇨ Some regional aspects need to be improved, e. g. regional disposable income

Modelling the Public Sector



3. Evaluation of Reform Strategies

► **The Case of the Solidarity Surcharge**

Evaluation of Reform Strategies

- Solidarity surcharge – Background
  - ⇨ 1990 reunification: new FS have less financial power compared to old FS → immediate integration into the FFES not possible
  - ⇨ Loss of revenue for old FS and federation would be too high due to clearing mechanism
  - ⇨ Interim solution (1990-1994): ‚Reunification Fund‘ was introduced and new FS got money from there
  - ⇨ New solution (1995-2004): ‚Solidarity Agreement I‘
    - Economic and financial adaptation process of the new FS was not successful
    - New FS were integrated into the FFES and federal financial relations have to be adopted (a. o. federation disclaimed of 7 % of VAT revenues)
  - ⇨ Solidarity surcharge was introduced already in 1991 (1991-92 to finance amongst others the 2. Gulf War, from 1995 onwards to compensate lower revenues of the federation)

Evaluation of Reform Strategies

- Solidarity surcharge: Pros and Cons
  - ⇨ Con: Tax weakens economic growth
    → Scenario 1: Deregulation
  - ⇨ Pro: Public revenues should be strengthened
    - Long-term financial capacity will become worse due to demographic processes without any counteractive measures
    - Debt limit for federation (2016 onwards) and FS (2020 onwards)

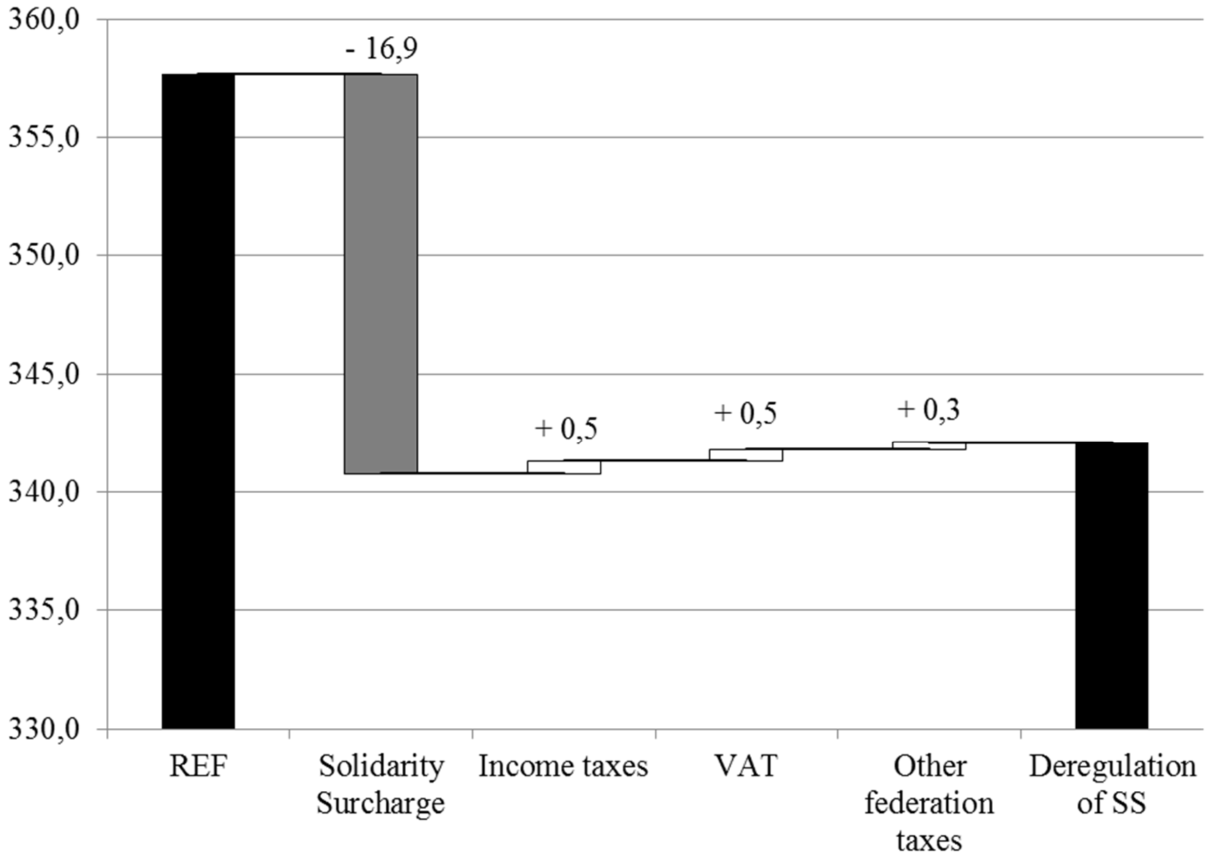
    → Scenario 2: Integration

Scenario 1: Deregulation

- Impulse: 2014-2020 tax rate 0 %
- Results:
  - ⇨ Tax payers are relieved by -17 bln. € until 2020
  - ⇨ Disposable income increases → higher consumer spending
  - ⇨ Positive GDP (+ 0.24 %; + 6 bn. €) and employment effects (+ 0.16 %; + 60.000 employees)
  - ⇨ Positive feedback effects on excise duties, VAT (+ 1 bln. €) and income taxes (+ 0.5 bln. €)
    - Excise duties are federation taxes (except beer tax)
    - VAT is divided by federation (~53 %), FS (45 %), LS (2 %)
    - Income taxes: federation and FS each of them gets 42.5 %, LS 15 %
  - ⇨ Negative effect on solidarity surcharge revenues -17 bln. €

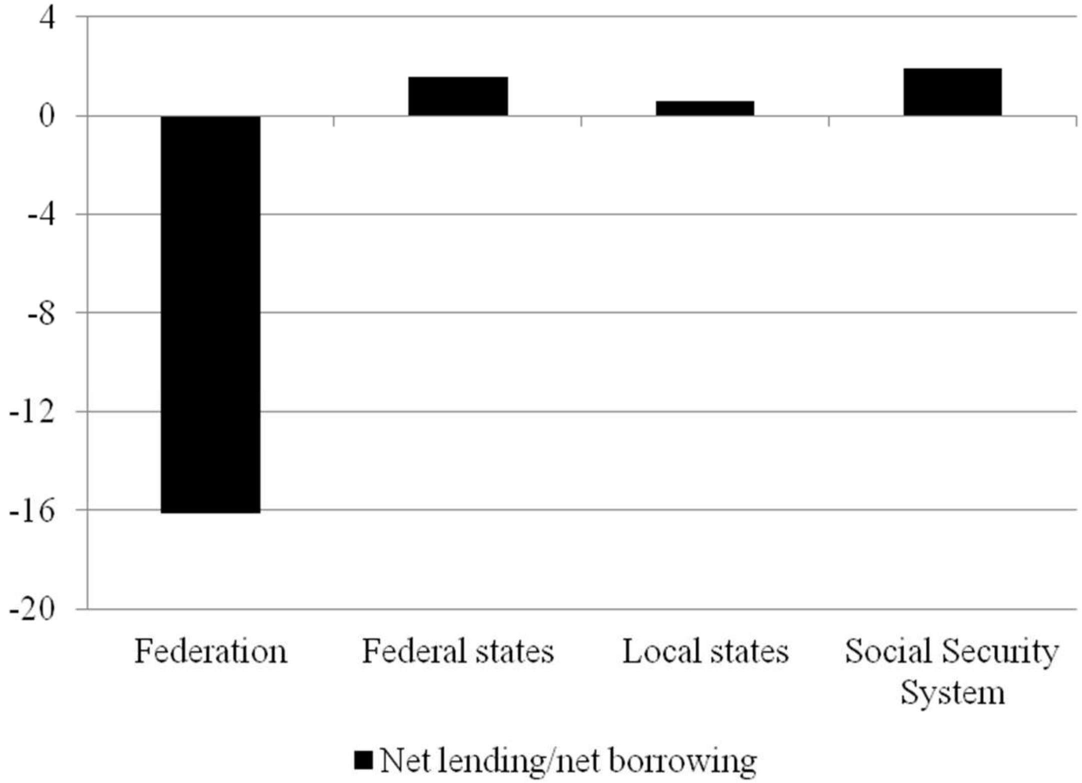
Scenario 1: Deregulation

- Results (cont.):
  - ⇨ Differences in tax revenues for federation in bln. € (2020)



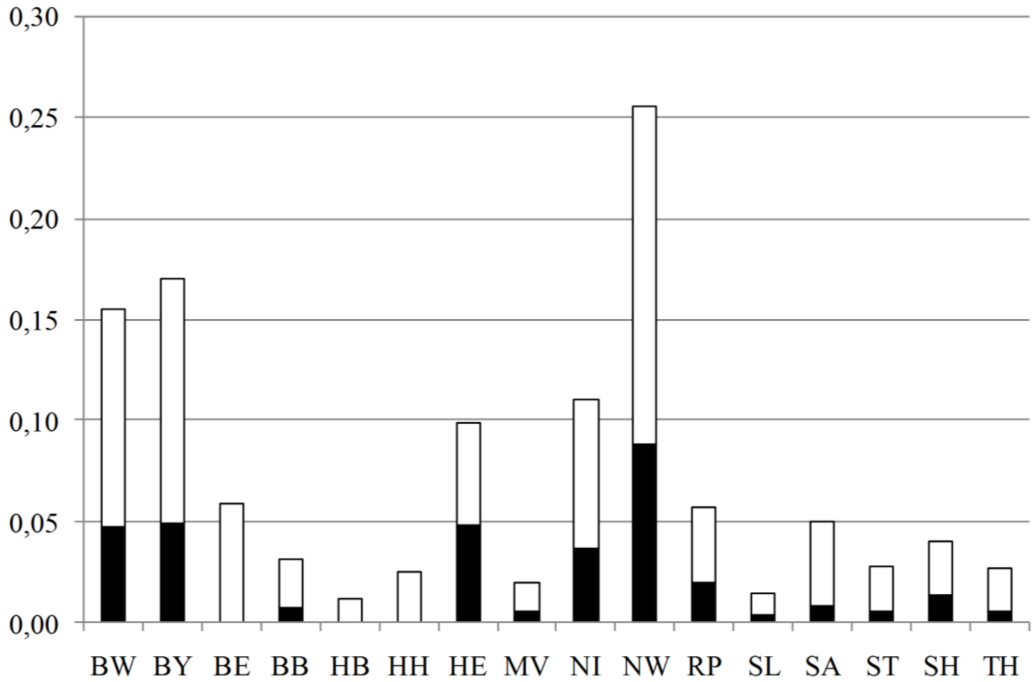
Scenario 1: Deregulation

- Results (cont.):
  - Positive effects on social contributions due to higher employment (+ 1.3 bln. €)
  - FS, LS and SSS profit from deregulation of SS compared to REF
    Differences in net lending/borrowing in bln. €



Scenario 1: Deregulation

- Results (cont.):
  - ⇨ Different regional effects: income tax payers are not equally distributed amongst Germany
  - ⇨ All FS can profit compared to REF
    Differences in net lending/borrowing in bln. € (black LS, white FS)

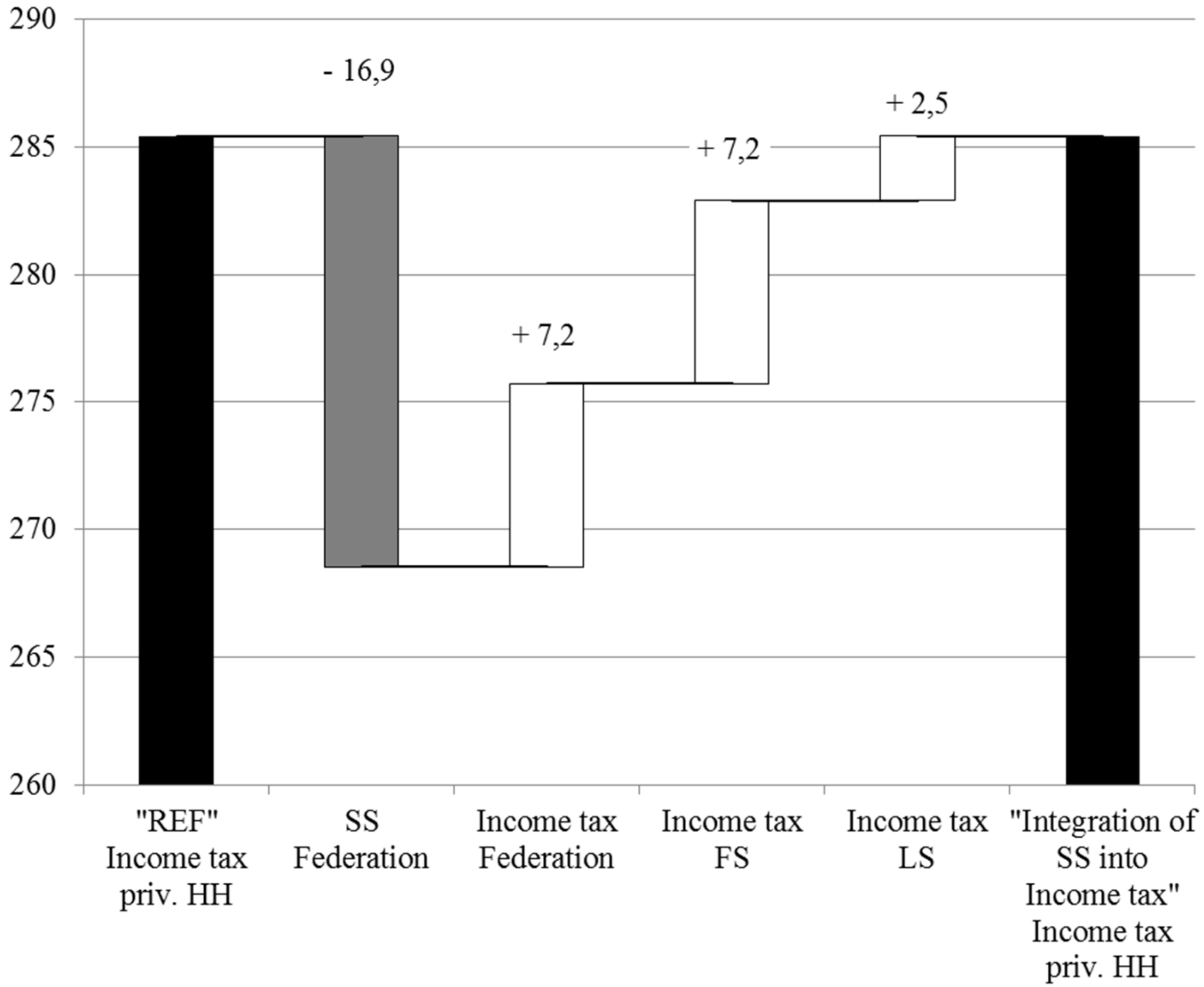


Scenario 2: Integration

- “Integration of solidarity surcharge into the income taxes”
  - ⇨ Impulse:
    - Federation losses SS revenue
    - Federation and FS: each 42.5 %
    - Local states: 15 %
  - ⇨ Results:
    - Tax payers are not affected more than in the reference scenario
    - Tax revenues are redistributed amongst federation, FS and LS

Scenario 2: Integration

⇨ Results (cont.):
redistribution of taxes in bln. €



Scenario 2: Integration

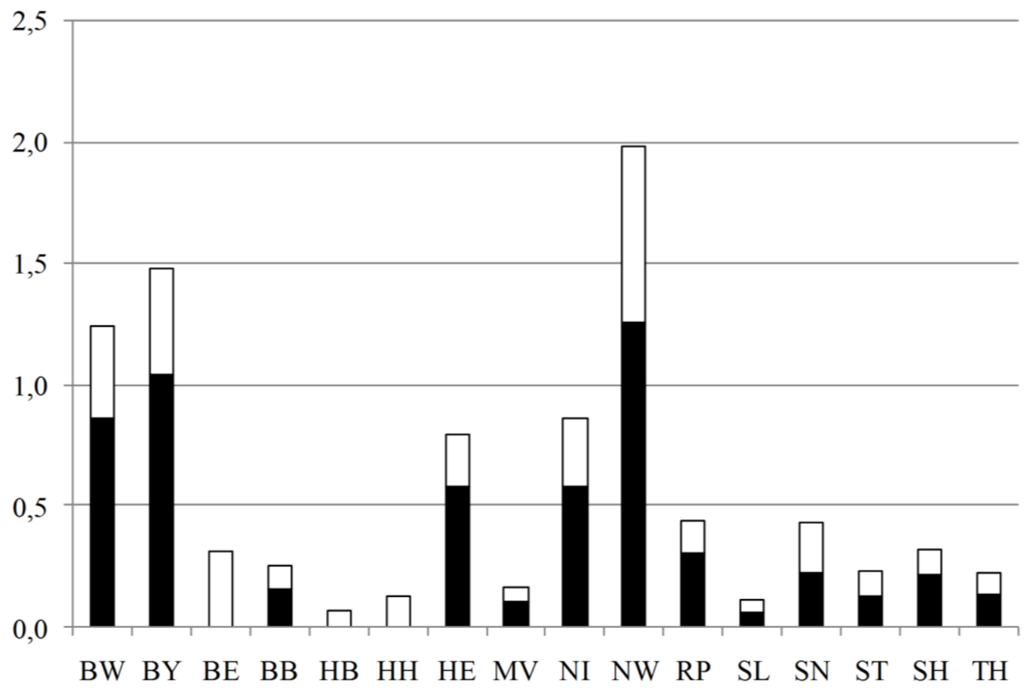
⇨ Results (cont.):

- FS and LS can profit from higher additional income taxes esp. economically strong regions
- Inequality in tax revenues is increasing before tax redistribution amongst FS
- At 2. step in FFES some FS losses their VAT revenues compared to reference
  - VAT revenues are at the same level
  - VAT supplementary portion for poorer FS increases
  - VAT distributed per capita decreases
- Balancing volume in 3. step in FFES is higher +350 mln. €
  - BW, BY, HE pay compensation to remaining countries

Scenario 2: Integration

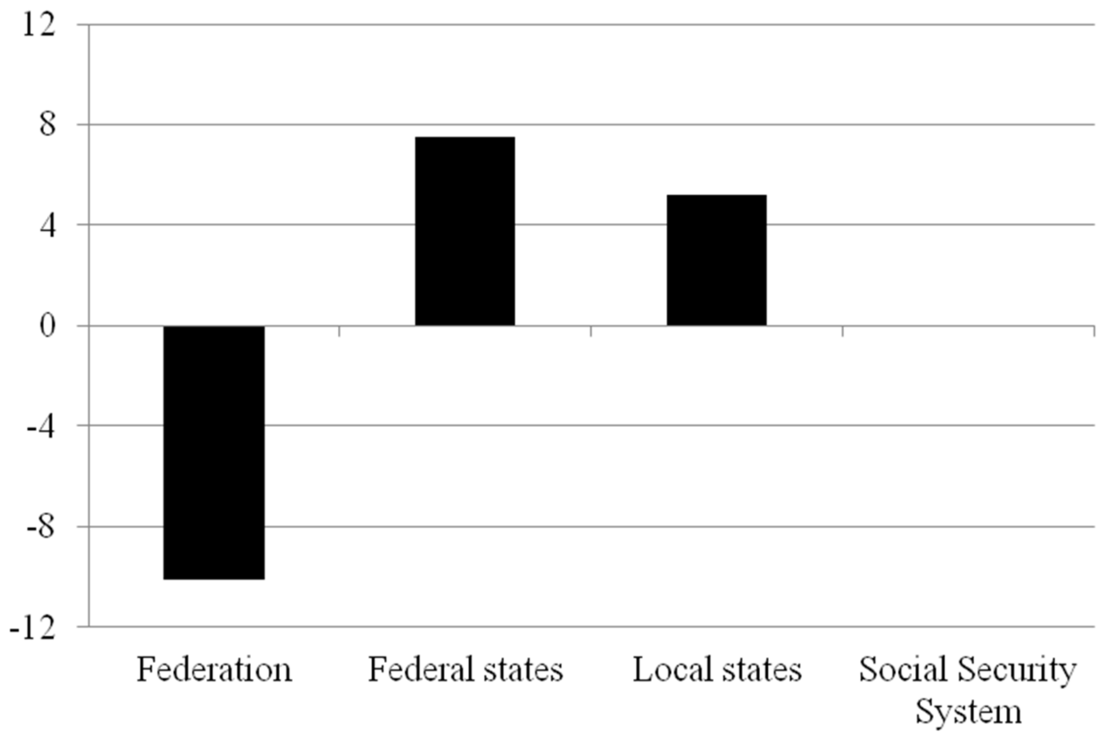
⇨ Results (cont.):

- Differences in net lending/borrowing in bln. € (black LS, white FS) compared to REF



Scenario 2: Integration

⇨ Results (cont.):
Differences in net lending/borrowing in bln. € compared to REF



4. Conclusions

Conclusions

- Deregulation of solidarity surcharge
  - ⇨ Relieves tax payers
  - ⇨ Higher purchasing power has positive impacts on economic growth and employment
  - ⇨ Additional taxes and social contributions
  - ⇨ Federation is loser if no countermeasures are taken into account (debt limit)

- Integration of solidarity surcharge into the income taxes
  - ⇨ Losses in federation tax revenues are smaller
  - ⇨ Additional tax revenues for FS and LS are higher
  - ⇨ Social security system cannot profit from the SS integration

Conclusions

- Actual discussion : SS will probably not be deregulated:
  - ⇨ Expenditures will further increase (a. o. demographic change)
  - ⇨ Debt limit for federation (2016 onwards) and FS (2020 onwards)

Thank you for your attention.

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