1. Some remarks on Germany as a federation

German federalism has for many years been the model for an efficiently functioning federal system. It has been contended that the German model in particular could supply a blueprint for the further integration of Europe.

First of all, it is surely correct to say that Europe can continue to grow together and to develop its own identity only in the form of a decidedly federal, decentralised system. Given the very significant economic and political as well as cultural and social differences, any centralising approach is doomed to failure from the outset. Quite apart from the no doubt urgent need to strengthen European parliamentary institutions, there is already probably too much centralism in Europe rather than too little. The task of achieving "unity in diversity" is already confronting us and will become even more pressing in the course of enlargement.

To be able to judge whether Germany, and in particular the German tax system, can in fact supply a model for further European integration and for a unified Europe in the long term one must take a closer look at the advantages and the drawbacks of the German system.

Germany has a short history. A unitary state existed only for some years in the middle ages, at a time when parts of today’s Germany and France made up one national territory. Certainly a high point of Charlemagne’s empire. After that, history diverges. Whilst a number of strong, centralised states emerged in Europe, the fragmentation of the German part of the Carolingian “empire” was a comparatively speedy process. For centuries thereafter the German language area incorporated a multitude of small medium and (later) large independent states which were forced to cooperate in one way or another – whenever they were not fighting one another.

To this extent the German-speaking area has a long and distinct tradition of federalism. We should not forget that it was only in the late 19th century that Germany was forged into a nation-state in a long and complicated process, albeit in the form of a confederation retaining the federal tradition.

Up to the first World War the principal emphasis was on the constituent states, but for the first time in centuries the post-war Weimar Republic was weighted slightly in favour of the central state, though of course retaining the basic federal concept and the sovereignty of the constituent federal states (the “Länder”).

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But this was only a brief intermezzo. After the few years of centralised, National Socialist domination, the historical German tradition of a federation and subsequently of a federal state was again taken up. The Allies were instrumental after 1945 in ensuring that Germany returned to a federal regime. This affords both the Federation and the Länder their own broad areas of responsibility. But despite having some fundamental powers in the field of economic and fiscal policy, the Federation is both in law and in fact politically dependent upon the Länder level. A strong Federation – a strong central level – was not the intention of the Allies: what they wanted was a Federation whose powers were curtailed.

In this respect, Germany today differs quite substantially from, say, Austria, which in principle has the same federal structure but where central government has in fact considerably greater powers. Hence Germany is more readily comparable to Switzerland.

From this starting point a second very crucial, typically German federal feature: A dense and complex network of coordination mechanisms which evolved over time. Separate attention must be given to the local level in this respect.

2. The federal financial (tax) system in Germany

By stipulating that “The Federal Republic of Germany shall be a democratic and social federal state” (Article 20 paragraph 1 of the Basic Law – GG –) the constitution establishes federalism as a structural and regulatory principle.

Article 79 paragraph 3 GG declares the principle of federalism to be inviolable and unamendable. This clause “for all time” is unique among modern democratic constitutions.

There are four main aspects to the inviolability of the federal order:

(a) Permanent division into Federation and Länder

The constitution prohibits the abolition of the Länder as such. But it does not protect the existing Länder in their specific configuration. Länder borders may be altered and existing Länder subsumed into or combined with others.

(b) State character of the Länder

The Länder are not merely large, self-governing entities in the same way as local authorities and administrative districts but have the character of states, which may be seen, for instance, from the fact that each has its own constitution. The constitutions of the Länder are distinct from and independent of the Basic Law. In the narrower sense, state character implies that whilst the sovereign powers of the Länder are limited, they do not derive from the Federation. Neither of the two levels of government in the federal state may circumscribe the powers of the other level.
(c) **Financial independence**

The Länder must have some degree of financial independence to enable them to pursue their own policies. Hence they are vested with their own powers of taxation. They are empowered to create and levy taxes, to administer the revenue thus raised and to decide how it is to be used. Conversely, the federal state must also have at its disposal financial resources sufficient to ensure its political independence from the constituent states.

(d) **Participation in legislation**

The constitution gives the Länder in principle a guaranteed right to participate in legislation. This means firstly that the Länder have their own legislative powers. Secondly, it means that the Länder must be allowed to participate in the legislative process at federal level.

The Federal Republic of Germany is a two-tier federal state comprising the Federation and the Länder. Hence the communes do not form a third tier of the state, but are part of the Länder. Yet towns, local authorities and administrative districts (in the following collectively referred to as the communes) play a prominent role within the administrative structure. Their prominent position is based on the right of communal self-government set out in Article 28 paragraph 2 GG.

In a federal regime, both the federal state and the constituent states including the communes must have a financial endowment and some degree of scope for taking action on the strength of that endowment.

There are four principal issues to which the constitutional rules on public finances in Germany apply:

(a) **Which level of government must finance which functions?**

In a federal regime, as in other regimes, the responsibility for a governmental function and the responsibility for financing that function must lie in one hand. The political subdivision to which the constitution assigns the performance of a function must dispose of the necessary resources for doing so (principle of coherence).

Neither the Federation nor the Länder may finance projects that do not fall within their sphere of administrative responsibility. This also implies that neither level in the federal state may impose the financing of its tasks on the other level. So there is in principle a clear cut diversification of tasks assigned to the different levels of government, but there also is a grey zone, partly nebulous, serving as a flexible political instrument on the spot, partly institutionalised in the so-called “Gemeinschaftsaufgaben” (“joint tasks”) or other rules of the fiscal part of the constitution.

Nevertheless there is a principle in Germany: The Länder are autonomous in drawing up and managing their budgets and are answerable only to their parliaments.
It is clear from this that the Federation has no right whatsoever to intervene in subnational budgets. But the budgets of the Länder account for about 50 per cent of public spending by political subdivisions and are thus a highly relevant factor with reference to the Maastricht criteria.

(b) Who passes which tax laws – the federal state or the constituent states?

Tax law is in fact largely federal law. The powers to pass tax laws are assigned as follows:

- The Federation has exclusive power to legislate only on customs duties and fiscal monopolies (Article 105 paragraph 1 GG, Customs Law, Customs Tariff Law, General Customs Regulations, Federal Spirits Monopoly). This ceased to have political relevance with the creation of the EU single market.
- The Federation has concurrent power to legislate on all other taxes (Article 105 paragraph 2 GG) where the revenue from those taxes accrues to it wholly or in part or where the conditions provided for in Article 72 paragraph 2 GG apply. This last provision is of major political and legal significance, as the proviso in Article 72 paragraph 2 GG that “the creation of equal living conditions throughout the country or the maintenance of legal and economic unity makes federal legislation necessary in the national interest” generally applies.
- Consequently, the Länder have scarcely any exclusive powers to legislate on taxes. They have power to legislate on local excise taxes as long and insofar as these are not identical with taxes imposed by federal legislation (Article 105 paragraph 2a GG). The first sentence of Article 106 paragraph 6 stipulates that the revenue from these taxes accrues to the communes.

Hence the constitutional rules on public finance give the Länder and communes in principle the right to create taxes, thus vesting them with fiscal sovereignty. In fact, however, they have only a few taxes of their own which bring in any revenue, such as beverage tax, entertainment tax, dog tax, hunting and fishing tax, secondary homes tax and packaging tax.

Some Länder have already dispensed with a part of these taxes because the revenue is out of proportion to the administrative effort. In such case they may assign to the communes to power to collect, say, dog tax under communal by-laws.

- But the first impression is often mistaken. The Länder are by no means excluded from fiscal sovereignty. Article 105 paragraph 3 guarantees them the right to participate through the Bundesrat, the chamber of parliament in which they are represented. Federal legislation on taxes whose revenue accrues wholly or in part to the Länder or communes requires the consent of the Bundesrat. In this way the Länder are able through a majority veto to influence tax legislation in their favour. And this veto is an absolute veto!

This is why almost any tax law amendment can turn into a trial of strength, as the revenue from the most important taxes (VAT, personal and corporate income...
An EU Inter- and Intranational Tax Regime: Some Lessons from the German Federalist Experience

There must be consensus or the law cannot be passed. There are complex mediation structures but whenever there is a conflict the need for consensus means that any tax law will be watered down from a fiscal policy point of view or it will be extremely costly for federal government to “buy” some Länder for the majority, especially when the political colour of the majority differs between both houses, which is often the case in Germany, as it is at present.

(c) **How is total state revenue divided up between the different levels?**

The allocation of revenue determines both the financial and the economic and fiscal policy scope available to the federal state and the constituent states as well as their interaction on fiscal policy.

One may envisage in principle separate or combined revenue allocation systems, with separate allocation systems generally affording a greater degree of autonomy and/or greater incentive to secure an adequate amount of tax revenue. Post-war Germany initially had a clearly defined separate allocation system, although this soon came to incorporate a growing number of elements of combined allocation. Hence the degree of autonomy of each level has appreciably declined, especially with regard to revenue.

The public finance reform in Germany in 1969 created a composite system of separate and combined revenue allocation with the aim of maximising the benefits and minimising the drawbacks of both systems.

Both the Federation and the Länder and communes now have a very small degree of fiscal autonomy. The share of revenue from joint taxes (in particular income tax, corporation tax and VAT) in total tax receipts amounted to about 75 per cent in 2002. About 20 per cent of tax revenue came from taxes accruing solely to the Federation (in particular mineral oil duty, tobacco duty, insurance tax, electricity duty, solidarity surcharge). Thus the fiscal autonomy of the Federation is still appreciably greater than that of the Länder and communes, which still receive almost half of total tax revenue (after supplementary federal grants and horizontal financial equalisation), though only about one tenth of this is attributable to taxes imposed by the Länder and the communes (specifically inheritance tax, real property transfer tax, motor vehicle tax and the gaming casinos levy as Länder taxes and trade tax and real property tax as communal taxes).

The shares of income tax and corporation tax revenue assigned to the Federation and the Länder are set out in the Basic Law. Federation and Länder each receive 42.5 per cent in income tax receipts and 50 per cent of corporation tax receipts. The horizontal distribution of tax revenue among the Länder is governed by the local revenue principle, with distortions being corrected by “reallocation”.

tax) accrues both to the Federation and the Länder and in part to the communes as well.

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The shares in VAT revenue are regulated by a federal statute which, however, requires the consent of the Bundesrat. to this extent, VAT is the most flexible instrument in the distribution of tax revenue. In 2002 the Federation received 51.4 per cent of VAT revenue with 46.5 per cent assigned to the Länder. In accordance with Article 107 of the Basic Law, at least 75 per cent of the Länder share in VAT revenue is apportioned on a per capita basis while not more than 25 per cent is apportioned as so-called supplementary shares to Länder with less than average revenue raising capacity (i.e. tax revenue of less than 92 per cent of the average of all Länder). The supplementary shares result in replenishment up to 92 per cent of the Länder average, so that the distribution of VAT revenue has financial equalisation effects by levelling out to some degree the differences in financial capacity between the Länder.

With regard to the apportionment of VAT revenue, Article 106 of the Basic Law stipulates that the Federation and the Länder shall have an equal claim to funds from current revenue to finance their necessary expenditure. Accordingly, the respective shares in VAT revenue are to be reapportioned whenever the ratio of revenue to expenditure differs substantially as between the Federation and the Länder, thus avoiding financial imbalances between the levels. In theory, this sounds simple and plausible, but in federal practice it is frequently the cause of differences of opinion between Federation and Länder, as the constitutional ruling leaves plenty of room for interpretation, especially in the definition of what constitutes necessary expenditure.

The powers of the communes to impose and collect taxes are not inherent but are assigned to them under the legislation of the Länder. They collect local taxes under their by-laws. However, the revenue from these taxes is not of great significance, amounting as it does to less than 5 per cent of the aggregate revenue accruing to local authorities. The communes and associations of communes are given a percentage of the share taken by the Länder of the total revenue from joint taxes. This percentage is set by Länder legislation. The communes also receive 15 per cent of the revenue from income and corporation tax and 2.2 per cent of VAT revenue for the whole of Germany. Trade tax and real property tax receipts accrue to the communes as well as the revenue from local excise taxes which, as already stated, is hardly significant. However, the Federation and the Länder receive a share of trade tax receipts through an apportionment.

\(d\) \hspace{10mm} The role of the financial equalisation system

Despite the offsetting or levelling effects of tax revenue allocation there are still marked differences in the financial endowment of individual Länder. This may be attributable to geographical disadvantages or to weak infrastructure just as to misdirected policy decisions by a regional government. To lessen the impact of this, Germany has a very complex system of horizontal and vertical financial equalisation.
In the course of horizontal financial equalisation between the Länder, tax revenue that has been assigned to the individual Länder may in part be channelled off again to the benefit of financially weaker Länder. The extent to which a Land is obliged to reassign revenue or has a claim to reassigned revenue is determined by the divergence of its own financial capacity (in terms of the ratio between tax revenue and number of inhabitants and making allowance for the financial capacity and financial requirements of its communes) from the average financial capacity of all Länder. Financially weak Länder are boosted to at least 95 per cent of the average financial capacity of all Länder by offsetting 37.5 per cent of the shortfalls existing between 92 and 100 per cent. The equalisation amounts to be contributed by the financially strong Länder are determined in a three-stage levy system. In the final stage, 80 per cent of the financial resources exceeding 110 per cent of the average financial capacity of all Länder is assigned to equalisation. In the outcome, the differences in financial capacity between the Länder are broadly, though not yet fully, levelled off.

The central element of vertical financial equalisation is the provision of supplementary federal grants to the Länder. The Federation enhances the capacity of financially weak Länder by providing from its own resources so-called shortfall complementary federal grants, while the special burdens of individual Länder can be lessened by federal complementary grants for special needs.

As this system is closely linked to aggregate state spending and revenue it is a key parameter in the federal context that plays a frequently decisive part in all coordination processes. The complex financial equalisation system, intensified by the special problems following on the unification of Germany, significantly encumbers the political and economic efficiency of the German federal regime.

Where the individual tax receipts of the communes are insufficient to enable them to discharge the functions assigned to them, the Länder are primarily responsible for ensuring communal financial resources (communal financial equalisation).

3. From “Modell Deutschland” to “German disease”

The principal feature of the German federal regime is its very subsidiary or decentralised basic structure with generally clearly defined assignment of responsibilities. The expenditure powers assigned to Federation and Länder give them a high degree of autonomy on the expenditure side of the budget. On the revenue side, however, the autonomy has been steadily diminished in practice by the predomination of the combined system of revenue allocation as well as the fiscal equalisation system.

Additionally all important tax policy decisions are taken in a relatively complex, lengthy process of coordination between the institutions. Added to this is financial equalisation, which can also be carried only in common and results in a
further distribution of income. This lack of autonomy on the revenue side also has a negative impact on expenditure-side autonomy, least so for the Federation, which still has some key taxes of its own (such as mineral oil, tobacco and spirits duties), but more so for the Länder and especially for the communes, which are almost wholly dependent on what “trickles down” from the Länder.

However, the relatively high degree of expenditure-side autonomy on the one hand and the diminished revenue-side autonomy on the other hand give rise to serious efficiency problems. The responsibilities for expenditure and for financing expenditure are not congruent, and additionally this mismatch is aggravated by the high level of joint financing that is no longer justified by the existence and the extent of external effects. The blurring of responsibilities for financing makes it more difficult to establish accountability on the part of the responsible decision-making bodies and thus also undermines any incentive to exercise expenditure discipline.

The present financial equalisation system featuring extensive reallocation of tax revenue and transfer payments between the territorial subdivisions provides other misdirected or inadequate incentives for the Länder. Efforts undertaken by a Land to improve its financial situation, for instance by making tax collection more efficient or by pursuing an economic and fiscal policy course designed to boost growth and employment, will produce scarcely any benefit as the Land will be able to retain only a small part of the additional revenue. With the system as it now stands, it is not even certain that the Land originally having the highest tax revenue will still occupy that position after financial equalisation and federal supplementary grants; in other words, financial equalisation may even lead to shifts in the ranking of Länder in terms of financial resources.

The lack of fiscal autonomy and a financial equalisation system dedicated to the creation of equal living conditions which largely levels out and in part overcompensates for tax revenue differences, plus the obligation for the Federation and the other Länder to bail out any Land under the threat of insolvency, make German federalism into an unwieldy and ineffective arrangement. Reforms (of tax law) can generally be pushed through only after a protracted struggle to reach a compromise between federal and Länder interests. These difficulties become even more acute if, as has almost always been the case in the past few years, there are different party majorities in the Bundestag and Bundesrat. The most recent example is the ongoing procedure to pass a law cutting tax concessions.

Despite these “inbuilt” – and steadily growing – defects, Germany managed for a long time to make the system work in a manner that gained reputation both at home and abroad, particularly because it was exceptionally suited to promoting cooperation and integration – a feature seen, for instance as being of decisive significance for reconstruction after the second World War and for the process of reunification.

Although other structurally incorrect decisions were taken as late as the end of the Sixties – especially in further intensifying the links between levels of government in respect of revenue and expenditure (for what are referred to as joint
tasks) – this consensus-based cooperative federalism operated very effectively if somewhat inconsistently until well into the Eighties. For a long time, too, this federal system was generally very efficient and productive in the field of economic and fiscal policy as well. Even today the German system would still grade well in terms of closeness to the citizen, regional effectiveness and participation, though not in terms of efficiency and transparency.

In the meantime, however, this positive assessment has undergone a dramatic change. German federalism is now equated with the compulsion to achieve consensus, protracted coordination processes, the protection of vested rights, standstill and blockade. The “German model” has turned into the “German disease”. Facing high unemployment, low growth and structural problems in Germany, especially on the labour market and in the social system, the institutional side is also crucial for the (lack of) implementation of bold reforms.

Effects providing economic incentives are slowly but surely forfeited, while negotiations are dominated by political strategies and tactical manoeuvring. The clearly defined assignment of factual and financial responsibilities and the monitoring of efficiency based on such assignment are rendered considerably more difficult.

This trend has already been long apparent, but for a long time the drawback was concealed by high growth. The state of affairs has now been revealed by the long run of weak growth rates and their fiscal consequences (which have had a particularly severe effect on Germany).

The central concern is to improve government structures that can enable unified policy to be pursued across all levels and generally increase the effectiveness of economic and fiscal policies. If possible, there should be no loss of participation, regionality and closeness to the citizen and a gain in transparency. Hence a centralist model has to be ruled out. The refinement of federal models incorporating less interlinking and greater autonomy coupled with clearly defined economic incentive effects could provide a solution.

4. **Reorganisation of the system of federal financial equalisation as from 2005**

A fundamental reshaping of the relationship between Federation and Länder is needed if these problems are to be resolved. The benefits of federalism can be brought to bear only if the decentralisation of responsibility is allowed ultimately to lead to differences and competition among the Länder and between them and the Federation. This does not mean that the system of cooperative federalism should be completely relinquished; after all, it managed to pass an important test on the expenditure side with the creation of the national stability pact last year. But it should be supplemented by more pronounced elements of competitive federalism. Here the object must be on the one hand to strengthen the fiscal autonomy of the
individual levels. On the other hand, the system of federal financial equalisation must be so reformed as to have less of a confiscatory effect.

An important reform of the system of federal financial equalisation has already been put in place by the Law to continue the Solidarity Pact of 20 December 2001. Financial equalisation is to be reorganised as from 1 January 2005 on a basis valid for the longer term. To quote the finance ministry’s monthly report for February 2002: “The system of financial equalisation has been more strongly geared than before to the aspect of incentive effects, though without calling into question the joint and several community of the Federation and the Länder.” This means that narrowing the obligations to equalise will provide greater motivation for all Länder to improve their respective revenue situation by their own efforts. This will be achieved in particular by the following new provisions:

- In financial equalisation between the Länder, the equalisation schedule takes a symmetrical and in part linear-progressive course. There are no abrupt rises in the marginal burden and in marginal replenishment. Full replenishment for recipient Länder will be discontinued. The scheduled maximum marginal burden on donor Länder will be reduced from 80 to 75 per cent and will apply only at 120 per cent of the average financial capacity instead of 110 per cent as at present. Additionally, a “cap” of 72.5 per cent will be introduced for the average assignment of surpluses registered by donor Länder. Finally, there will be a novel feature in the form of a “bonus” model: “Länder registering disproportionately large per capita tax revenue increases on the year will in future be granted a part exemption from the obligation to assign the excess of such tax revenue increment.”

- Standard federal complementary grants will be made only to those Länder whose post-equalisation financial capacity is less than 99.5 per cent (at present 100 per cent) of that of all other Länder. Additionally, the equalisation intensity will be reduced from 90 to 77.5 per cent.

The reorganisation of financial equalisation under the Law to continue the Solidarity Pact will apply up to 2019. By that time the process of economic reconstruction in eastern Germany is likely to have been concluded, so that further refinement of federal financial relations can be tackled taking account of the experience gained up to then with the new system. This reorganisation is at all event an important step in the right direction – on the path to a system of financial equalisation that is appreciably less levelling yet still compatible with incentives.

5. Next step: greater fiscal autonomy

But there is more to the task than this. What further adjustments are needed to encourage this change in the state of mind? Essentially, the aim must be to increase as far as possible the autonomy of each individual level and to establish the correct patterns of economic and political incentives.
The factual and financial responsibilities of each level must be clearly demarcated and identifiable. At all events, a possible solution for Germany would be for greater emphasis to be placed on a system of separate apportionment on the revenue side.

Initially, greater fiscal autonomy for the Länder could be achieved by reinstituting the specific revenue system. But this proposal is not feasible, as both federal and Land politicians refuse to countenance it and it would probably be impossible to reach agreement on which type of tax revenue should be assigned to which level of government. A further argument against this is that each of the major types of tax at present coming under the joint revenue system (taxes on earnings on the one hand and turnover taxes on the other) has specific advantages and drawbacks which justify the revenue being assigned jointly to all levels.

For this reason the necessary broadening of fiscal autonomy should be achieved by introducing a Länder-specific addition in the tax scale to personal and corporate income tax (possibly also to VAT). A federal statute (requiring the consent of the Bundesrat) would subsequently fix the uniform basis for assessment and if required a maximum rate for the Länder-specific addition. This would ensure, firstly, that regional differences apply only within certain limits and that conversely the equality of living conditions requirement is not fully undermined. Secondly, it would avert the threat of a race for subsidies. By exercising their claim to an addition the Länder would be able to take more effective account of their priorities and objectives, though they would also have to assume the appropriate responsibility and would thus be under greater pressure to substantiate and justify their actions than they are at present. The differing financial requirements of the Länder would be reflected in differing tax charges on individuals and enterprises, which could in general be expected to exert a disciplinary effect on spending by the Länder and encourage them to make more efficient use of funds.

However, it would initially be conditional upon cuts in the income tax scale, which it would be sensible to combine with a comprehensive broadening of the tax base, since the introduction of a claim to additions must not be allowed to increase the tax burden.

There will of course still be a need for federal financial equalisation to assist financially weak Länder and the ensure that structurally weak Länder in particular are not forced to make very large additions to taxes on earnings, causing them to fall even further behind in the regional competition for business investment and jobs.

Autonomy is all well and good, but regional divergence should not be allowed to take on excessive dimensions in a unified state. This would imply both in economic and in political terms a reversion to “particularism”.

A line must be drawn at some point if greater autonomy and decentralisation also means more competition. Unrestricted competition between federal states would comply neither with the principle of “subsidiarity” nor with that of “unity in diversity”.
Unrestricted competition between unequal partners (unequal because of differing economic capacity and financial endowment and other general conditions) would intensify the existing imbalances. This is especially important in view of the differences still existing between the old and the new Länder. Extreme imbalances are bound to result in demands on central government, eroding its capacity to act. The positive aspects of competition between the Länder will benefit the state as a whole only if the Länder are of roughly equal capacity as well as having comparative advantages in a Ricardian sense. Thus if the modernisation debate is seriously intended, the Federation will also have to concern itself with the issue of “reorganising the Länder”.

Additionally, the existing arrangements for joint financing and the performance of tasks should be reassigned as necessary with clearly defined attribution to either the Federation or the Länder. In the provision of public infrastructure, however, certain minimum standards should be jointly prescribed.

A reform along these lines, affording greater autonomy combined with basic joint standards or fiscal policy rules, could provide the breakthrough to a new federal model.

The concept would have to be applied to the communes as well, which are at present largely dependent on what “trickles down” from the Länder. This will call for more radical institutional reform. The communes would first have to be given de facto fiscal autonomy and would have to assume greater responsibility for the revenue and expenditure sides of the budget. Initially this implies assigning to the communes their own local tasks. At the same time, (minimum) standards are to be prescribed for the provision of goods and services at local level. Added to this are further financial management standards and rules, such as the commitment to run a balanced budget under normal conditions.

To be able to discharge these responsibilities, the local level would in future have to be less dependent on grants from the Länder, which have hitherto been subject to quite arbitrary changes, and would have to derive the bulk of their resources from revenue which they themselves determine. This could conceivably include local powers to access revenue from direct taxes as well as local tax sovereignty (power to create new taxes).

Hypothecated grants should be forthcoming for the provision of public goods and service of the Länder at local level. Direct grants by the Federation to the communes might also be conceivable in future.

But although increasing autonomy provides greater incentives for economic efficiency it must still be linked to very direct “auditing”. As there is no market as such in the narrowly defined public sphere which would automatically correct misdirected action, it must be possible for undesirable trends and inefficient management to be rapidly identified and sanctioned (by the Länder). Any “bailout” can only be the exception.
If it is to ensure equality of living conditions in Germany as a whole, this system would certainly not function properly without Federation/Länder or Länder/Länder financial equalisation, and especially not without financial equalisation between Länder and communes. But the arrangements could be much less extensive and also much less complicated.

It must be remembered that interventions in the existing federal system will generally call for changes to the constitution. These require a two-thirds majority in both houses of parliament, the Bundesrat and the Bundestag. It seems likely that more extensive changes can be implemented only if there is a growing perception among the public at large that the lack of effectiveness of fiscal policy and the poor performance of “model Germany” are largely attributable to the institutional structures currently in place.

If we succeed in fully modernising Germany’s federal organisation in line with these criteria we will be able to define more clearly the decision-making structures and hence the responsibilities at all political levels – in the Federation, the Länder and the communes. This would be of decisive significance for fiscal policy, as it would bring the division of responsibilities for aggregate expenditure and deficit trends more sharply into public focus and make it more readily perceptible to the public. The new incentive structures applying equally at all levels would be a further contribution towards ensuring a unified fiscal policy.

6. Some remarks on Europe as a federation: lessons from Germany

What conclusions may now be drawn for Europe from the German system and from German experience? First: Whether Europe shares a lot of common values and traditions, the difference is still large and grows with enlargement. Second: The European approach is not a far-reaching equalization/neutralization of difference, but valuing and keeping those difference for innovation and (local, regional) participation besides any necessity for a “common sense” and a European identity.

In EU tax policy, the subsidiarity principle has become broadly established. The responsibility for tax policy is still almost exclusively a national concern, with harmonisation and efforts to achieve it being limited to areas in which distortions of competition can and should be prevented by national means – to date principally in the field of indirect taxation. A long awaited breakthrough in the fight against cross-border tax evasion was finally achieved on 21 January 2003 with the agreement on the taxation of interest income reached in the ECOFIN Council.

In the long term, I consider that a German system reorganised in accordance with the criteria already described could well serve as a model for a unified Europe. But there is still a very, very long way to go and many obstacles to be surmounted. The requirements are these:

Expenditure and financing powers must be “in a single hand” and clearly attributable in order to ensure the accountability of the responsible bodies. The trend
is clearly in favour of a specific revenue system. The unavoidable financial equalisation system must contain strong incentives.

The more pressing question at present no doubt has to do with how the revenue system of the EU as an organisation can be reformed. Around 85 per cent of the funds accruing to the EU budget currently derive from contributions from the national budgets of Member States in the form of VAT-based and GDP-based own resources. This arrangement gives rise to problems similar to those described in connection with the German system. In particular, the present funding system suffers from a lack of transparency – not only for finance ministers and parliamentary deputies but even more so for the citizens of the EU. This is doubtless one of the causes of the sceptical stance still adopted in relation to European integration and the European institutions.

For this reason Germany is definitively receptive to the proposed introduction of an EU tax in the medium to long term. In my view, preference should be given to the right to make additions to an existing tax (VAT springs to mind in this context) rather than to introducing a new tax.

But the following conditions would have to be fulfilled. An EU tax:

- must not impose an extra tax burden on individuals and enterprises;
- must not lead to extension of the financial framework;
- must be balanced as among the Member States with regard to the expected revenue;
- must be harmonised or capable of being harmonised;
- presupposes continuing political integration of the EU.

It must be understood that an EU tax could represent the first step in a transition from a community of states to a federal state, fiscal sovereignty being one of the central elements of statehood. This must be balanced by political control on the part of the citizen on every level of the state of the union.