Focus on Germany

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DISTRIBUTION OF TAXES BY REGIONAL AUTHORITIES

Germany has very strong and independent local authorities. This high degree of local autonomy has as a prerequisite that the local authorities have at their disposal a financial base of their own that makes them as independent as possible from higher levels of territorial administration and governance. The consequence of this is a highly complex tax system which does guarantee that local councils as well as regional governments have a sufficient income base to pursue their policies. This paper describes the basic features of this tax system.

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Introduction

The tax and finance system of the Federal Republic of Germany is extremely complex. There are a multitude of financial connections between Federation, Federal States and local authorities which pay tribute to the interconnections between the various layers of governance that exist in a Federal state with strong regional and local authorities.[1]

The national government (the "Federation"), the Regions and local authorities each collect their own taxes. Yet, three of the most important taxes – in total over 70% of the tax revenue – are regarded as so called community taxes: they are divided between the national government, Federal States and local authorities.

Once the authorities have collected the taxes to which they are entitled, subsequent redistributions take place between the various levels. The relevant instruments for this are the "**financial equalization mechanisms**" operating between the Federal States and between the municipalities (see below) as well as levies. Therefore the tax system and the financial equalization system must be looked at as one system.

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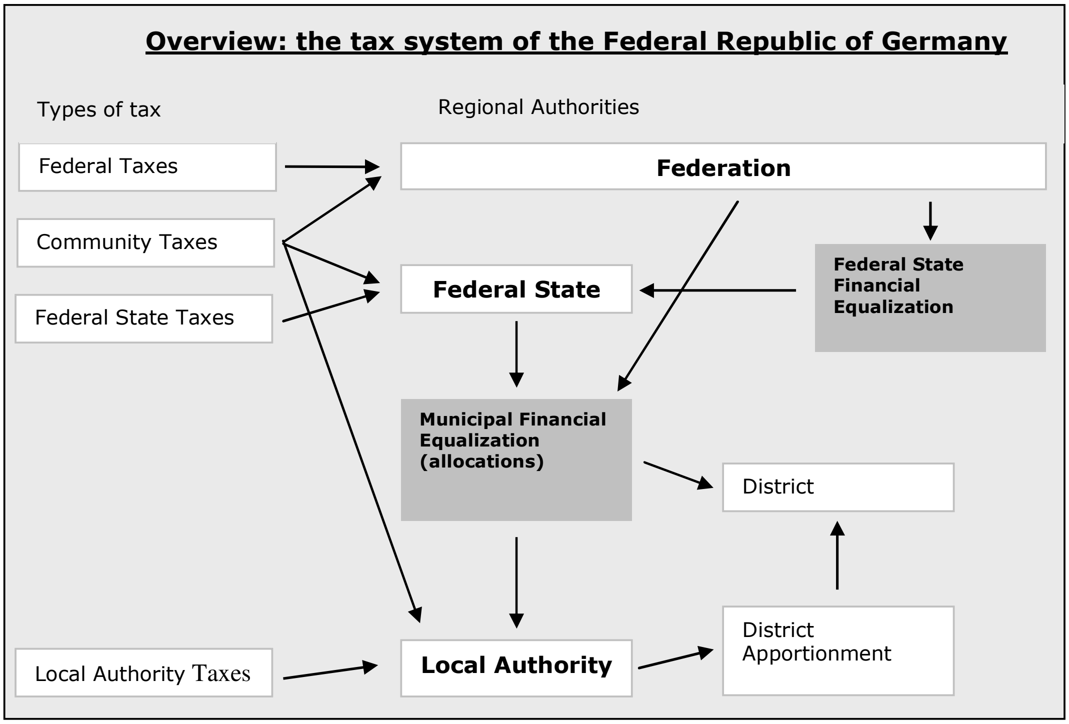
This diagram shows a simplified overview of this system:



Division of the tax revenue

1. General

The German Constitution defines the responsible level of government for the fulfilling of state functions and makes the responsible administration carrying the costs. This distribution of the financial burden presumes that the responsible authority has command over its own earnings. This legal requirement implies that the tax revenue is divided between Federation, Federal States and local authorities according to the distribution of duties and functions. The distribution of the financial resources must align with the duties (and not the other way around).

2. The Mixed System

Tax revenues in Germany are distributed among the various layers of government according to a “Mixed System”.[2] This mixed system respects the sovereignty of Federation and Federal States and the own responsibility of the municipalities. At the same time it allows for a flexible distribution of the tax revenue: The allocation of the financial resources must accord with the distribution of the responsibilities. In this system certain taxes go into a common pot (revenue sharing system) and are then divided between the regional authorities whereas other taxes are immediately allocated to the responsible authority.

The tax revenue to be divided according to the revenue sharing system is also designated as *“community taxes”;* their portion amounts to more than two thirds of all tax revenue. The remaining yield is allocated to the Federation, the Federal States and the municipalities as own tax source.

3. Community Taxes

Income tax (which includes salary/wage tax), turnover tax (=VAT) and corporation income tax are community taxes, i.e. are to be redistributed between the various layers of government. Local authorities receive 15% of the yield of salary and wage tax. The remaining yield from the salary and wage tax as well as the income tax and the corporation income tax are divided equally in half between Federation and Federal

States. The local authorities are entitled to 2.3% of the turnover tax; the remaining turnover tax revenue is divided between Federation and Federal States.

Via the **communal financial equalization** (KFA), the local authorities participate additionally in the community taxes. More precisely, they participate in the quota of the Federal States in these taxes, as about 20% of these revenues enter into the mechanism of communal financial equalization and, via this route, benefit the local authorities.

4. Local Authority Taxes

True Local Authority Taxes are the **trade tax** and the **land tax**, from which, however, a portion of the trade tax must be handed over to the Federation and Federal States. Further, the local authorities can levy duties such as the dog tax and (in so far as there is no hindrance from the State legislation) other “local excise duties and luxury taxes” such as **hunting, fishing, drinks, second home taxes** etc.

5. Federal State Taxes

Absolute State taxes are **motor vehicle tax, inheritance tax, beer tax** and **gaming tax**. The motor vehicle tax plays a special role in so far as most of the Federal States’ local authorities have a share in the yield via the communal financial equalization. The basis for this is the fact that the local authorities provide a significant portion of the transport financing (building of streets, public transport system as well as continuing costs of the transport system, for instance in the protection of the environment). The Federation receives the **customs duties** as well as specific **excise duties**, of which the most important is, by a significant degree, the **mineral oil tax**, followed by the **tobacco tax**. **The movement of capital and insurance taxes** as well as some **other taxes** are of lesser importance. The customs duties and the EU duties are paid over to the EU.

Financial Equalization

1. General

Since the division of taxes is predominantly carried out according to the local yield, a gradation in so called poorer and richer Federal States occurs. The mechanism that implements the equalization between these States is called **state financial equalization** (LFA). It is based on the average income of all regions (Federal States). As a consequence of this fact, the poorer Federal States receive equalization allocations from the richer Federal States.

The equalization process must move towards a harmonization, without however completely levelling the differences. The financial equalization scheme among the Federal Government and the Federal States guarantees that the financially weaker Federal States receive the financial requirements for their autonomy and prevents them coming in a position where they are dependant upon financially stronger Federal States or on the Federation. At the same time, because of the autonomy of the Federal States and the basic financial responsibility which they have, it must be assured that the financial equalization does not undermine the will to help oneself and to achieve better economic performance in the future.

This can, however, only be achieved if existing variations in the financial strength are simply brought more into line, but not completely levelled out. A modern welfare state that wants to offer all it’s citizens similar standard of living, cannot permit that the extent and quality of the public services in the various parts of the country show excessive differences. The financial equalization scheme must create the financial prerequisites so that in all parts of the Federal Republic public services are delivered to an approximately similar level of support. The financial equalization scheme cannot, with this, correct the causes of the differences in the economic performance between the regions; it can only look at and try to address the symptoms. Therefore it must be supplemented by regional development and investment schemes.

2. The Implementation of the Regional Equalization Scheme

As per Article 107 paragraph 2 of the Federal Constitution, it must be ensured by law that the different financial strengths of the Federal States or regions should be adjusted "appropriately". This is to ensure that a similar tax yield shall be attained in all the Federal States per head of population, and therewith a similar offer of public services can be provided. This should lead to the attainment of "uniformity of the standard of living" within the Federal Republic of Germany.

3. Communal Financial Equalization

The local authorities make no reciprocal financial equalization payments. Therefore, the **communal financial equalization** is purely vertical. Firstly, in the communal equalization a share of the income collected by the Federal States is diverted towards this equalization. The portion of both the local authorities and the associations of local government in these revenues is determined by the individual regions in their respective **financial equalization laws**. In several of the Federal States, also the revenues from the Regional Equalization Scheme, the communal financial equalization tax and other State taxes are included in the financial equalization between the local authorities on a pro rata basis. In fact, in some of the Federal States a portion of the Federal State revenue from the trade tax turnover, is actually diverted back to the local authorities via the communal financial equalization.

The Federation also makes provision for isolated payments to the local authorities in the form of purpose-orientated allocations, for instance, within the framework of the Local Authority Traffic Financing Act, the Town and Country Planning Act etc. These payments too, in the wider sense, can be included in the accounting of the communal equalization.

Conclusion

The complex system which has been described here has developed through a long historical process.
It describes a finely balanced network, not only financially but also politically.
The statement often heard, that the tax system of the Federal Republic of Germany is the most complex in the world, is undoubtedly valid not only from the point of view of those liable to pay taxes, but equally for the regional authorities.

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[1] The division of the taxes as also the revenue equalization is regulated as per **Articles 106 and 107 of the Constitution of the Federal Republic of Germany** (GG), and furthermore in the individual tax and **financial equalization laws** of the Federation and the Federal States.

[2] There are two other possibilities for the distribution of tax revenues:

The Divided System, which allocates to each regional authority particular taxes as own sources of revenue. From the point of view of self government the separate system provides an optimal solution for public finances, as the tax creditors are, to a large extent, independent of each other. The disadvantages are in the inability to adapt or adjust, if the weighting of the areas of responsibility among the regional authorities and therewith their financial requirements, change and when the tax revenues develop differently. This system also makes a standard short term economic and financial policy more difficult to achieve.

The joint system, where all tax revenues are consolidated centrally, into a uniform financial amount and then distributed pro rata to the individual regional authorities. The advantage of this system lies in the fact that it offers a greater flexibility for the division of tax revenue when there are variations in the importance of the functions, as basically only the final distribution has to be altered numerically. Further this system avoids different source of revenue developments between the participants as a result of diverging growth of individual taxes. A considerable disadvantage is created by the question of an equitable division among the individual regional authorities and the "anonymity" of these "tax shares".