

The Fiscal Equalization and Public Service System in Germany

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I. Theoretical Background

The German fiscal equalization system mainly follows the principles of fiscal federalism, which provide some important insights of the optimal allocation of tasks, expenditures, and revenues among the different levels of government. This theory also deals with the theory of intergovernmental transfers.

1. Expenditure assignment

Expenditure assignment addresses the question which level of government is best able to provide public goods according to the preferences of the people, or, to use the words of MUSGRAVE (1971) "... what goods should be provided where and by whom". The answer to this question has been given by Professor Zimmermann.

2. Revenue assignment

In a decentralized federal state, we assume in general that subnational governments should be allowed to set their own tax rates, constrained by the requirement to balance their budgets so that borrowing is unnecessary. If subnational governments do not have independent sources of revenue they will not truly enjoy fiscal autonomy, but will be under the "financial thumb" of the central government.

In his classic article on the tax assignment problem, MUSGRAVE (1983) establishes the following six tax assignment rules:

1. middle and especially lower-level jurisdictions should tax those bases which have low inter-jurisdictional mobility;
2. personal taxes with progressive rates should be used by those jurisdictions within which a global base can be implemented most efficiently;
3. progressive taxation, designed to secure redistributive objectives, should be primarily central;
4. taxes suitable for purposes of stabilization policy should be central, while lower-level taxes should be cyclically stable;
5. tax bases which are distributed highly unequally among sub-jurisdictions should be used centrally; and
6. benefit taxes and user charges are appropriate at all levels.

Combining these principles, Musgrave suggests the following assignment of taxes to the three levels of government:

Central level	Regional level	Local level
Integrated income tax	Resident income tax	Property tax
Expenditure tax	Non-resident income tax	Payroll tax
Natural resource tax	Destination-type product tax	Charges
Charges	Natural resource tax	
	Charges	

In accordance with Musgrave's three-branch system of government, progressive individual income taxes and corporate income taxes can be used for purposes of redistribution and, through their countercyclical effects on revenues and disposable income,

macroeconomic stabilization. Therefore these two taxes should be assigned to the central government.

3. Intergovernmental transfers

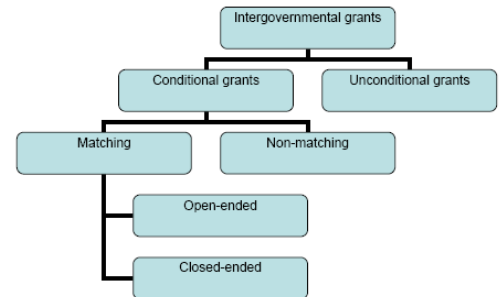
Intergovernmental grants can be justified with several arguments. First of all, intergovernmental grants are needed to achieve what is called “vertical fiscal balance”. That means, revenues and expenditures of each level of government are supposed to be approximately equal. Reality, however, is characterized by vertical fiscal imbalances¹ (VFI), because the central government usually has more revenue-raising capacity than the lower levels. It also may be efficient that the central government raises more revenues than it needs for its expenditures and then transfers the excess to lower levels of government which collect fewer revenues than they need for their expenditures. Vertical intergovernmental transfers from higher to lower levels of government are then used to fill the existing vertical fiscal gap (VFG). But transfers from the central to the regional governments do not only close the VFG, they also have “important objectives in their own right.” They may be given either for efficiency or equity reasons.

The most common justification for the introduction of horizontal intergovernmental grants put forward in the relevant economic literature is the existence of benefit spillovers. Other possible objectives of a horizontal intergovernmental transfer system could be the reduction of horizontal imbalances between poor and wealthy regions to achieve fiscal equalization, the stimulation of subnational tax efforts by encouraging localities to raise more own-source revenue, and to influence subnational spending decisions.

Intergovernmental grants can take two basic forms: they may be conditional or unconditional (see figure 1). Conditional grants – also called categorical or earmarked grants – have to be used for specified purposes by the recipient. They can be grouped into matching grants, which again can be open-ended or closed-ended, and non-matching grants. Unconditional grants

can be used by the recipient freely at its own preferences.

Figure 1 Types of intergovernmental grants



The theoretical literature on intergovernmental grants suggests using the different types of grants in the following way: Unconditional grants should be used for establishing vertical fiscal balance (i.e. for closing vertical fiscal gaps) and for achieving horizontal fiscal balance (i.e. for equalization purposes). Conditional matching grants should be used for the internalization of benefit spillovers by (co-) financing specific expenditures in order to encourage local governments’ provision of merit goods of supra-regional interest such as cultural facilities.

II. TAX SHARING AND FINANCIAL EQUALISATION IN THE FEDERAL REPUBLIC OF GERMANY

1. Basic elements of Germany’s fiscal federalism

The assignment of taxes in the Federal Republic of Germany is one of the essential questions for the balance of powers between the Federation and the 16 Länder (states). It has to be seen against the background of the general structure of the German federal system, the basic elements of which can be described as follows:

a. Political independence of Federation and Länder (states)

The Länder are politically independent from the Federation although subject to federal laws. Länder governments frequently are formed by political parties, who are in opposition to the Federal Government.

b. In general the Länder are assumed to be competent

According to the federal constitution (Basic Law) the Länder have the general competence in all public matters unless the constitution gives competence to the Federation for specific tasks. In practice the Länder are mainly competent in the field of administration, whereas the Federation has largely used its extended concurrent power to legislate on matters that are of overall importance for Germany.

c. Federal legislation is subject to the consent of the Bundesrat in important areas

In fields of major importance to the Länder (e.g. public expenditure or revenue at Länder level; administrative procedure) federal legislation by the Bundestag (Federal Parliament) is subject to the consent of the Bundesrat (legislative body composed of representatives of the Länder governments).

d. Budgetary autonomy of the Federation and the Länder

The Federation and the Länder are autonomous and mutually independent in their budget management, i.e. each level of government is responsible for preparing, executing and monitoring its own budget. However, the Federation and the Länder each have the responsibility to take due account of the requirements of macroeconomic equilibrium.

e. Expenditure competence follows administrative competence

The right and the obligation of financing state activity follows the general rule that the Federation and the Länder shall meet separately the expenditure resulting from the discharge of their respective tasks in so far as the federal constitution does not provide otherwise. Deviations from this general rule are in principle limited to the following:

First Deviation: Länder act as agents of the Federation

Where the Länder act as agents of the Federation (Bundesauftragsverwaltung, for example: construction of highways and federal roads), the Federation has to meet the resulting expenditure. However, not the administrative expenditure.

Second Deviation: Laws involving the disbursement of funds

Federal laws that are to be executed by the Länder and involve the disbursement of funds (Geldleistungsgesetze) may provide that such funds shall be contributed wholly or in part by the Federation. If the Federation meets one half of the expenditure or more, the Länder act as agents of the Federation. The consent of the Bundesrat is required if the Länder meet one quarter or more of the expenditure.

Third Deviation: Federal investment grants

The Federation may grant the Länder financial assistance for specific important investments (Finanzhilfen) to avert a disturbance of the overall economic equilibrium, to equalise differences of economic capacities within the federal territory or to promote economic growth. The details of how the funds are used are, however, decided by the Länder.

Fourth Deviation: Joint tasks

In certain precisely defined areas the Federation may assist in the discharge of functions of the Länder when these functions are important to the nation as a whole and the assistance of the Federation is needed to improve living conditions. Actually a big reform of Germany's fiscal federalism is on its way. It includes some changes in the assignment of tasks as well as changes in the distribution of tax revenues.

2. The German system of competences in the field of taxation

2.1. Legislation

The distribution of legislative powers concerning taxation follows mainly the general idea to ensure a rather uniform system of

taxation in the whole territory. The Basic Law therefore gives the Federation the concurrent power to legislate on the large majority of all taxes, even on taxes the revenue of which accrues wholly to the Länder or to the local communities.

Such federal laws are, however, subject to the consent of the Bundesrat. The Länder have power to legislate on local excise taxes. Communes are authorised by the constitution to fix the percentages of taxes on real property and businesses within the framework of existing laws.

2.2. Administration of taxes

The administration of taxes in Germany is split between separate revenue authorities of the Länder and the Federation. Whereas customs and excise taxes and the import turnover tax are administered by federal authorities down to the local level, Land taxes as well as the joint taxes are administered by Land revenue authorities.

If the taxes accruing wholly or in part to the Federation are administered by Land revenue authorities, those authorities act as agents of the Federation. Both revenue authorities cooperate on regional and government level.

2.3. Apportionment (assignment) of tax revenues

a) General remarks

The apportionment of tax revenue to different tiers of government in the Federal Republic of Germany has always been a highly controversial subject due to the fact that the development of the revenue of different taxes varies over the years in relation to the general economic activity and the expenditure necessities of the Federation, the Länder and the communes. Because of these difficulties a mixed system of apportionment of tax revenue has been established.

The revenue of certain taxes accrues wholly either to the Federation, the Länder or the

communes („partition system“). By far the most important part of the tax revenue is, however, allocated to all tiers of government attributing certain percentage shares to each tier („tax pool system“). The system follows the basic idea that each tier of government should meet separately the expenditure resulting from the discharge of its respective tasks (connexion principle). This basic principle is considered as being important to ensure political independence of the different member states of the Federation and a more efficient use of public expenditure.

b) Vertical apportionment of tax revenue

aa) Federal taxes, Land taxes, Municipal taxes

The revenue of the following taxes accrues wholly to one tier of government in Germany:

FEDERAL TAXES	LAND TAXES	MUNICIPAL TAXES
- Spirits monopoly	- Inheritance tax	- Municipal trade tax
- Insurance tax	- Real property transfer tax	- Real property tax
- Customs duties and other levies required by the European Communities	- Motor vehicle tax	- Local excise taxes and taxes on certain non-essential spendings (e.g. dog tax, beverage tax)
- Excise taxes on tobacco, coffee, sparkling wine and mineral oil	- Beer tax	
	- Tax on betting and lotteries	
	- Gaming casinos levy	
	- Fire protection levy	

bb) Joint taxes

The revenue of the most important taxes is shared by the Federation, the Länder and the Communes as follows:

	Wages and income tax	Corporation tax	Turnover tax
Federation	42,5 %	50 %	52,2 %
Länder	42,5 %	50 %	45,7 %
Communes	15 %		2,1 %

Whereas the principle, that the shares of revenue from the wages and income tax and the corporation tax of the Federation and the Länder shall be equal, is laid down in the Federal Constitution, the portion of the receipts from the wages and income tax going to the local communities is to be determined by federal law with consent of the Bundesrat.

Of particular interest is the apportionment of the turnover tax revenue, because it is the flexible instrument for the vertical tax sharing among the three tiers of government. The percentage shares of the Federa-

tion, the Länder and the communes are determined by federal law requiring the consent of the Bundesrat. The constitution contains a set of principles for the adjustment of the distribution of the turnover tax revenue that aim at a just and fair balance of overall revenue-sharing among the three levels of government. In practice, however, the percentage shares of the turnover tax revenue are the result of political bargaining between Bundestag and Bundesrat. In this bargaining normally the Länder governments represented in the Bundesrat are stronger than the Federation. Thus since 1970 the vertical tax sharing system has led to a growing Länder portion of the overall tax revenue.

c) Horizontal tax sharing

The allocation of tax revenue to the specific Länder or communes follows basically the following principles:

The general rule is the principle of local revenue. It applies to the Land taxes and the Land share of revenue from income and corporation tax. These tax receipts accrue to the individual Länder to the extent that they are collected by revenue authorities within their respective territories. Distortions that arise from the application of the principle are corrected by delimitation and allotment of local revenue from wages tax and corporation tax revenue (Zerlegungsge-
setz). The Land share of turnover tax is not allocated among the Länder according to local revenue; 25 % is distributed according to taxing capacity (so-called supplemental shares), and the rest on a per capita basis. Länder whose receipts from Land taxes, the Land share of income and corporation tax and the trade tax apportionment is below 92 % of the per capita average of all Länder receive supplemental shares from the Land share of turnover tax to make up the difference (so-called turnover tax equalisation). Apportionment on a per capita basis is connected with the nature of turnover tax which is passed on along the commercial chain and often is not paid to the tax authorities in the Land in which the final consumer of the goods, who actually bears the tax, is located.

The turnover tax equalisation is itself a form of financial equalisation, since its purpose and effect is to bring the tax revenue of the individual Länder into line. This redistribution function has acquired considerably greater importance since the new Länder and Berlin were fully included in the general system of German fiscal federalism in 1995. The inadequate financial resources of the new (eastern) Länder necessitate considerable transfer payment from the financially strong old (western) Länder. The Federation supported the old Länder by changing the vertical turnover tax apportionment in favour of the Länder by more than 16 Billion DM. With decreasing differences in taxing capacity between new and old Länder the importance of the horizontal turnover tax equalisation will be gradually reduced.

3. Horizontal financial equalisation (HFE)

The purpose of horizontal financial equalisation is to make a further correction of the results of the preceding tax sharing by making suitable payments in the interest of ensuring living conditions in the national territory. The new Länder and Berlin have been participating in horizontal financial equalisation since 1995 after the end of a transition period which was largely dominated by West to East transfer payments through the so-called German Unity Fund.

The System of horizontal equalisation among the German Länder is strictly based on a comparison of public revenue, excluding in principle a comparison of the expenditures of different Länder. Only structural differences between the city states (Berlin, Hamburg and Bremen) and the rural Länder and – as an exception - certain harbour costs are taken into account. Federal legislation about the horizontal equalisation has established a set of mathematical principles to calculate the equalisation claims of the weak Länder and the amounts to be paid by the financially strong Länder.

Solidarity among Länder does not mean complete equalisation of differences in financial capacity. The objective of financial equalisation is merely to reduce disproportions.

tionate financial disparity between the Länder.

Länder whose financial capacity is below average (financially weak Länder), are in principle brought up to at least 95 % of the average with equalisation payments made by the financially strong Länder. The equalisation payments are calculated in application of complex rules that avoid excessive burdens on financially stronger Länder or a change in the order of financial capacity.

4. Federal supplemental grants (FSG)

Finally, federal supplemental grants are made to financially weak Länder in order to complement the coverage of their general financial requirements. Unlike the horizontal equalisation payments federal supplemental grants may take special expenditure necessities of individual Länder into account. The Federation is obliged to equal treatment of Länder having similar expenditure necessities. The Länder receiving supplemental grants are free to dispose of the funds as part of their budget autonomy.

The total volume of supplemental grants was considerably expanded in 1995 when the new Länder were fully incorporated in the German system of fiscal federalism in order to take account of additional special requirements. Since 1995 the following types of supplemental grants can be distinguished:

- Financially weak old and new Länder receive shortfall supplemental grants (FSG shortfall) from the Federation amounting to 90 % of the shortfalls which remain after the financial equalisation among Länder.

- Besides that over the period 1995 to 2004 the Federation will pay the new Länder special supplemental grants (FSG new Länder) of 14 Billion DM a year in order to reduce special burdens linked to the division of Germany and to compensate the less-than-average financial capacity of the municipalities.

- Smaller old and new Länder which have been disproportionately burdened by the

inclusion of the new Länder in the national system of financial equalisation are receiving from the Federation graduated transitional supplemental grants (FSG transition after German unification) over a period of 10 years.

- Since 1994 the Länder Bremen und Saarland are supported by the Federation with special supplemental grants for restructuring their budgets (FSG for bailing out Saarland and Bremen). These funds must be directly applied to paying debts.

- Besides that smaller Länder receive supplemental grants as a compensation for their relatively higher per capita burden for participating in the federal political process (FSG small Länder).

Besides financial equalisation per se the Federation has since 1995 also been according the new Länder federal investment grants as a further supporting measure to increase their economic strength; these amount to 6,6 Billion DM a year and will run for a period of 10 years.

In November 1999 the Federal Constitutional Court decided that the whole system of financial equalisation has to be revised in order to make it more transparent. Federal legislation has to establish general guidelines for the new system till the end of 2002 and the new system itself will have to start as from 2005.

III. THE POSITION OF MUNICIPALITIES WITHIN THE SYSTEM OF PUBLIC FINANCE IN GERMANY

1. The principle of self-administration of municipalities

According to Art. 28 paragraph 2 GG municipalities have the right of "governing all affairs of local interest within the scope of law on their own responsibility". In particular cases the field of activities which a singular municipality is responsible for depends on its structural circumstances, especially on the size of its population [Einwohnerzahl], the size of the area [Gebietsgröße],

the economic structure and the fiscal capacity [finanzielle Leistungsfähigkeit].

Tasks which cannot be handled by smaller municipalities are in larger municipalities often regarded as affairs of local importance. Generally municipalities may handle new tasks of local interest unless they are explicitly assigned to other institutions by law. The most important characteristic of the municipal self-administration is the right to decide autonomously about the realization of municipal tasks. Self-administration though does not only require a high degree of task autonomy [Aufgabenautonomie], but also corresponding flexibility concerning expenditures and disposable revenues. I.e. it should be in their responsibility to decide for what and how they would like to employ their funds. Restrictions of municipal self-administration derive from the "framework of laws", which can refer to the [prinzipielles] assignment of a task to the municipal level as well as the mode of realising a task of local relevance.

There are mainly two groups of tasks which can be distinguished: tasks of self-administration and externally defined tasks.

Tasks of self-administration are performed by communes in their own responsibility. They are merely subject to legal supervision by national non municipal institutions. These tasks can again be split into compulsory and voluntary tasks of self-administration. Regarding the first group communes are legally obliged to perform the tasks, but in principle they are free to choose the mode of task-performance. For voluntary tasks of self-administration municipalities have a right to decide upon whether they take over the task or not.

Examples for voluntary tasks of self-administration are especially cultural and social institutions such as theatres, museums, social aid stations [Sozialstationen], but also the promotion of local economic activities. Examples for compulsory tasks of self-administration are particularly social welfare payments, primary schools, regional construction guide planning and sewage disposal. The increasing influence of the cen-

tral government on the task performance [Aufgabenwahrnehmung] proves to be a problem as it affects self responsibility of municipal actions. In many cases it is hardly possible to distinguish compulsory self-administration tasks from externally prescribed tasks.

Delegated tasks are performed by the municipalities on behalf of superordinate regional authorities. These tasks are governmental tasks which are delegated to the communes by the federation or a Land due to legal regulations. The state has a global authority, which also allows in-detail regulations, unless laws provide for other arrangements. However the communes stay responsible for personnel and organisation.

2. The revenues of the municipalities

Municipalities may dispose of several sources of revenues to cover their expenditures. The total amount of municipal revenues (credit raising excluded) is at about 144 billion € in 2001.

The funding mainly results from taxes whose share of income is at 34.1 percent. Nearly on the same level are grants [Finanzzuweisungen] with 33 percent. In addition there are fees and (financial) contributions [Beiträge] with 13,1 percent, alienation gains [Veräußerungserlöse] with 4.8 percent and other revenue with 15.1 percent (revenue from economic activity, concession levies). The level of debt is, due to more restrictive regulations, of little importance.

Only 2.7 percent of municipal spendings are financed by credits. Fees are levied for the individual use of certain municipal services. They can be divided in price resembling user fees (e.g. waste and sewage disposal) and tax resembling administration fees (fees for official acts). Contributions are mainly levied to finance actions of land preparation for buildings (Erschließungsbeiträge). Just as fees contributions are a reward for particular services. The main difference is that fee financed services can be apportioned to singular persons whereas those services financed by contributions can only be apportioned to certain user groups.

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Fees and contributions are the communes' primary instruments of financing their expenditures.

A rise of municipal property tax multipliers [Realsteuerhebesätze] or the indebtedness to cover expenditures is basically only tolerable if possibilities of fee financing [Gebührenfinanzierung] are widely exhausted. Fee financing is ceiled (limited) by the production costs. If expenses are entirely covered by the earmarked fees, for instance in the sector of waste and sewage disposal, it is not allowed to collect higher fees.

In contradiction to the tasks of the municipalities, which are only generally defined, the German constitution specifies very precisely which kind of taxes are assigned to the municipalities (sovereignty of claiming tax revenue). According to Art. 106, paragraph 5 GG, they get a share of 15% of the income tax (but not the corporation tax) as well as a share of the VAT. Additionally the municipalities are entitled to the revenues of the business tax (Gewerbesteuer) and the real estate tax (Grundsteuer), whose revenues the municipalities can be influenced by a municipal multiplier (Hebesatz). Finally municipalities and municipal associations are entitled to the revenue of fiscally unimportant local excise taxes.

The quantitatively most important tax is the wage and income tax, adding up in 2001 to 41.6% of all tax revenues. At present the municipalities receive 15 percent of their land's revenue of pay roll tax and the individual income tax as well as 12 percent of the tax revenue on interest incomes. The distribution of these tax shares between municipalities depends on the paid income tax revenue of their inhabitants. However, tax revenues are limited to taxable wages and personal incomes of not more than 50,000 Euro for singles and 100,000 Euro for couples. These limits have the consequence that municipalities with high average income of their citizens obtain less income tax than they would be entitled to according to total local tax payments. Since 1998 the municipalities participate in the turnover tax with a share of 2.2 percent. In

2001 these revenues added up to 5,5% of all municipalities tax revenues. At present the distribution to individual Länder as well as the distribution to the individual municipalities within the Länder is carried out by a complicated two-stage system. In 2003 the distribution follows a standard key, which is based on the number of employees which are subject to social insurance contributions [without government employees], fixed assets, inventories, salaries and wages of the enterprises.

Regarding aspects of autonomy, the business tax is the most important municipal tax. The share of the business tax revenue was 34.9 percent in 2001. Nowadays only the earnings of the domestic business enterprises [Gewerbebetriebe] are taxed. The enterprise earnings are calculated on the basis of the calculated taxable profit of enterprises (Gewerbebetriebe) plus some additions and minus some cutbacks. Furthermore, a tax-exempt amount of 24,500 € for natural persons and private partnerships needs to be considered. That means that the business tax is paid mainly from juridical and big enterprises.

3. The municipal fiscal equalization system

The municipal fiscal equalization system basically has two functions. The fiscal function shall extend the financial capacity of the municipalities so far that they are able to perform their self-determined and externally defined tasks. The redistributive function intends to reduce inter-municipal differences in per capita financial capacity unless these differences have not been caused by autonomous decisions of the municipalities. Besides the two main functions the municipal fiscal equalization system also has the function of improving regional planning. Finally, the municipal fiscal equalization system can fulfil a stabilization function provided that the Länder arrange the system in such a way that municipalities' incomes are stabilized over economic cycles.

Germany's municipal fiscal equalization system is arranged differently within the singular federal states. However, the subse-

quently presented basic procedure corresponds to all Länder. The financial basis of the municipal fiscal equalization system consists of the shared revenue fund [Finanzausgleichsmasse, Verbundmasse]. According to Art. 106, paragraph 7 GG, the Länder are obliged to let their municipalities participate in the Länder's share of the income-, purchase- and corporation taxes (mandatory „tax network“ [Steuerverbund]). Moreover the Länder may include voluntarily the revenues from Länder taxes (motor vehicle tax, real property transfer tax) or from the Länder fiscal equalization system into the „tax network“ (fakultativer Steuerverbund]). The amount of grants (Verbundquote) is determined by the Bundesländer. It depends primarily on the distribution of tasks between Land and municipalities, but also on the Land's „commune friendliness“.

Municipalities and districts are paid unconditional and conditional grants from the shared revenue fund [Finanzausgleichsmasse]. Unconditional grants [Schlüsselzuweisungen] are free funds to cover general fiscal needs. Conditional grants [Zweckzuweisungen] endow certain tasks and concrete needs of the municipalities. The main part consists of investment grants. But also expenses for externally prescribed tasks are refunded. The funds for conditional grants are normally taken from the fund of shared revenues [Finanzausgleichsmasse] in advance.

Unconditional grants mainly serve to strengthen the municipalities' fiscal capacity in general as well as to reduce divergences in fiscal capacity. They are the core of the municipal fiscal equalization system. The distribution of unconditional grants to the singular municipalities is based on the relation of their fiscal needs to their fiscal capacity. The indicator of per capita fiscal needs (Bedarfsmesszahl) depends mostly on the size of a municipality. The bigger a municipality, the higher the indicator of per capita fiscal needs. Additionally other indicators are included, as for example the (relative) number of pupils, the presence of foreign soldiers, etc.

The indicator of tax capacity (Steuerkraftmesszahl) of a municipality is basically defined by the share the municipality gets from income tax, VAT, real estate tax and business tax.

However the indicator of fiscal capacity does not depend on effective, but on standardised tax rates of the real estate and the business tax. Thus it can be ensured that tax multiplier policy [kommunale Hebesatzpolitik] does not influence the amount of unconditional grants. If the indicator of fiscal needs of a municipality exceeds the tax capacity measure ($BMZ > SMZ$), the difference is reduced by unconditional grants according to the tariff of compensation. Given the easiest case with a proportional tariff of compensation (Ausgleichstarif) and the compensation rate "a" we receive:

$$SZ = a(BMZ - SMZ).$$

Often the tariff also includes a guarantee of a minimum fiscal capacity besides the general compensation rate. If the tax capacity measure exceeds the indicator of fiscal needs ($SMZ > BMZ$), the municipality is called "abundant". An abundant municipality does not receive any unconditional grants. In some countries the surpluses are even partially skimmed by a fiscal equalization assessment and transferred to the fiscal equalization volume.

The levelling effects of unconditional grants mainly depend on their volume. If the volume is increased the basic amount goes up too. So the relative gaps between financially weak and financially strong municipalities are diminished if the total amount of grants increases. Above that the Länder have quite different rules which define fiscal capacity and fiscal need. Together with the compensation tariff they play an important role for the levelling intensity of the municipal fiscal equalization system. While setting these parameters the legislator must take into account that there exists a latent conflict between redistribution and municipalities' fiscal autonomy.

In general, Germany's fiscal equalization systems have a high levelling effect. This is

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true for the Länder-Fiscal-Equalization-System as well as for the FES between municipalities.

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¹ Also known as vertical fiscal gap. That is the difference between expenditures and own-source revenues at different levels of government. In most nations, the central government raises more revenue than it needs and transfers the excess to subnational levels. The extent of the vertical fiscal imbalance varies across countries. Germany, for instance, has a much larger VFI than the USA or Canada.