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
4. Conclusions
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 heterogeneous with respect to population and economic structure → influences expenditures and revenues

![Maps showing population and GDP distribution](image_url)

- Dark: high values
- Light: low values

Population

GDP
Background

- **Overall target** for allotting the revenues of the FS: create and maintain equal living conditions throughout 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 contributions and tax revenues (75 %, \(\sim 1.100\) 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, ...

<table>
<thead>
<tr>
<th></th>
<th>Income Tax</th>
<th>Cooperation Tax</th>
<th>VAT</th>
</tr>
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<tbody>
<tr>
<td>Federation</td>
<td>42.5 %</td>
<td>50 %</td>
<td>~53 %</td>
</tr>
<tr>
<td>FS</td>
<td>42.5 %</td>
<td>50 %</td>
<td>~45 %</td>
</tr>
<tr>
<td>LS</td>
<td>15 %</td>
<td>0</td>
<td>~2 %</td>
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</tbody>
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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 donating 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

Demography

INFORGE

Macro-Economy

National Accounts

Coorporations

Private Households

Foreign States

Government

16 LAENDER

Regional Economy

Primary Income

Taxes, Social Contributions, Social Benefits

Disposable Income

Federation

Federal States

Local States

Social Security System

Revenues (Taxes, Transfers etc.)

- Expenditures (Employees, Transfers, Investment etc.)

= Net Lending/Net Borrowing

Federal Financial Equalization System
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

  ▪ 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

![Chart showing differences in net lending/borrowing for various regions in Scenario 2: Integration.](chart-image)
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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