

Fiscal federalism in Germany

by Ulrich Karpen

FEDERALISM WORLDWIDE

Federalism describes a state form according to which a state consists of several member states. The federal state and the member states have state quality. Currently there are 28 federal systems worldwide, comprising large ones, like India (1.2 bn citizens), the United States of America (280 m), and Brazil (202 m), and smaller ones such as Austria (8.5 m) and Belgium (11 m). Germany is a middle range federation with some 80 million citizens. The vertical division of powers in a federation may – historically and politically – follow one of two tendencies: centralisation and unitarisation, thus limiting the strength of the federal units (like in Germany), or decentralisation (leaving the major part of governance to the units, ie the member states of the federation, like in the US or in Switzerland). Some federations are decentralised to the extent of coming close to a confederation, a conglomerate of internationally sovereign states – what the member states of a federation are not! These subjects of international law form a loose organisation of states, a sort of an association of states. The European Union and Kurdistan in the Iraqi Federation are examples of this type.

FEDERALISM AND CONSTITUTION

A constitution can basically perform two different functions: either its objective is to limit government intervention, or it empowers government to influence society's development. The modern type of constitutional state does both: as a democratic state it guarantees human rights, namely by rule of law mechanisms, and as a social state society and government assume responsibility for the welfare of its citizens. The federalist state model as a fourth principle of government strengthens all the aforementioned principles: democracy, rule of law and social state. In contrast to a centralised, unitarian system of government a federal state establishes an additional level of participation of the people in the common agenda: government bottom-up, not top-down.

On both levels of government, federation and states, we find elections, Parliaments, referenda, opinion polls etc. A main tool of rule of law is the separation of powers. As Lord Acton wrote in 1887: "Power tends to corrupt and absolute power corrupts absolutely" (letter to Bishop Mandell Creighton, 1887, in John Emerich Edward Dalberg-Acton, Lord Acton, Historical

Essays and Studies, eds John Neville Figgis and Reginald Vere Laurence, London (Macmillan) 1907). The best solution to avoid that particular danger is a horizontal separation of powers: legislative, executive, judiciary, respectively institutionalised in Parliament, government and independent courts. A federal state adds a vertical axis of separation of powers: federal, state, provincial or regional (as in some states) and local government. In a social federation the units may enjoy their autonomy: in tradition, culture, ethnicity, language and religion. But equally important are solidarity, subsidiarity and proportionality (Arts 3 and 5, Treaty of the European Union) within the federation.

The philosophy and real legitimation of a federation consists of "unity in diversity" and "integration by solidarity". Germany's federal system in all its history since the 19th century suffered – as all federations do more or less – under the tension of unitarism and devolution. It had to strike a balance between centralization and decentralization, between cooperation and competition. Basically, it is the suspension of equity and diversity, social federal state and statehood of its autonomous units (Arts 20 and 30 of the German Constitution in the Basic Law of 1949). The German federation has never been "ready", nor will it be. The ridge of balance between centre and units may be described as leading to homogeneity, cooperative federalism and comity. Citizens don't tolerate too many social and economic differences in living conditions in their respective places of residence.

In Germany, besides the gathering of most legislative powers at the centre (over time a unifying element of federalism), there are joint tasks and there is a lot of coordinated activity among the *Länder*. The *Bund* and the *Länder* have preferred bargaining over litigation as the usual method of settling their differences (see Ulrich Karpen, "Federalism", in idem (ed), *The Constitution of the Federal Republic of Germany, Essays on the Basic Rights and Principles of the Basic Law with a Translation of the Basic Law, Baden-Baden (Nomos) 1988*; pp 205-21; idem, "Application of the Basic Law", in Christian Stark (ed), *Main Principles of German Basic Law*, pp 55-88 (71)).

Decisions of the Federal Constitutional Court are, however, important benchmarks in the constitutional life of the country. Cooperation is enhanced by the fact of the ability of the Federal Council, the Second Chamber (*Bundesrat, Länder-Chamber*), to

block federal legislation, a fact which often leads to a deadlock of politics. The concern for balance and practicability induced the court to proclaim the doctrine of “federal comity” or “pro-federal behaviour” (*Bundestreue*), which obliges the *Bund* and the *Länder* to consider each other’s interests in exercising their authority (see Donald P Kommers and Russel A Miller, *The Constitutional Jurisprudence of the Federal Republic of Germany*, 3rd ed, Durham (Duke University Press) 2012, p. 94). It is an unwritten principle inferred by the court from the various structures and relationships created by the Constitution. Each side has a constitutional duty to “keep faith” with – and respect – the rightful prerogatives of the other.

FEDERAL FINANCIAL CONSTITUTION

As has been explained above, federalism as a devolution of powers competes with the centralizing tendencies of the social state principle. Accordingly, the German Constitution’s apportionment and distribution of public funds is a combustible mix of state autonomy, often contentious social welfare policy and competing claims to tax revenue. The financial constitution is 10 pages thick, with 16 Articles (ch X of the Constitution, Arts 104a-115). It is certainly the most complicated part of the Constitution, and has been amended again and again. The old saying proves to be true: “If the purse is at stake, kindness and cosiness come to an end.”

The Financial Constitution covers the collection, apportionment and distribution of all financial resources, namely revenue, customs, monopolies and debts, furthermore transfers and financial assistance from the *Bund* to the *Länder* for particularly important investments (Art 105b, and see Matthias Reimann and Joachim Zekoll, *Introduction to German Law*, Munich (Beck) 2005, p 61). Budgetary matters and financial planning are also part of the Constitution. For purposes of brevity, the focus of this paper is on revenue distribution and the equalization between the different *Länder* (as the typical fiscal instruments of German federalism). Articles 104a through 115 of the Basic Law thrust the *Bund* and the *Länder* into an intricate web of inter-governmental relations in the area of public finance and fiscal policy. Both have the right to legislate and to collect taxes in their respective areas, as prescribed by the Constitution: revenues and expenditures of local government shall be deemed to be revenues and expenditures of the *Länder*. *Bund* and *Länder* are, however, not entitled to dispose freely of the revenue as collected.

The Constitution provides for the distribution, both vertically (from *Bund* to *Länder*) and horizontally (among the *Länder*), in a complex multi-stage system, known as financial equalization. The first step is a vertical equalization (Art 106). The revenue of the most important taxes – income tax, corporation tax, the tax on consumption (turnover or “value added tax”) – accrues jointly to the *Bund* and the *Länder* (joint taxes). Both sides share

the income and corporation tax revenue equally. The revenue of the most productive tax – the value added tax – is shared by both sides in a fixed proportion according to a formula which is regulated by Federal Law with the consent of the Second Chamber, the *Länder*-Chamber. The main purpose of this law is to ensure equivalent living standards throughout the federal territory.

Article 107 provides for the horizontal level (or second stage) of the equalization process. On this plane, population and production generally determine how tax revenue is to be distributed among the *Länder* and local governments. For example, the *Länder* share of the value added tax is distributed on a per capita-basis. But Federal Law enacted with the Second Chamber’s consent may require the redistribution of as much as one quarter of the *Länder* share of the value added tax to those *Länder* with per capita revenue below the average of all *Länder* combined. Horizontal equalization is aimed at “ensur(ing) a reasonable equalization of the disparate financial capacities of the *Länder*” (Art 107, para 2) A law may, in addition, provide for grants to be made by the *Bund* to financially weak *Länder* from its own funds, in order to assist them in meeting their general financial needs (supplementary grants).

Germany has two forms of transfers. Firstly, there is general transfer according to size, number of inhabitants and economic power. The range varies from just 1 million inhabitants (Saarland) to 17 million (North-Rhine Westphalia). Secondly, there are selective and ear-marked transfers according to the recipient’s financial capacities and to the recipient’s governance performance. In view of the budgetary autonomy of the *Länder* it could well happen that a *Land* more socially and distributive-minded – and less effective in governance (like the Capital-City-State of Berlin) – receives subsidies from more prosperous *Länder* like Bavaria, Baden-Wuerttemberg and Hesse on a regular basis.

DOES GERMANY NEED FISCAL REFORM?

Not everybody agrees with this approach of striving for more similarity and cooperation of the *Länder* in the German Federation. Does that go too far? The system of vertical and horizontal equalization was meant to advance Germany’s post-war commitments to equivalent living conditions. It rejects the idea of federalism as competition (see Ulrich Karpen, “German Federalism in Need of Constitutional Amendments”, in Ralf Thomas Baus, Raoul Blindenbacher, Ulrich Karpen (eds), *Competition versus Cooperation: German Federalism in Need of Reform – A Comparative Perspective*, Baden-Baden (Nomos) 2007, pp 55-62). The Constitution rather believes – at least economically – in the homogeneity of the whole country. Unsurprisingly, the constitutional provisions that regulate taxation and budgetary matters have been the subject of more amendments than any other part of the constitution, including the amendments of

2006 and 2009. The former streamlined the system of fiscal relations between different levels of government by cutting back on the powers of the *Länder* Chamber and by drawing brighter lines of authority between the *Bund* and the *Länder*. The regulations on joint tasks of *Bund* and *Länder* – eg higher education and research – were amended to the detriment of the *Bund*. The maintenance of fiscal discipline was strengthened for the *Bund* and the *Länder*. The budgets of both (altogether amounting to around 1,100 bn US\$) shall, in principle, be balanced with revenue from credits. Credit financing shall not exceed 0.35 per cent of the GNP (which in 2012 amounted to 3,500 bn US\$). A so-called “Stability Council” provides early warnings of the danger of exceeding this limit. A third amendment with a fiscal focus is expected in the course of the current legislature, rendering equalization less detail-friendly.

AND FINALLY...

In a case on Geriatric Nursing (Federal Constitutional Court, *Geriatric Nursing Act case* (2002), OffColl of decisions, vol 100, p 62) the Federal Constitutional Court signalled

its sympathy for a more defined role of the *Länder* in the governance of Germany, a position seemingly in line with the political will in the country at the beginning of the new millennium, at least as reflected in the changes brought about by the 2006 federalism reform. The court in all federation decisions did not hold back from intervening to arbitrate on the Basic Law’s scheme of federal/state relations. As a member of the European Union family, Germany, by comparison, learned more about competition. Federalism is more of a task than a result. As Judge Oliver Wendell Homes from the US Supreme Court wrote: “The Life of the Law has not been logic; it has been experience” (The Common Law, 1881, p 1).

- The author’s paper on the Financial Constitution of Germany will be published shortly in the *European Review of Public Law*.

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