CHAPTER 14

Public Finance

Gisela Färber

1 Introduction

Public budgets are often called 'government programmes in numbers'. They represent the financial side of government activities. They cover the salaries of civil servants, interest payments on public debt and a broad variety of transfer payments to enterprises and private households as well as among governments. On the revenue side, we find taxes and fees and received grants. A specific perspective comes up on the public sector, not as a homogeneous entity, but as a multilevel system with different levels of governments and a variety of financial transactions among them.

The chapter gives an overview of public finance in Germany. It provides information on the volume and structure of expenditure and revenue, the latter with special focus on the tax system, the system of multilevel tax distribution among the levels of government and finally on public debt. The chapter refers also to the legal framework for public budgeting and accounting standards, which differ to a certain degree among the levels of government or—in the case of local budgets—among the *Länder* (federal states).

G. Färber (✉)
German Research Institute for Public Administration, Speyer, Germany
e-mail: faerber@foev-speyer.de

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2 Regulation of Public Budgets and Budgeting

In Germany, the Federation has established the law of principles of budgeting which sets out the requirements for the regulation of public budgets for all levels of government. In addition, the federal budget code regulates all the details for federal ministries and agencies, as the budget codes of the *Länder* set out very similar detailed regulations for ministries, administrations and agencies.

2.1 Principles of Budgeting, Structures and Classifications

The law on budgetary principles was passed in 1969 in order to establish a framework for the common rules for federal, state and local budgets. This legislation aimed at establishing standardised legal procedures and structures as well as a common basis for the public sector financial statistics. The law is based on traditional principles of budgeting, of which the most important are: principle of annuality, principle of coverage in total, principle of gross coverage, principle of unity, principle of totality, principle of balancing the budget, principle of exactness, principle of efficiency and economy, principle of public information and principle of budgetary trueness and clarity.

Budget acts are rather short and must include the total amount of estimated revenue and expenditure as well as the maximum permissible borrowing amount. They include as attachment the budgetary plan, which consists of surveys of the appropriations of all ministries and the administrations and agencies in their responsibility (overall plan), revenue and expenditure according to economic categories (grouping survey), revenue and spending purposes (the so-called functional plan), a budgetary profile combining institutional and economic categories, and finally a directory list of all personnel positions to be approved.

The Federation and the majority of the states present their budgets in the traditional 'institutional structure' and still apply the cash-based accounting system. Only Bremen, Hamburg and Hesse have changed to an accrual budgetary system. Local governments have all changed compulsorily to accrual budgeting but follow a common institutional structure, although they are free to decide on their organisational structure and show a broad variety. The idea of programme budgets, which are not based on the institutional structure but on political goals and programmes, has not been successful; this information is shown, if included in the budget, in addition to the traditional items.

2.2 *The Budget Cycle*

A budget cycle, the period starting with the preparations leading to drafting and coordinating the budget plan through to parliamentary approval, execution, the rendering of accounts, financial control and the discharge of the government by parliament, takes about three years.

The starting point is usually the tax estimation in November, which the representatives of all 17 ministries of finance, the Ministry of Economic Affairs, the *Deutsche Bundesbank* (Federal Central Bank) as well as academics and experts from the six big research institutes undertake twice a year. On this quantitative basis, the ministries of finance determine the baselines for the new budget which will come into force more than one year after the year being budgeted for. The financial framework includes total revenue expected, the amount of expenditure to be funded, standards for inflation rates and civil service salary increases. The ministries then ask their units to deliver their 'financial needs'. The budget plan and other documents of the budget bill traditionally receive cabinet approval in the last meeting of the cabinet before the summer break. The budget bill is then submitted to the legislative bodies, the German Bundestag and the Bundesrat. From September, the German Bundestag adopts the budget bill after three readings.

On 1 January, the implementation of the budget starts. The Ministry of Finance decrees details. Particularly in the event that revenue falls behind scheduled expectations, the Minister of Finance can order a spending freeze or other specific measures to reduce expenditure. The budgetary year closes by 31 December. The institutions can only carry forward remaining spending allowances into next year's budget with a special executive permit of transfer. The Ministry of Finance renders the accounts by the end of February, which are then transferred to the Court of Audit. Usually in October, the Court of Audit delivers its annual report to parliament where the Audit Committee, a sub-committee of the Budget Committee at the federal level, examines the report. The report of the Audit Committee provides the information for granting discharge to the government.

2.3 *Recent Budgetary Reforms*

After timid experiences with Planning-Programming-Budgeting Systems in the 1970s, Germany continued with conservative budgeting and financial management procedures until the early 1990s, when a recession after the boom created by German reunification restricted the tax revenue of all levels of government. Local governments were the first to reform their budgetary planning and financial management procedures, following the ideas of the Tilburg model of new public management (cf. Chap. 22). Federal and state governments do not apply performance budgets.

Gender budgeting is even less widespread in Germany than performance budgeting. Here the budgetary impacts are planned and documented according to their effects on men and women (Färber, Christine). However, it is still difficult to get majorities for these types of budgets in Germany. A little more popular are the so-called citizens' budgets, which involve the citizens themselves, that is the local voters, in the budgetary decision-making process. The participation of voters in budgetary issues mainly takes place in situations where a sharp fiscal consolidation needs to be implemented. The citizens then create ideas for expenditure cut-backs and increases of revenue. Neither measure is very popular, therefore the organised inclusion of 'normal citizens' in making these difficult political decisions promises a better acceptance. However, it is unclear whether local politicians favour participatory budgeting procedures not only in periods of fiscal stress, but also when tax revenue is growing.

3 Basic Regulation for the 'Fiscal Constitution' in the Basic Law

The Basic Law regulates the fundamental rules for public sector finances in its tenth chapter. In addition, the provisions of Article 28 (2) of the Basic Law guarantee the local governments financial autonomy and, to a certain degree, tax autonomy, by granting them the right of self-administration to manage all their own affairs.

The rules of the financial constitution are based on the specific 'division of labour' between the Federation and the *Länder* in the so-called administrative federalism. The Federation passes the legislation in the majority of policy fields while the states execute federal laws as their own responsibility. The *Länder* very often delegate the execution of federal and their own laws to their municipalities, each with a slightly differing degree of decentralisation. Therefore, the Federation has the smallest administrative body, while state and local governments cover the big personnel expenditures for administration.

The budgets of all jurisdictions are independent of each other. All jurisdictions set up their proper budgets and pass them to their parliaments and local councils for legislative approval. Only local governments need legal approval from their state administrations, which is a formal approval for all municipalities delivering balanced budgets.

Article 104a (1) of the Basic Law provides that the Federation and the states cover the costs for their respective public tasks. The obligation of cost covering follows the right of execution, not the right of legislation. This means that the upper level establishing new or additional regulations does not cover the costs of its administration. Only certain laws regulating specific social transfers contain the rule that transfer payments are shared on a 50:50 basis (e.g. housing subsidies) between the federal level and the states. The respective problems of cost covering by the decentralised levels result from European legislation. Since 2005, however, Article 104a (4) of the Basic Law has prescribed that federal laws, which foresee transfer payments, allowances in kind and other obligations in favour of third parties, and which are executed by the states as their own tasks, need the approval of the *Bundesrat*.

The *Länder* have, in principle, the same right to further decentralise the administration of federal laws and their own regulations to their counties and municipalities. For several years now, a so-called principle of connectivity has been established in all state constitutions prescribing that in the case that the *Länder* decentralise additional administrative tasks to their communities, they must cover the costs. The respective detailed regulations vary from state to state, particularly with regard to the procedures on how to measure the costs of administration and how the transfer payments are to be shaped (i.e. specific-purpose grants, general grants or inclusion in the local fiscal equalisation scheme). Municipalities have won several proceedings before state constitutional courts with regard to cost covering for decentralised tasks; many more are expected in the future. Recent reforms include the provisions under Article 104b–d of the Basic Law regulating vertical specific purpose grants for investment expenditure in order to stabilise economic development and foster economic growth as well as equivalent living conditions across Germany, other specified investment purposes for state and local governments and for affordable housing policies.

The tenth chapter of the Basic Law sets out the basic rules for tax assignment in the following articles: legislation in Article 105; revenue competences in Article 106; vertical and horizontal fiscal equalisation in

Article 107; and tax administration in Article 108. Additionally, Article 109 regulates the limits of public debt and includes a specific rule to avoid budget emergencies in Article 109a. As the previously mentioned articles cover the Federation and the states, the articles following Article 110 only concern federal finance. Articles 110 to 113 set out the ground rules for federal budgeting, courts of audit (Article 114) and, more specifically, for federal public debt (Article 115).

4 Public Expenditure

The volume and structure of public expenditure provides a good insight into the different tasks of the levels of government. Public sector expenditure and revenue include not only the three levels of government but also the social insurances (pensions, healthcare, long-term care, unemployment and occupational accidents), which underlie a specific governance of self-administration and for which the Federation only has the right and duty of legal control, but not supervisory control. However, they are responsible for the large budgets of transfer payments and cover about 40 per cent of the total public sector budget. They dominate public expenditure in two areas: material expenses, which are mainly the expenditures on the healthcare insurance for medical services, medications and other materials; and the pension scheme for rehabilitation services and transfer payments to the private sector, including mainly payments for pensions from the general pension scheme and unemployment allowances from the unemployment insurance. The third biggest expenditure item of social insurances comprises transfer payments within the public sector, which mainly cover payments among the social insurances, such as the contributions for pensions, healthcare and long-term care insurances for pensioners and the unemployed, including contributions from both employers and employees, which, on the other side, are deducted from the payments transfers of pensioners and the unemployed. The expenditure on personnel is the lowest for all levels of government (Table 14.1).

The respective governments of the three levels show very specific structures of expenditure too. The federal budget is dominated by transfer payments to other public sector institutions and to the private sector. The first mainly cover transfer payments to the social insurances (to the general pension scheme and unemployment insurance, the latter for expenditure in favour of the long-term unemployed); to the states for general vertical grants in the context of intergovernmental fiscal equalisation (Federal

Table 14.1 Public expenditure at government level and social insurances in 2018

(billion euros)	*Federal govt*	*Land govts*	*Local govts*	*Social ins*	*Total govt*
Personnel expenses	51,943	151,143	69,090	21,515	293,691
Material expenses	38,775	52,760	59,193	257,936	408,665
Interest payments	23,859	13,293	3009	81	40,242
Current transfer payments[a]	254,800	173,597	150,024	618,907	1,224,854
To other public sector budgets	193,253	133,707	69,570	257,542	654,072
To the private sector	61,547	39,890	80,454	361,365	570,782
Real investment expenditure	12,156	13,230	30,103	711	56,200
Capital transfer payments	29,002	26,730	2949	1	58,681
To other public sector budgets	10,954	16,960	1655	11	29,579
To the private sector	18,048	9770	1294	-10	29,102
./. payments from same level	-28,869	-44,284	-59,094	-255,181	-679,246
Total expenditure	385,998	398,805	260,128	647,874	1,428,512
% of total expenditure					
Personnel expenses	13.5	37.9	26.6	3.3	20.6
Material expenses	10.0	13.2	22.8	39.8	28.6
Interest payments	6.2	3.3	1.2	0.0	2.8
Current transfer payments[a]	66.0	43.5	57.7	95.5	85.7
To other public sector budgets	50.1	33.5	26.7	39.8	45.8
To the private sector	15.9	10.0	30.9	55.8	40.0
Real investment expenditure	3.1	3.3	11.6	0.1	3.9
Capital transfer payments	7.5	6.7	1.1	0.0	4.1
To other public sector budgets	2.8	4.3	0.6	0.0	2.1
To the private sector	4.7	2.4	0.5	0.0	2.0
./. payments from same level	-7.5	-11.1	-22.7	-39.4	-47.5
Total expenditure	100.0	100.0	100.0	100.0	100.0

Source: Federal Statistical Office (2018); author's own calculations

Differences of the sums result from rounding

[a]Some figures include double counting; therefore, the total figures could be lower or higher than the figures reported/percentages shown

Supplementary Grants); for a broad range and growing number of specific purpose grants according to Article 104b–d of the Basic Law; and for the refugees administration of the *Länder* and their communities. Current transfer payments to the private sector include the federal share of social transfer payments for housing allowances, parents' allowances, students' allowances, minimum pensions for people of old age and unable to work. The Federation shows the lowest spending on personnel because it does not execute its own regulations. However, personnel expenditure has been increasing above average in recent years largely due to the Federation employing increasingly more staff in the federal police services and buying equipment for its ministries and federal agencies—and sometimes probably just spending federal tax revenue growth.

The states are the 'big employers' in the public sector. This is not only because of their responsibility for the execution of federal law—which they share with their municipalities—but also because of their own tasks in the field of education (schools and universities), police, courts of law and prisons as well as tax administration, where they spend most on salaries and other salary-related costs, including pensions for civil servants. The second biggest budget item consists of current transfer payments within the public sector. These mainly cover the local fiscal equalisation scheme through which the states share their tax revenue with their local communities (see below). Current transfer payments mostly represent the states' share in the above-mentioned federal social transfer programmes.

Last but not least, local governments cover the smallest share in expenditure with 'only' €270 billion. The budgetary statistics, however, do not show the true volume of local expenditure because local communities, especially the larger ones, provide a huge variety of expensive local services—local public transportation, water provision and sewage, garbage collection, and even local construction activities—via government-owned, 'formally privatised' local enterprises. Public sector financial statistics do not include these expenditures and only account for transfer payments to them or profits paid by them. Therefore, the financial data of local governments presented underestimate the financial volume of local service production, and the public sector revenue only includes the activities of the proper 'administration' and services 'within the budgets'. Approximately €70 billion is for personnel expenditure, which has been steadily growing in recent years. This is particularly the result of increasing the number of kindergartens in line with federal regulations to guarantee early childhood care for all children from the age of three.

An even heavier burden is the increasing expenditure on social transfer payments—€800 billion in 2018—since local governments are still responsible for all remaining areas of the guaranteed minimum income system, which covers a certain proportion of the accommodation costs for long-term unemployed job-seekers, full support for people with disabilities who are not privately covered as well as for poor people in long-term care institutions who cannot cover the costs themselves. The transfer payments within the public sector are mainly payments among local governments. Among them dominate the apportionments which counties in particular and other local government associations levy on their member municipalities in order to cover their expenditure.

Finally, the specific role of local governments for real investment expenditure should be mentioned. The local communities are still the biggest investors in public infrastructure, although here other expenditure not shown in the documented investment expenditure is hidden in the accounts of the locally owned enterprises. However, the financial crisis in local budgets of the late 1990s and 2000s led to sharp cuts in investment expenditure. In particular, the poor communities in regions of strong economic structural change were not able to maintain their stock of public infrastructure.

5 Public Sector Revenue

Public sector revenue is more than taxes, although these dominate the receipts. Therefore, the next chapter outlines the various revenue streams and shows the differences among the levels of government before the German tax system is presented. Finally, the distribution of tax sources and tax revenue among the jurisdictions informs about the effective tax sharing system in Germany.

5.1 Revenue in General

Taxes and compulsory contributions to social insurances amounted to €1.3 trillion in 2018. The revenue share was 60 per cent for taxes and 40 per cent for contributions to social insurances. The second important revenue source of social insurances are transfer payments, of which €255 million are transfers paid by other social insurances for the above-mentioned contributions of pensioners and the unemployed. The remaining €120 million come from the federal budget, mainly from the Ministry of Labour and Social Affairs (BMAS) in favour of the general pension fund. These latter transfer payments are designated to cover the costs not funded by earlier contributions, which are calculated in a general way. The only explicit contributions to the pension fund cover compensations for child education, that is three years of average contributions for each child born after 1998 (Table 14.2).

The federal and state governments cover their expenditure from tax revenue amounting to €351 billion (88 per cent) and €299 billion (71 per cent), respectively. Local governments, however, generate only 38 per cent of their revenue from taxes. The latter, by contrast, receive 56 per cent of their income from current transfer payments from other public budgets, and 22 per cent from the state. The majority of these transfer payments represent vertical fiscal equalisation and, in the case of the *Länder*, some horizontal redistribution. These explicitly aim to cover the structural lack of own tax revenue of the lower levels of government and include horizontal distributional effects. Payments from the same level of local government do not include horizontal equalisation payments; they

Table 14.2 Public revenue at government level and social insurances in 2018

(billion euros)	*Federal govt*	*Land govts*	*Local govts*	*Social ins*	*Total govt*
Tax revenue/social contributions	351,158	298,509	101,213	534,130	1,313,535
Current transfer revenue[a]	35,528	105,506	162,012	375,247	677,294
From public budgets	28,898	93,641	152,316	372,815	64,767
From private sector	6629	11,865	9696	2431	29,624
Other current revenue	31,241	37,507	47,439	4642	82,130
Sale of real assets	3175	1859	5266	147	10,447
Capital transfer revenue	3588	15,879	11,300	11	30,779
./. payments from same level	-25,611	-38,074	-56,989	-255,170	-648,917
Total revenue	398,441	419,030	269,906	659,027	1,482,112
% of total revenue					
Tax revenue	88.1	71.2	37.5	8.1	88.6
Current transfer revenue[a]	8.9	25.2	60.0	56.9	45.7
From public budgets	7.3	22.3	56.4	56.6	4.4
From private sector	1.7	2.8	3.6	0.4	2.0
Other current revenue	7.8	9.0	17.6	0.7	5.5
Sale of real assets	0.8	0.4	2.0	0.0	0.7
Capital transfer revenue	0.9	3.8	4.2	0.0	2.1
Total revenue	100.0	100.0	100.0	100.0	100.0

Source: Federal Statistical Office (2018); author's own calculations

Differences of the sums result from rounding

[a]Some figures include double counting; therefore, the total figures could be lower or higher than the figures reported/percentages shown

are mainly the apportionments in favour of county governments and other types of associations of local government. Capital transfer revenue partly follows the same goals, but is bound to cover investment expenditure and often requires a co-finance share from the recipient budgets (matched grants).

Other current revenue, which accounts for the third most important source of public revenue, is dominated by user fees and profits from government-owned enterprises. The amount of fees is bigger in local budgets because local governments provide specific public goods for their citizens and the local economy to which the exclusion principle can be applied and, therefore, the principle of equivalence. However, the fees covered in the financial statistics meanwhile only document the smaller share of local user fees because the 'big fee budgets' for water provision, sewage, waste collection, local public transportation, etc., have been privatised, although their fees remain as revenue regulated by (public) administrative law but never 'touch' a public budget.

5.2 Tax Revenue

Tax revenue, which in Germany has to follow the 'ability to pay principle', is almost completely under the legislation of the Federation. The Federation has the 'exclusive legislative competence' with respect to taxes, of which the revenue belongs to the federal budget. With respect to all others taxes, of which the revenue in part or in whole funds *Land* and local budgets, the Federation has the so-called concurrent legislative competence and requires the approval of the *Bundesrat*.

Seventy-three per cent of total tax revenue depends on two or three types of taxes, each levied in the form of several special forms of collection:

- the personal income tax consists of the wage tax on the income of employees, the assessed income tax on the profits of sole traders and partnerships as well as the self-employed, an interest income tax and a capital gains tax, which amounted to €299 billion in 2018 (38.5 per cent of total tax revenue);
- the corporate income tax for enterprises established as corporate entities (€33.4 billion or 4.3 per cent of total tax revenue); and
- the turnover tax in the form of a value-added tax for domestic sales (€175 billion, 22.6 per cent) and as a turnover tax on imports (€59 billion or 7.6 per cent of total tax revenue) (Fig. 14.1).

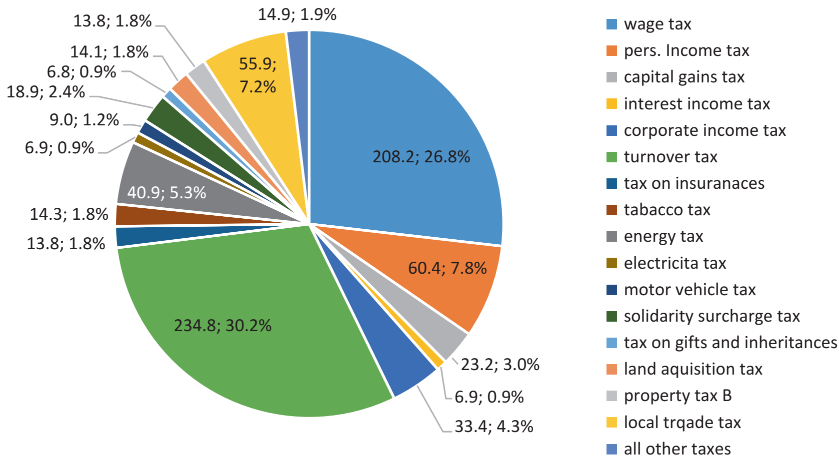

Fig. 14.1 The German tax system. Source: Federal Statistical Office, author's own calculations and for the references: Statistisches Bundesamt (Federal Statistical Office): Fachserie 14.4 - 2018, Wiesbaden 2018

The tax revenue is shared among the three levels of government. The Federation levies in addition a special surcharge tax of 5.5 per cent of income taxes intended to fund the costs of German unification.

Furthermore, the German tax system consists of a variety of excise taxes on tobacco, petrol, energy and electricity, coffee, spirits and beer (but not wine!), a motor vehicle tax and an insurance tax; the latter is 19 per cent on insurance premiums and 'replaces' the turnover tax because insurances are not subject to value-added tax. These taxes—except the beer tax—are revenues in the federal budget.

The states are entitled to receive the revenue from taxes on gifts and inheritances, land acquisition, gambling, lotteries and casinos, which are classed as taxes of smaller yield. The land acquisition tax is the only state tax for which the *Länder* have the right to decide autonomously on the tax rate. A wealth tax, which was levied until 1995 when the Federal Constitutional Court ruled the tax as unconstitutional, still exists but cannot be charged.

Local governments receive the revenue from the local property tax and the local trade/business tax. Both taxes belong to the old so-called real taxes, which are levied on the gross added value. Property tax is assessed on the gross added value of real assets (A for agricultural assets, B for all others) and the local trade tax on local business tax profits. The taxes on the amount of wages paid by an enterprise and the value of invested capital were abolished in 1979 and 1998. The tax bases and tax rates are established by federal law; local governments, however, have the right to decide on a local multiplier. A recent property tax reform gives the states regulatory power to determine the tax base; the changes, however, will only become effective in 2026.

The smallest German taxes are the so-called local consumption and expenditure taxes. These are basically regulated by the states, but local governments decide whether they want to levy them and on the tax rates. Among the local consumption and expenditure taxes are the dog tax and the entertainment tax—in the past on cinema and other local event tickets, today on peep shows and gambling saloons—local beverage tax, and second home tax. The local governments have, in principle, the right to invent local taxes as long as they are not levied on tax bases which are already taxed by the Federation and the states. In 1998, for example, the Federal Constitutional Court ruled a local package tax on single-use plates, cups and cans in Hesse to be unconstitutional for these reasons.[1]

The levels of government usually administer the taxes from which they receive the revenue. Exceptions arise regarding the vertically shared taxes. Here, the Federal Tax Office administers the capital gains tax and the VAT on imports, while the taxation offices of the states accept the tax declarations of the taxpayers, receive the tax payments, organise tax audits in enterprises for the domestic (and meanwhile the European) turnover tax and the income taxes. Tax administration is administered 'on behalf of the Federation', which means that the Federation establishes special regulations for personnel keys, administrative procedures and the application of the respective tax laws and decrees. On behalf of the Federation, the states also administer the social insurance tax and the solidarity surcharge tax.

5.3 Intergovernmental Financial Relations: Multilevel Tax Sharing Assignment

All 'smaller' taxes are revenues of the respective jurisdictions according to the territorial location of its source. This is, in general, the location of the transaction or the residence of the owner of the income or fortune. Some taxes need a specific definition, for example the tax liability on gifts and

Table 14.3 Distribution of tax revenue between the federal, *Länder* and local governments

Revenue in 2018 (billion euros)	*Tax*	*Federation*	*Länder*	*Local governments*
268.6	Wage and assessed income tax	42.5%	42.5%	15%
33.4	Corporate income tax, capital gains tax	50%	50%	
6.9	Interest income tax	44%	44%	12%
234.8	Turnover tax up to 2019	4.45% + 5.05% 50.5%[b]	49.5%[b]	2.2%[a]
	Turnover tax from 2020	52.809% -€6.7 bn. (2020) -€6.9 bn. from 2021	45.195% +€4.3 bn. (2020) €4.5 bn. from 2021	1.996% +€2.4 bn. from 2020

[a]+€2.76 bn. in 2018; €3.4 bn. in 2019

[b]./. €6.5 bn. in favour of the *Länder* in 2018; €7.4 bn. in 2019

inheritances is allocated to the residence of the donor or the heir, although many recipients live in another jurisdiction or abroad.

The three big taxes—personal, corporate income and turnover tax—are, however, vertically shared taxes according to specific keys, as seen in Table 14.3.

While the distribution keys are fixed for the income taxes, the turnover tax is, in principle, flexible. According to Article 105 (2) of the Basic Law, in the case of diverging expenditure-revenue relations of the Federation on the one hand, and the states and their local governments on the other, the key must be changed by federal law, which requires the consent of the *Bundesrat*. The vertical shares of the turnover tax have been changed several times in recent years, mostly in favour of the *Länder* (Färber 2015). In 1998, the increase in the turnover tax rate of 1 per cent was specifically transferred to the pension scheme. Since 1998, local governments have participated in the revenue with a share of 2.2 per cent. Smaller adjustments have been made by lump-sum deductions or extra payments. From 2020, the keys will change to simpler shares after the reform of the intergovernmental financial relations. De facto, the turnover tax revenue will again slightly change in favour of the *Länder*—this was a condition for

Table 14.4 Tax revenue of the different government levels and the EU before and after distribution in 2018 (billion euro)

Before distribution			*After distribution*		
Shared taxes	566.9	73.0%			
Federal taxes	108.6	14.0%	Federal tax revenue	322.4	41.5%
Land taxes	23.9	3.1%	*Land* tax revenue	314.1	40.5%
Local taxes	71.8	9.2%	Local tax revenue	111.4	14.3%
Customs (EU)	5.1	0.7%	EU revenue	28.6	3.7%
Total	776.3	100.0%		776.4	100.0%

Source: Federal Statistical Office (2018); author's own calculations

their approving the reform. Table 14.4 presents the revenue before and after distribution among the levels of government, including the revenue of the EU, which is administered by the Member States and then transferred to Brussels.

Horizontally, tax revenue is assigned according to the territoriality principle, which for the income taxes are the residence and the place of production principles. The wage tax of taxpayers who live in a place other than their workplace is transferred to their place of residence. The income tax and the corporate income tax liability of enterprises with several production sites is apportioned to the respective jurisdictions according to a key combining the added value and the number of employees.

From 2020 onwards, the state share of the turnover tax is distributed according to the number of inhabitants, including deductions and additional payments for those *Länder* whose revenue falls below the average per capita fiscal capacity.[2] The local fiscal capacity is included in the formula at 75 per cent. The remaining below average fiscal capacities after distribution of the state share of VAT revenue and local fiscal capacities of less than 80 per cent of the average is supplemented by specific funding from Federal Supplementary Grants (FSG) (Federal Ministry of Finance 2018).

The German multilevel tax sharing system finally contains the obligation of the states—according to Article 106 (6) of the Basic Law—to share their tax revenue from the above-mentioned joint taxes (including FSG) with their local communities. As the degree of decentralisation differs among the *Länder* and, therefore, also the financial needs of local governments, the percentage rates of state tax revenue vary from 12.75 per cent in Bavaria to 23 per cent in North Rhine-Westphalia. Most *Länder* also share the revenue of their proper tax sources often using diverging transfer rates. The majority of this income is then assigned to 13 different local fiscal equalisation schemes, which include indicators for financial needs and fiscal capacity. All financial needs indicators are based on the number of local inhabitants and in most states are supplemented by other indicators, such as the number of pupils or costs per pupil, social expenditure burdens, number of employees, length of streets. These local fiscal equalisation transfer payments explicitly aim to close the fiscal gap and provide a more equal financial balance among the municipalities and counties.

6 Public Debt

Public debt was for many years an important source for funding public expenditure. A reform of the constitutional borrowing limits in 2009, however, changed the long tradition of an ever-increasing volume of debt. Since 2011, the ratio of public debt to GDP has been decreasing, since 2013 the absolute amount too (see Fig. 14.2). The Federation holds the largest share of public debt; state and local government cover less than a third of total debt. Here again, it should be mentioned that the debt of

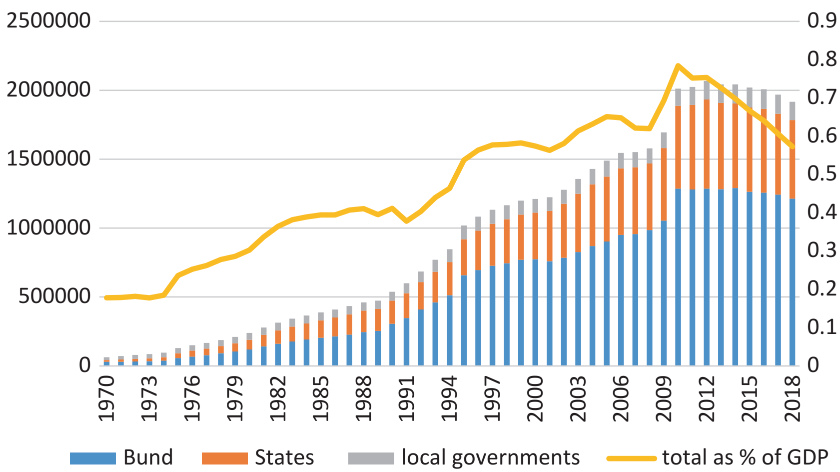

Fig. 14.2 Volume of loans and securities at the different levels of government 1970–2018. Source: Federal Statistical Office, author's own calculations and for references: Statistisches Bundesamt (Federal Statistical Office): Fachserie 14.5 - 2018, Wiesbaden 2018

privatised state and local government-owned enterprises is not included in the official statistics. However, a decline in the absolute level of public debt at all levels of government (on average) has not been experienced since the 1960s.

In addition to loans and securities, there are other types of public debt. The amounts are detailed in Table 14.5. While debt from other public sector institutions or levels of government, liabilities from deliveries of goods and services, and transactions similar to credits are of minor importance, and guarantees are only very rarely called, the cash credits of local governments have become a real political issue. Cash credits are short-term borrowings, usually used to cover a temporary budgetary deficit. In some states (Saarland, Rhineland-Palatinate, North Rhine-Westphalia, Hesse and Saxony-Anhalt) these deficits became 'chronic' during the 2000s and many municipalities have not been able to reduce or erase them. In recent years, the respective state governments have established programmes to help solve the problems, but have not been able to make sufficient transfer payments to clear the debt over a shorter term due to the underlying continuing problems of high social expenditure and the fundamental underfunding of local budgets in these communities. As a result, the Federation is currently having discussions about offering a means of financial support to achieve a quicker solution.

After the regulations to limit the public debt of the Federation and the *Länder* to budgeted (i.e. planned) investment expenditure—a rule following the principle of intertemporal equivalence—in 2009, the Federation and states decided on the requirement in future of an (almost) balanced budget. Since 2016, the Federation has only had permission to borrow up to 0.35 per cent of gross domestic product (GDP). As from 2020, the states are required to balance their budgets. Exceptions only arise for recessions and natural catastrophes (see Korioth 2016). Debt amassed in economically difficult periods and as a consequence of natural disasters is booked into a special account and must be redeemed over a shorter term.

In 2011, in response to the Euro debt crisis, particularly in the South European countries, a new debt regulation was introduced for the Member States of the European Union. The so-called fiscal pact followed the same concept as the German 'debt brake' and restrained public borrowing to 0.5 per cent for 'normal' economic development. Germany 'reserves' 0.15 per cent of GDP as fiscal space for local borrowing, which in the past was sufficient.

Table 14.5 Public debt tax revenue of the different levels of government and the EU before and after distribution as at end of 2018

31 December 2018 (1000 euros)	*Public debt from the private sector*	*of which*		*Debt from the public sector*	*Liabilities from deliveries of goods and services*	*Transactions similar to credits*	*Guarantees*
		securities and loans	*cash credits*				
Federation	1,213,217	1,192,266	20,951	12,138	4635	26	474,497
Länder	570,525	562,216	8309	43,628	2457	629	60,822
Local governments	132,768	97,068	35,700	13,653	5587	1019	27,398
Total	1,916,638	1,851,677	64,960	81,871	45,023	1814	562,735

Source: Federal Statistical Office (2018); author's own calculations

Against this background, the debt limits for local governments have remained unchanged. The local debt limits are covered by the state constitutions and the local government laws of the 13 territorial states. Local budgets require the approval of their *Länder*, which is part of the supervision of local authorities; it stops at either special state administrations or the counties (in the past, the lowest level of state administration). In general, local governments are allowed to finance investment expenditure by borrowing, but only if there are no other financial means (e.g. tax revenue, fees, charges and transfer payments). Since the introduction of accrual accounting and profit and loss budgets, the requirement is to have a balanced budget. This means that local authorities have to cover interest and depreciation of investments from regular revenue. According to the requirements of accounting standards, the rule of balancing the profit and loss budget includes—theoretically—all other forms of open and hidden debt too (cash credits and hidden obligations of future payments).

The broad agreement on the new 'debt brake' across the majority of the political parties did not last for long, although good economic growth created additional revenue, some of which an increasing number of governments used to redeem old debt. Taxes increased more than GDP growth because there was no majority in the Bundestag and in the Bundesrat to approve reducing tax revenue to the former ratio. The states, in particular, argued that they needed the revenue to shoulder the financial burden of increasing education and early childhood education at the local level. The Federation and *Länder* also increased the number of personnel in their police forces. The problem of below average investment expenditure in public infrastructure, which emerged during the economically difficult years of the late 1990s and 2000s, remained unsolved. In contrast to this, the particularly poorer states and local communities achieved their budgetary consolidation but only by cutting back even more on investment expenditure.

As a result, a new discussion on the reliability of the so-called black zero policy has started. A part of the discussion deals with the question of whether governments should stabilise economic development by additional borrowing, even though the incoming tax revenue is still sufficient to cover all planned expenditure. More important are the questions on how to fund the necessary investment expenditure which—after cut backs in the past—require enormous financial efforts to meet both the considerable backlog demand for costs as well as accommodate the demand for public infrastructure modernisation. In the event that investment expenditure at all levels of government exceeds 0.5 per cent of GDP in economically 'normal' times, a borrowing fund would not only be unconstitutional, but would also violate European law. Therefore, might then the consequence be that bigger investment projects are shifted to times of recession? Why should governments intentionally violate the principle of intertemporal equivalence, the so-called golden rule of funding investments, and accept instead that they are (over)burdening generations of taxpayers? Despite all the successes of breaking the long-term continuous growth of public debt because of the actual constitutional and European debt limits, politicians should no longer ignore that the actual rule does not meet the requirements of sustainability. This will probably result in a new reform in the not-too-distant future.

7 Local Finance

The local right of self-government includes financial affairs (Werner 2006). Municipalities, counties and other types of associations of local governments, therefore, need substantial autonomy with regard to deciding on their budgets, including local tax rates on their 'own' tax sources. The revenue from joint taxes, which the states are obliged to share with them according to Article 106 (7) of the Basic Law, should suffice to fund not only the expenditure for transferred tasks, but also a considerable amount of spending for the tasks of local self-government. Article 106 (6) of the Basic Law grants the right not only to the revenue from the local property and the local business tax, but also to decide on the local multiplier of these taxes. Local governments, therefore, have substantial autonomy on both sides of their budgets, although the scope of their financial decisions is restricted by the dominance of transferred tasks and the corresponding expenditure.

About 20 years ago, almost every territorial state introduced the so-called principle of connectivity into their state constitutions. The idea was that when transferring new tasks to local governments, the states would also include the necessary financial means for execution. However, reality shows that there is regional regulatory divergence with regard to (Schmidt 2016):

- the tasks specified by the principle; no *Land* has incorporated European and federal regulations into the compensation catalogue;
- the strictness of the application and duty of compensation; and
- the instruments and calculation methods of compensation.

Meanwhile, there are doubts about whether the practised principle of connectivity has helped to protect local governments against additional financial burdens, or whether it has even created new distortions by establishing a broad range of new specific grants in addition to local fiscal equalisation and disturbances to the efficiency mechanism of the annual local budget decisions. The principle is actually rumoured to prevent an efficient assignment of tasks between state and local governments as states avoid regulations in order not to create new obligations to make compensation payments.

All local fiscal equalisation schemes have two main goals: to top up local revenue due to 'chronically' deficient vertical tax assignments and to close horizontal gaps of fiscal capacities regarding local needs. As the decentralisation of tasks as well as local tax capacities differ from *Land* to *Land* (see Table 14.6), the volume of local fiscal equalisation needs to vary too.

Table 14.6 Per capita expenditure of state and local governments and aggregated state-local governments 2018

Per capita expenditure (in euro)	*State and local gov. aggr.*	*State gov.*	*Local gov.*	*Share of local gov. of aggregated %*	*Local tax revenue*
Baden-Württemberg	6495.3	4771.6	3595.8	55.4	1489.4
Bavaria	6953.9	4746.4	3285.4	47.2	1537.7
Hesse	7294.5	4841.2	3583.8	49.1	1602.0
Lower Saxony	5976.5	4121.9	3136.0	52.5	1181.0
North Rhine-Westphalia	6807.9	4374.3	3799.6	55.8	1406.5
Rhineland-Palatinate	5873.2	4362.0	2982.1	50.8	1183.0
Saarland	6016.4	4409.9	2564.6	42.6	1091.3
Schleswig-Holstein	7374.8	5574.6	3149.6	42.7	908.9
Brandenburg	6552.9	4988.6	3238.6	49.4	811.7
Mecklenburg-Vorpommern	6132.4	4728.6	3017.9	49.2	876.7
Saxony	6040.4	4485.2	3150.1	52.2	819.6
Saxony-Anhalt	6717.9	5126.1	3033.0	45.1	1169.8
Thuringia	5919.8	4674.2	2666.6	45.0	842.4
Territorial *Länder*[a]	6611.7	4615.0	3389.4	51.3	1318.8

Source: Federal Statistical Office (2018); author's own calculations

[a]Territorial states span a wider area and include a level of independent local governments while the three city-states Berlin, Hamburg and Bremen administer local tasks by dependent districts

Table 14.7 Changes in the local shares of the compulsory tax sharing revenue of the *Länder* 2000–2019 (percentage of state tax revenue)

Land	*BW*	*Bav*	*He*	*LS*	*NW*	*RP*	*Saar*	*SH*	*BB*	*MV*	*Sax*
2000	23.0	11.54	22.9	17.59	23.0	20.25	20.00	19.00	26.1	27.36	26.365
2011	23.0	12.20	23.0	15.50	23.0	21.0	20.555	17.74	20.0	23.81	22.09
2019	23.0	12.75	–	15.50	23.0	21.0	20.573	17.83	21.0	26.09	22.135

Source: Fiscal equalisation laws of the *Länder*

Most states—except Thuringia, Saxony-Anhalt and Hesse, which estimate a minimum financial equipment for their communities—just apply a certain percentage to their tax revenue. The resulting sum is the basis for local fiscal equalisation. All states then start by using a rather large share of the fiscal equalisation sum for specific purpose grants, which amounted to 42.7 per cent of total fiscal equalisation grants in 2013 (Deutscher Städtetag 2013) and should actually not be much lower (Table 14.7).

The remaining amount is then distributed as unconditional so-called key grants. Key grants show—in different combinations and quantities among the states—three basic forms:

- often a part of the key sum is given as lump-sum grants—diverging for the types of local authorities—in order to cover the costs of compulsory local tasks;
- some *Länder* (e.g. Baden-Württemberg and Rhineland-Palatinate) secure a minimum fiscal capacity per inhabitant for municipalities by top-up grants to a certain percentage of the average fiscal capacity;
- all fiscal equalisation schemes contain key grants covering a certain share of the gap between financial needs and fiscal capacity for each local government.

The measurement of financial 'needs' is based on the size of the population (main approach) and other factors representing important cost factors (secondary approach). In most states, the number of citizens is evaluated by a factor increasing with the size of the municipality. The variety of indicators for the secondary approach is broad and ranges from the number of pupils or standardised school costs per pupil, number of long-time unemployed, number of employees, number of students and 'central locations' from regional planning categories, to the size of the military personnel, mining communities, spas, etc. Each community then has an indicator for abstract financial needs without any particular monetary dimension.

Fiscal capacity is accounted as the real revenue from the local shares of personal income tax and turnover tax plus standardised revenue from local property and local business tax, which is weighted by a uniform multiplier in order to avoid inefficient local tax policies. Fees and charges as well as minor local taxes are not included in the fiscal capacity.

The rate of equalisation varies between 50 per cent and 90 per cent from state to state. The 'neutral' indicators of financial needs are multiplied by a 'basic grant', which is calculated to absorb exactly the whole key sum. These local authorities receive key grants, of which the monetised financial needs indicator exceeds the fiscal capacity. If the fiscal capacity exceeds the financial needs, no key grants are available.

Although German local governments have experienced a long period of economic growth as well as growing tax and fiscal equalisation revenue, communities in certain states suffer from persistently high amounts of cash credits. In particular, the cities and counties in regions undergoing massive structural economic change 'accumulated' cash credits during the periods of recession in the late 1990s and 2000s until the financial crisis of 2008–2010 and have not been able to reduce them in the amount or as quickly as required. All states concerned have established programmes for local debt relief using transfer payments for interest payments and redemptions or—more recently in Brandenburg and Hesse—assumptions of local debt (Stolzenberg 2018). The Federal Minister of Finance has now offered to help all remaining over-indebted municipalities (particularly in North Rhine-Westphalia, Rhineland-Palatinate and Saarland) by means from the federal budget, which then needs to be matched by state financial resources. The process of intergovernmental decision-making in this important issue is ongoing.

8 Lessons Learned

Germany experienced increases in public expenditure until the late 1970s and later again to cover the immense costs of German reunification in the 1990s and 2000s, periods when economic growth had slowed down because of the recession and the economic and financial crisis and rising social insurance contributions. The tax ratio to GDP has remained fairly

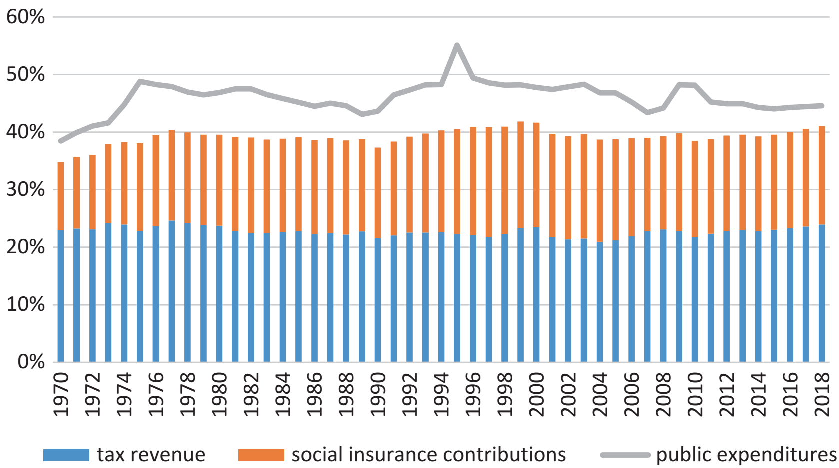

Fig. 14.3 Tax revenue, social contributions and public expenditure in relation to GDP 1970–2018. Source: Federal Statistical Office, author's own calculations and for references: Statistisches Bundesamt (Federal Statistical Office): Fachserie 14.2 - 2018, Wiesbaden 2018

stable across the economic cycles. Growth in expenditure has been slower than that of GDP in recent years, obviously as a result of the consolidation efforts to achieve the balanced budgets of the debt brake from 2020. Since 2012, the sustainable growth of GDP has helped to balance public budgets (Fig. 14.3).

However, tax revenue and social insurance contributions have grown faster than GDP since 2013 and 2017. New programmes for climate change, expensive payments for additional pensions for childcare ('mother pensions' for children born before 1992), early retirement and most recently for low income contributors, higher transfers for long-term care cases, increasing staff for police, schools and early childhood education, will enforce the recent trend of increasing rates of public spending as well as tax revenue and social insurance contributions to GDP. The gap of infrastructure investment expenditure and additional needs for the policies of climate change and new mobility concepts will set further pressure on growing public budgets (Bardt et al. 2019). Further reforms will be necessary to find legal and constitutional financial solutions. Germany faces—like many other industrialised countries—probably a turn-around of the fiscal doctrine.

Notes

1. See BVerfG, Urteil des Zweiten Senats vom 07. Mai 1998–2 BvR 1991/95-, Rn. (1–114), http://www.bverfg.de/e/rs19980507_2bvr199195.html.
2. Until 2019, the equalisation scheme included a VAT-pre-equalisation formula and horizontal transfer payments from the rich to the poor *Länder.*

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