Financial Equalization Reform (February 20, 2017)

Abstract

The German federal system relies heavily on the distribution of tax revenues between so-called rich and poor federal states [Länder]. The system increasingly drew criticism due to the growing imbalance between payer states and recipient states. After years of difficult negotiations, a new system was agreed upon in 2016 (going into effect in 2020) which increases the financial contribution of the federal government along with its competences but, according to the author, the individual states also benefit.

Source

The long road to an agreement

The federal relationships are being reorganized. All states win; the federal government gains more competences.

December 3rd, 2015, was a historic day. At least in the relationship between the federal government and the federal states. At a meeting in the offices of Bremen's representation with the federal government, the minister presidents of the states were able to agree on a joint proposal for a reform of financial equalization. They surprised themselves. Before the round of talks, which was a bit turbulent, the signals were by no means pointing to an agreement. Most of all, however, they caught the federal government and the Bundestag off guard. The assumption there had been that the states – in keeping with long experience – would once again fail to agree. And then came the news: 16 [yes votes] to 0 [no votes].

The federal government was not prepared. Finance Minister Schäuble (CDU) and his State Secretary Werner Gatzer, no doubt somewhat worn down after nearly two years of talks, had neither a real counterproposal ready nor a list of conditions that the federal government, which was envisaged as the funder in the states' model, could have introduced into the subsequent negotiations. It was only a few weeks later that Schäuble presented a paper. The federal government tried to improve its position by delaying an agreement and informally linking the parallel talks about financing the costs for refugees to the negotiations about financial equalization.

Finally, on October 14, 2016, the chancellor and the leaders of the states wrapped things up provisionally. By then the federal government had introduced additional points into the package, so that in the end – as Volker Ratzmann, Baden-Württemberg's representative to the Bundesrat, put it – it was almost a third reform of federalism that was agreed on – and not simply a new financial equalization. […]

However, it became clear very quickly that the compromise would not hold up. Additional negotiations became necessary. At another summit meeting at the chancellor's office during the night of December 9, 2016, the participants were able to find a solution that could be cast into draft laws – the details still contested, of course, as the statement from the last session of the Bundesrat reveals: the representative chamber of the states is proposing around seventy changes.

Seehofer's wish: it all began years earlier with the wish, above all from the Bavarian Minister President Horst Seehofer (CSU), for relief for the payer states in the fiscal equalization scheme of the federal states. The Basic Law makes provisions for equalization, but the development since the reform of 1994, which the federal government made possible by waiving seven points of the VAT, did not lead to an approximation of the states' ability to raise revenue through taxation. Quite the opposite: paying was always more a matter for the states of Bavaria, Baden-Württemberg, and Hesse, while once strong North Rhine-Westphalia fell behind and the East did not catch up. The expiration of the Solidarity Pact II for the eastern German states in 2019 brought the threat of a financial equalization scheme – if there was no reform – that would have drawn even more heavily on the paying states. The government in Munich filed a suit in Karlsruhe, with legal support from Wiesbaden, and political support from Stuttgart.

But it was unclear whether taking the matter to Karlsruhe would go very far. Far more promising was the attempt to bring all the states together to hammer out a new financial equalization, jointly with the federal government or also against it. The fact that all states had an interest in coming together played a role in this: the payers wanted relief (Bavaria's goal: one billion euro, something that Seehofer did achieve in the end), North Rhine-Westphalia wanted to appear as a payer state, the weaker western German states by now had minor budget problems because of the debt ceiling, the high-debt states – chiefly Bremen and Saarland – needed even greater outside help, and the East did not want to prolong its dependence on the federal budget.

The eyes of all the minister presidents were on Berlin, the object of their desire was the "Soli" [solidarity tax]. This surcharge on the income tax, to all of which the federal government was entitled, had long ceased being used only to finance the reconstruction of the East between Rostock and Dresden. An extension beyond 2019 was therefore only feasible if one incorporated it into the income tax – the states and local governments would then take a share of 57.5 % - a tidy sum of eleven billion euro (in relation to 2019), with which a restructuring of financial equalization seemed doable. […]

The proposal from the states, which the Federal Minister of Finance could no longer thwart, is a political compromise, one that does not quite reach the systematic purity wished for by financial experts or professors of constitutional law. But it is not as bad as it is depicted in some commentaries. The chief goal of its creators was to unite 16 interests. […]. The reform is by no means an end to solidarity among the states. The difference to the status quo is that the outflows from the state budgets of the "payers," in the final analysis nothing other than pass-through items, are replaced by a waiver of revenue from the stronger states. The distributory effect via increases and deductions in the distribution of the VAT can be easily depicted also in the future.

No Solidarity Pact III: During the entire negotiations, there was grumbling in the Bundestag, because the parliamentarians were not included in these purely governmental talks. Budget politicians of the coalition, like Eckhardt Rehberg (CDU) or Carsten Schneider (SPD), continuously demanded that the agreement could not come at the expense of the federal budget. In the end, while the federal government's share of the equalization volume has grown, from one fifth to one third, in practice a part of the previous federal contributions to the solidarity pact were integrated into the general system. No side wanted a third solidarity pact, but the financial weakness of the East remains. That the eastern states supported the compromise has to do with the fact that they benefit above all from the federal allocation that is linked to the ability of local governments to raise tax revenue. However, that allocation is strictly bound by rules – with that, the East is not subject to the reins of the federal Minister of Finance, and that is what mattered to the eastern minister presidents.

In addition, the federal government is in no way burdened with an additional 9.7 billion euro. The Federal Ministry of Finance's press release of 14 December 2016 itself made this clear. One can read there that the amount contains also "the continuation of regulations already in force or similarly in force today." […] The federal government will thus not pay much extra.

More competences: In return, the minister presidents conceded to the Berlin central government a gain in competence, the scope of which was a surprise and which some minister presidents are already assessing as possibly too high. Here one should mention above all that the ministers of transport of the states and their agencies have waived the responsibility for the planning and building of highways within the framework of the federal executive administration. This is one of the most massive centralization projects in the history of the federal republic. While the relevant ministers in the states tried tenaciously to fend off this wish by the federal government, the prime ministers went along, because both Schäuble and ex-minister of the economy Sigmar Gabriel (SPD) tied the entire deal to it. Added were co-financing possibilities on the part of the federal government for investments by financial weak municipalities, which is aimed especially at school buildings, rights of coordination when it comes to the digitalization of administration, and more supervisory rights for the Stability Council and the federal minister of finance in the administration of taxes. Overall, a bundle which the federal government can certainly regard as a major win.

Source: Albert Funk, “Der lange Weg zur Einigung,” *Das Parlament*, No. 8, February 20, 2017, p. 3.

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