



Bundesministerium  
der Finanzen

# **The Federal Financial Equalisation System in Germany**

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The Federal Republic of Germany is a federal state comprising the Federation and 16 federal states, the so-called Länder. In the structure of the German state, the Länder represent an independent level of government endowed with its own rights and obligations. According to the constitutional rules on public finance, the local authorities are deemed to be part of the Länder. In order for the Länder, as independent constituent states, to fulfil the tasks allotted to them under the Constitution (which is called the Grundgesetz or Basic Law in Germany), they need adequate financial resources. The Länder must also have free and independent control over these resources. Aligning the revenue of the Länder is intended to create and maintain equal living conditions for the entire population in all of Germany.

Germany's constitution guarantees that the Federation and Länder receive appropriate levels of funding. The procedural regulations in this regard can be divided into four phases:

1. First, the entire tax revenue is distributed to the two levels of government – namely the Federation and all the Länder – and the local authorities receive a supplementary grant of revenue (vertical distribution).
2. Next, the total Länder portion of tax revenue is assigned among the various Länder (horizontal distribution).
3. In a third stage, there is equalisation between poor Länder and rich Länder (financial equalisation among the Länder).
4. In addition, poor Länder also receive funds from the Federation (supplementary federal grants).

The details of the individual stages are regulated by ordinary law.

## **Stage 1: Vertical distribution of tax revenue**

The Constitution jointly allocates several particularly important taxes to the Federation, Länder and, to a degree, the local authorities. According to the Constitution, either the Federation, the Länder or the local authorities are entitled to the remaining types of tax in full.

Income tax, corporation tax and VAT are divided between the Federation and the Länder as a whole. The local authorities are entitled to a share of the income tax and VAT. These taxes are therefore referred to as joint taxes. The Federation receives 42.5 % of the income tax, 50 % of the corporation tax and 2018 around 49.6 % of VAT. The revenue accruing to the

Länder is 42.5 % of the income tax, 50 % of the corporation tax and 2018 47.2 % of VAT. 15 % of the income tax and, in 2018, well over 3.2 % of VAT go to the local authorities.

Of all the types of tax, income tax and VAT generate by far the most revenue.

The Federation receives all of the revenue from the federal taxes. The majority of the excise duties (such as energy duty and tobacco duty) as well as the insurance tax are federal taxes. The Länder are entitled to receive all of the revenue from Länder taxes. These include the inheritance tax, most types of transactions taxes (in particular, the real property transfer tax) as well as some other types of taxes that generate small amounts of revenue. The local authorities receive the revenue from the trade tax, the real property tax as well as the local excise taxes. The Federation and the Länder receive a share of the trade tax receipts through an apportionment.

## **Stage 2: Horizontal distribution of tax revenue**

At the second stage, the tax revenue belonging to the Länder as a whole is distributed among the individual Länder. Apart from VAT, the individual Länder are entitled, in principle, to the tax revenue which is collected by the revenue authorities on their territory (principle of local revenue).

In the case of income tax and corporation tax, the principle of local revenue is corrected by special regulations, or what is referred to as allotment. With regard to income tax, this means that in the end every Land receives approximately the tax revenues that are collected for the income of its inhabitants inside or outside of its territory. Companies pay corporation tax centrally. In line with the principle of allotment, this tax is distributed to all states in which a company maintains a place of business.

VAT is not distributed according to the principle of local revenue. Up to 25 % of the Länder share of VAT goes as a supplementary portion to the Länder. They are meant for those Länder, whose receipts from the income tax, the corporation tax and the Land taxes per capita are lower than the per capita average of all the Länder. This partially closes the gap between the tax revenue of the fiscally weak Länder and the Länder average. The exact amount of the VAT supplementary portions depends on the amount by which the per capita tax revenue of a Land falls below the average per capita tax receipts for all Länder. A linear-progressive topping-up schedule is used to calculate the exact amount of the VAT supplementary portions. The remainder of the Länder share of VAT, at least 75 %, is distributed according to the number of inhabitants among all Länder. The distribution of VAT thus already has an equalising effect.

### **Stage 3: Financial equalisation among the Länder**

In the system of financial equalisation among the Länder, poor Länder receive adjustment payments which are funded by the wealthy states. In the interest of the fiscal autonomy and sovereignty of the Länder, the differences in receipts among the Länder are only partially reduced by the financial equalisation.

The starting point for the financial equalisation among the Länder is the financial capacity per inhabitant of the various Länder. The financial capacity of a Land is the sum of its receipts and (64 %) of the sum of receipts of its local authorities.

The local authority revenues are taken into account when assessing financial capacity because the Länder are responsible for providing their local authorities with appropriate and adequate financial resources. Länder with financially strong local authorities are required to spend less of their own finances on the financial resources of their local authorities than Länder with financially weak local authorities.

In principle, all types of Länder and local authority revenue are taken into account when determining the financial capacity, but in fact, basically the tax revenue is regarded as relevant for the equalisation scheme: The Länder share of joint taxes, the tax revenues of the Länder and partially the tax revenues of local authorities are taken into consideration for the financial equalisation among the Länder.

In principle, the system of financial equalisation among the Länder assumes that the financial requirement per inhabitant is the same in all the Länder. This assumption is not appropriate in the case of the Länder of Berlin, Bremen and Hamburg, which are city-states. The city-states are simultaneously both local authorities and Länder in their own right. They have a much higher financial requirement per inhabitant than the normal Länder. Therefore, for the purposes of the equalisation system, their populations are notionally increased by 35 %. The three sparsely populated Länder of Brandenburg, Mecklenburg-Western Pomerania and Saxony-Anhalt also have a slightly higher financial requirement per inhabitant. Their populations are therefore slightly notionally increased for the purposes of the financial equalisation.

The exact size of the adjustment payments to a poor, fiscally weak Land depends on the amount by which its financial capacity per (fictitious) inhabitant falls below the average financial capacity per inhabitant. A linear-progressive topping-up schedule is used to calculate by how much the difference from the average is partially topped-up.

Similarly, the size of the adjustment amounts which a rich, fiscally strong Land has to pay depends on the amount by which its per capita financial capacity exceeds the average fiscal capacity per inhabitant. The difference from the average is skimmed-off partially. A linear-progressive skimming-off schedule is used, which is symmetrical to the topping-up schedule. To ensure the sum of the adjustment amounts correspond with the sum of the adjustment payments, the adjustment amounts are either increased or decreased by a corresponding percentage.

The regulations are designed to ensure that the order of the Länder, in terms of financial capacity per inhabitant, does not change as a result of the financial equalisation among the Länder.

The system of financial equalisation among the Länder further reduces the differences in the levels of their financial resources. Take the example of a fiscally weak Land with a financial capacity per capita that is 70 % or 90 % of the average before financial equalisation. Once the financial equalisation system has been applied, this increases to 91 % or 96 % of the average. On the other hand, a fiscally strong Land with 110 % or 120 % of the average financial capacity per inhabitant before equalisation, has between 104 % and 106½ % per cent afterwards (see also Table).

#### **Stage 4: Supplementary federal grants**

Supplementary federal grants are grants which the federal government makes to poor Länder to complement financial equalisation among the Länder. These grants are uncommitted funds and serve to meet general financial requirements. There are two different kinds: general supplementary federal grants and supplementary federal grants for special needs.

General supplementary federal grants further reduce the gap between the average financial capacity per (fictitious) inhabitant and that of poor Länder which still remains after financial equalisation among the Länder. General supplementary federal grants go to Länder whose financial capacity per inhabitant, after financial equalisation among the Länder, is less than 99.5 % of average financial capacity per inhabitant. The shortfall is made up proportionally by 77.5 %.

This means that a financially weak Land, whose financial capacity per inhabitant stands at 70 % or 90 % of the average before financial equalisation among the Länder, has 97½ % or 98½ % of the average per capita financial capacity once the equalisation and general supplementary federal grants have been applied (see also Table). The difference from the average for the Länder is therefore considerably and clearly reduced overall.

Financial capacity per inhabitant <u>before</u> financial equalisation among the Länder as a % of the average financial capacity per inhabitant	Financial capacity per inhabitant <u>after</u> financial equalisation among the Länder as a % of the average financial capacity per inhabitant <sup>1</sup>	Financial capacity per inhabitant <u>after</u> financial equalisation among the Länder and the general supplementary federal grants as a % of the average financial capacity per inhabitant
70	91	97½
80	93½	98
90	96	98½
100	100	
110	104	
120	106½	
130	109	

Table: Equalisation of the differences in financial capacity by applying the system of financial equalisation among the Länder and the general supplementary federal grants

Supplementary federal grants for special needs serve to compensate individual poor Länder for special burdens they have to bear.

The special burdens merely provide the basis and reasons for granting supplementary federal grants for special needs. The funds are not legally tied to a specific purpose. The Länder receiving such federal grants for special needs bear sole responsibility for their use. The exact amount of supplementary federal grants for special needs is listed in the Law on Financial Equalisation (Finanzausgleichsgesetz) and is thus not related to the financial capacity of the receiving Länder.

Until 2019, the eastern German Länder and Berlin receive in accordance with the Solidarity Pact II (Solidarpakt II) special-need supplementary federal grants amounting to around €105 billion. The grants are meant to build up the infrastructure, which is still comparatively underdeveloped as a result of the partitioning of Germany, and to compensate for the disproportionately weak financial capacity of local authorities. The funds will gradually be phased out by 2019 and in 2018 amount to a total of €2.8 billion. They are therefore extremely important to the Länder that receive them.

In addition, the eastern German Länder receive special-need supplementary federal grants, in 2018 worth a total €504 million, to compensate for the special burdens placed on them by structural unemployment and the resulting disproportionately high burdens caused by the combination of the former unemployment assistance (Arbeitslosenhilfe) and social assistance (Sozialhilfe).

<sup>1</sup> Numbers for the rich states (financial capacity > 100%) neglect the (above mentioned) factor ensuring the correspondence of the adjustment payments with the adjustment amounts.

Furthermore, small, poor Länder receive special-need supplementary grants, amounting to around €517 million annually, to make up for their above-average administrative costs. Smaller Länder have higher administrative costs per inhabitant than larger Länder. This is because the fixed costs of administration in smaller Länder have to be divided between a smaller number of inhabitants. A review is held every five years to establish whether the preconditions for awarding these supplementary federal grants for special needs still exist.