Between Crises and Reforms: German Fiscal Federalism at a Crossroads

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Main points

- The chapter wants to…
  - outline the „deutsche Problem“ of fiscal federalism in international comparison
  - discuss impact of financial crisis on framework of German federalism
  - identify options of possible next steps in German fiscal federalism
- The chapter argues that…
  - the financial market crisis has triggered some institutional changes in German fiscal federalism
  - the main effects of those changes will become apparent towards the end of this decade only, when states must present structurally balanced budgets
  - market participants start to perceive changes in the German system, but still believe in a bailout-guarantee by the Federation
  - no coherent strategy for a systemic overhaul is in sight

I. The flawed design of German fiscal federalism

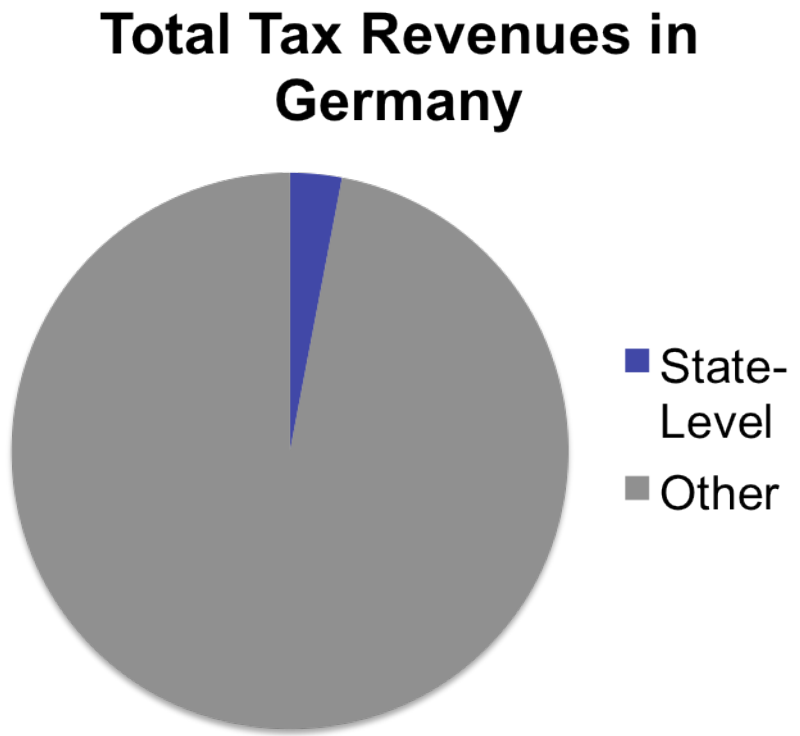
The “German Problem“ of fiscal federalism consists of three components

- Fallacy 1: The fiscal equivalence illusion
  - Discrepancy a the level of the Länder between true own resources and own expenditures is too high
  - Voters don‘t sanction fiscal misbehavior
- Fallacy 2: The solvency illusion
  - No own tax-income at the level of the Länder
  - The federal government bears the final responsibility for decisions taken by the Länder
- Fallacy 3: The equal-treatment illusion
  - Asymmetry in the incentives for fiscal policies in the Länder
  - Rich Länder have to behave responsibly (they know they will not be eligible for compensatory transfers)
  - Poor Länder have a strong incentive not to behave responsibly (they know they will receive compensation)

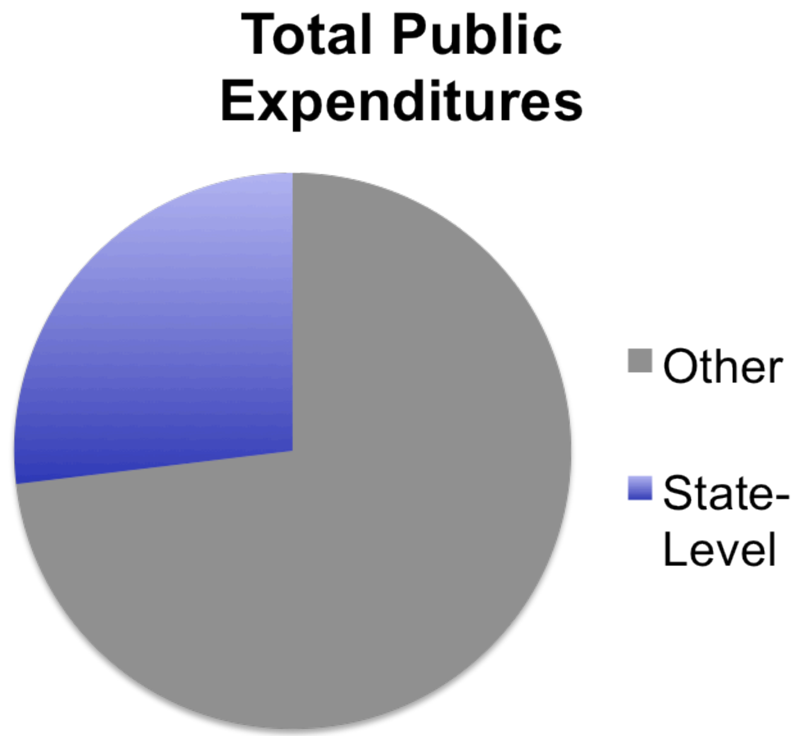
The fiscal equivalence illusion

Discrepancies exist with regard to the alignment between tax competencies and expenditure obligations of German States

German States claim a small share of total tax revenues…



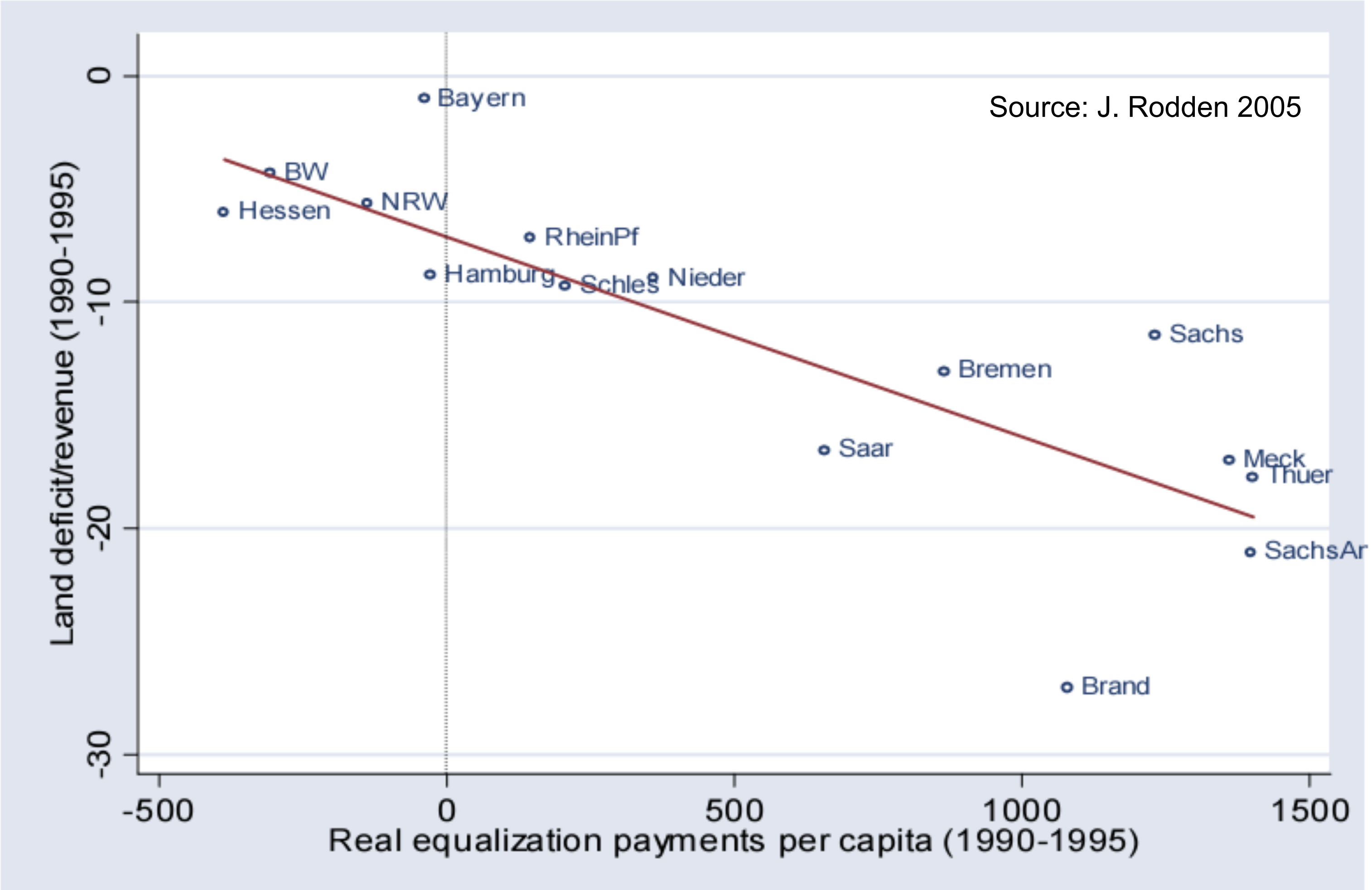
…but a large share of total public expenditures



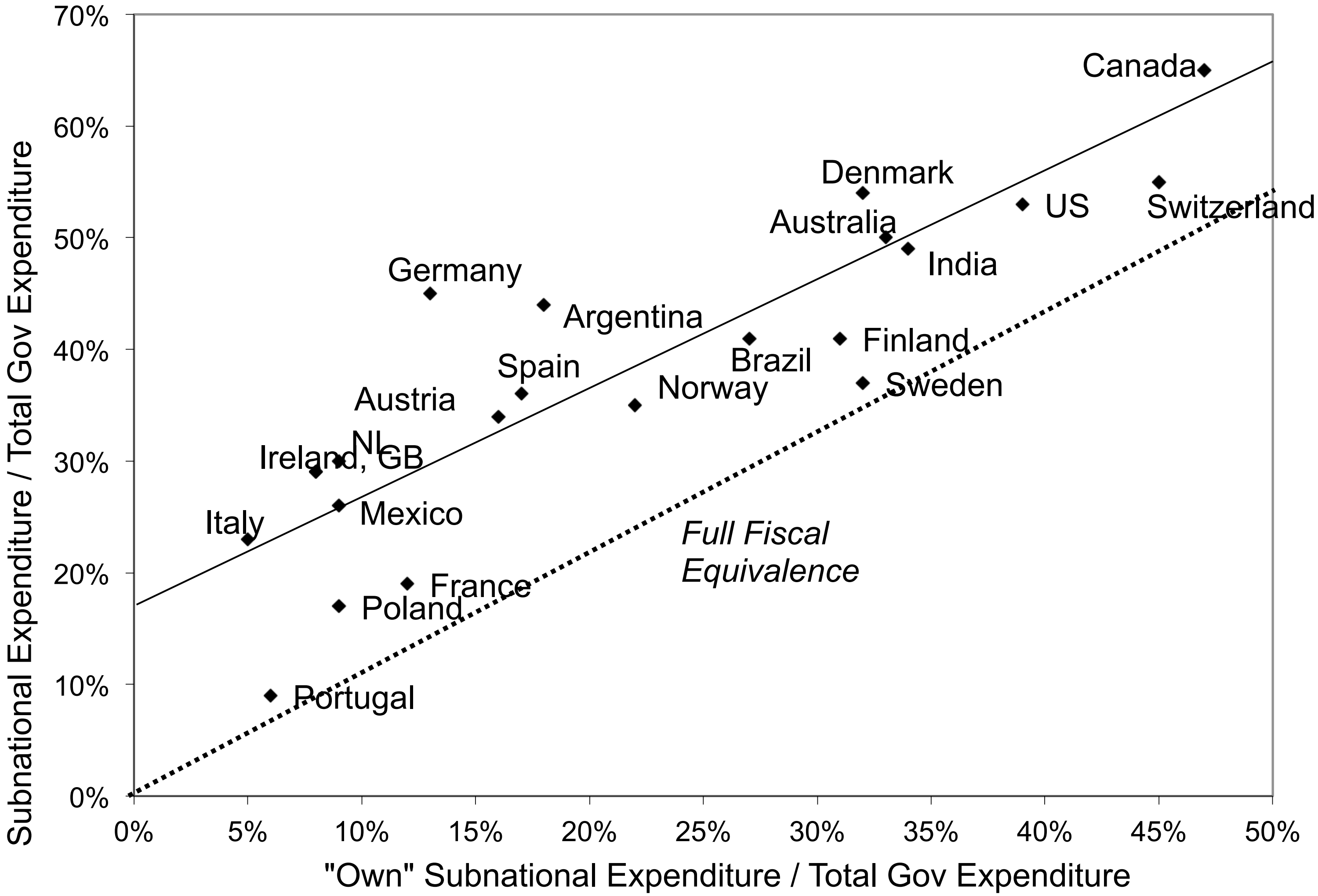
Graph 3: Expenditure and Income Sovereignty of German States

The fiscal equality Illusion (from Jonathan Rodden)

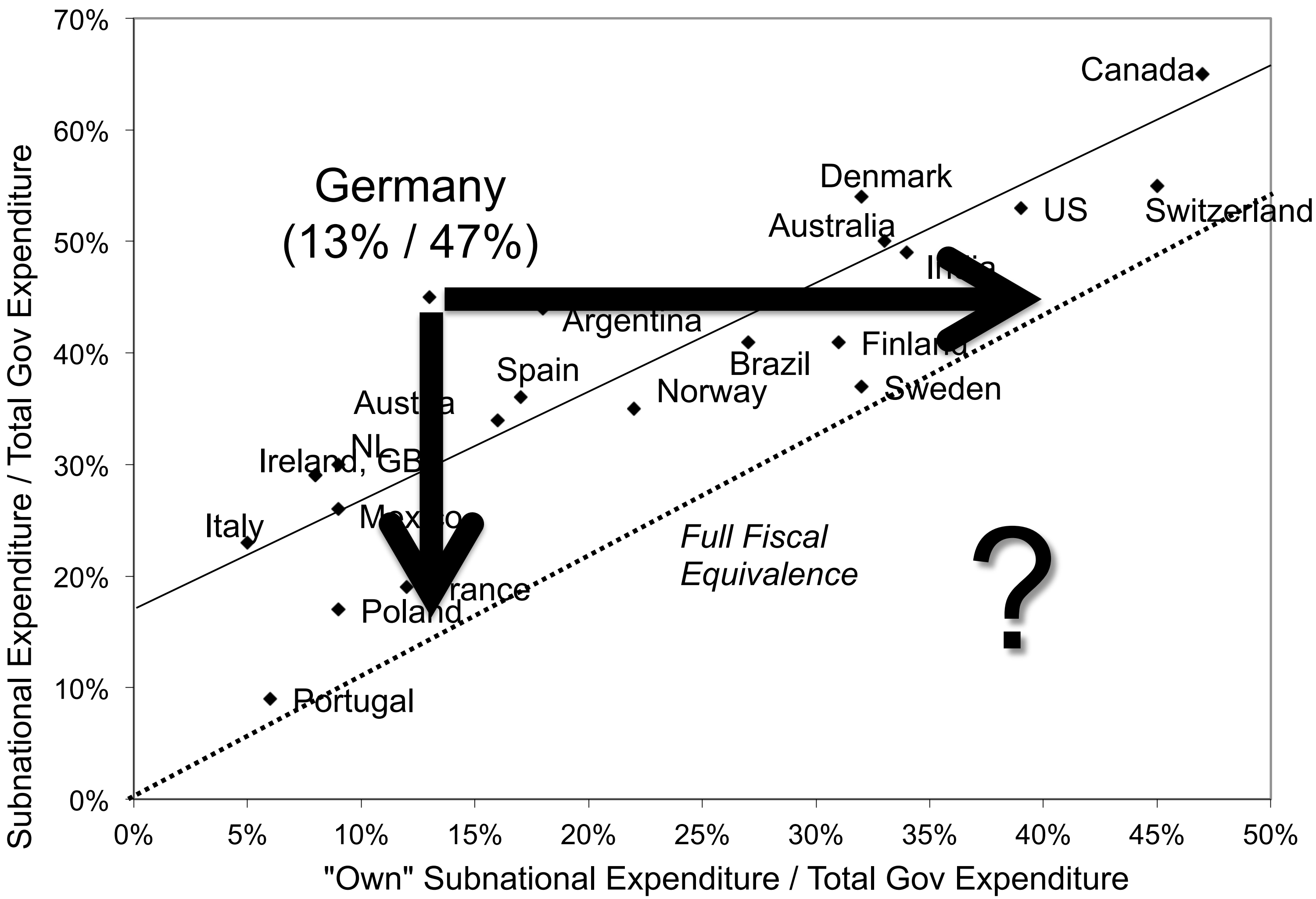
Net transfer receivers tend to spend more in terms of revenue (or is it that they receive more because they spend more?



The German problem in a comparative perspective (I)



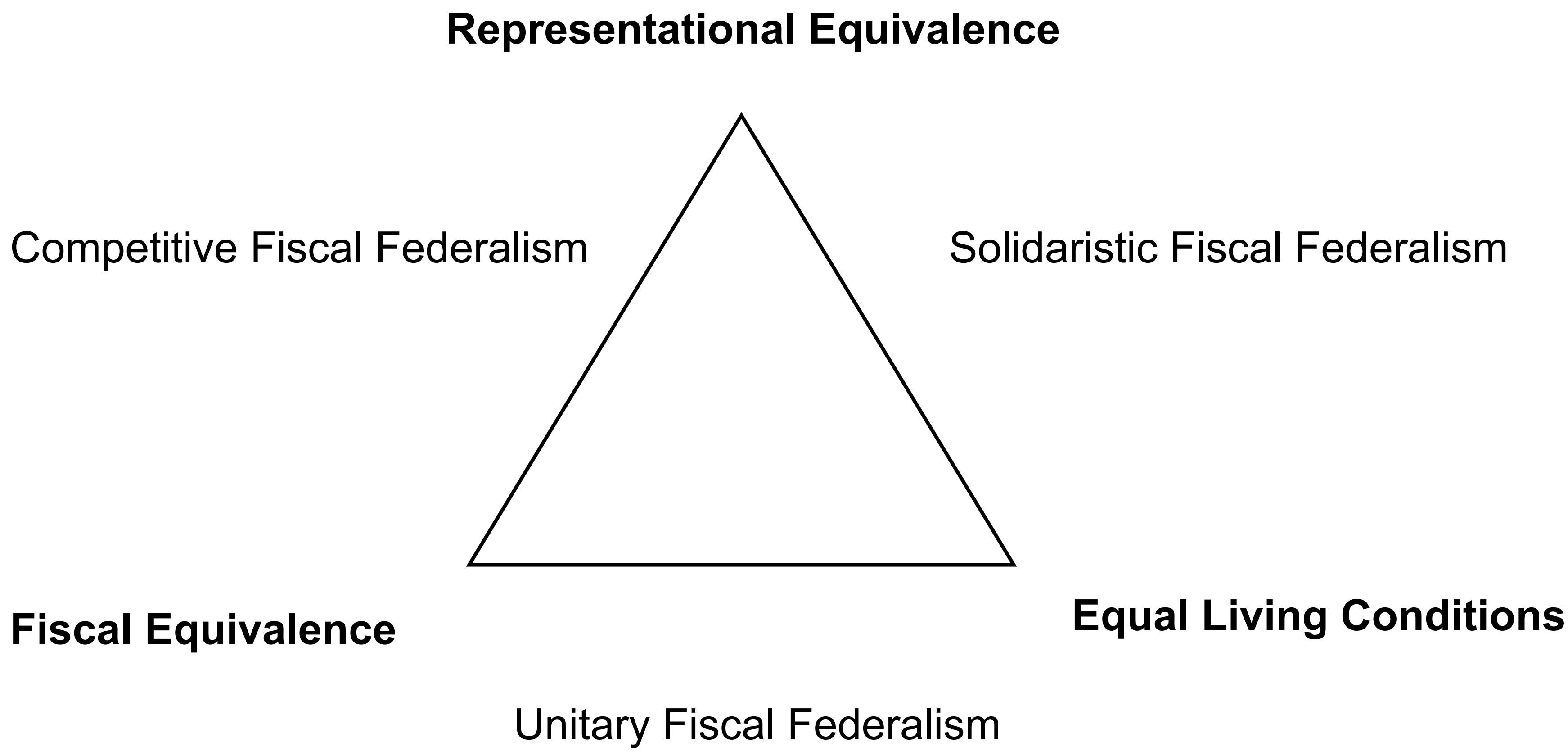
The German problem in a comparative perspective (II)



Background: Trilemma of fiscal federalism (Enderlein, under review)

- Three goals in a fiscal federation
  - Shared power of federal and state level
    - Fiscal spending authority (partially) owned by subnational entities
  - Equality of living conditions
    - Explicit (e.g. Germany) or implicit goal (e.g. Austria)
    - Achieved in form of horizontal and vertical transfers
  - Fiscal Equivalance (Olson)
    - Same state level finances and consumes public goods delivered
    - i.e. state revenues finance state expenditures
  - Those goals are ideal types
- The trilemma
  - Only two of those three can be reached simultaneously
  - Pursue two of the three at the expense of the third

The Trilemma of Fiscal Federalism



Three Worlds of Fiscal Federalism

- Competitive Fiscal Federalism
  - US, Switzerland, Canada, Australia, perhaps India
    - Two chambers (Canada as a special case)
    - High sub-national tax-income and expenditure (fiscal equivalence)
    - Inter-regional inequality is high
- Unitary Fiscal Federalism
  - Sweden, Finland, Denmark
    - Only one chamber – decentralization through delegation
    - High sub-national tax income and expenditure (fiscal equivalence)
    - Inter-regional inequality is very low
- Solidaristic Federalism
  - Germany, Austria, perhaps Spain, perhaps Belgium
    - Two chambers, high degree of influence of sub-national actors
    - Very low sub-national tax income
    - Inter-regional inequality is low

Implications for Germany

- Is there a problem?
  - Yes. Mainly: *Länder* spend money which they don't raise
  - Which options?
- Unitary Fiscal Fedaralism is no real option
  - Would allow higher tax-autonomy for the *Länder*
  - Conditions
    - Reduce *Länder* competencies
    - Fundamentally transform role of the *Bundesrat*
- Competitive fiscal federalism is no real option either
  - Would allow higher tax-autonomy for the *Länder*
  - End of automatic equalization scheme
  - Conditions
    - Give up constitutional clause on „equal living conditions" (GG 95)
    - Reorganize *Länder* structure
- The big reform had always been unlikely

II. Muddling through: when reforms and crises come in parallel

Reforms and Crises

- 2001-2006: First attempt to reform German federalism
  - No changes in fiscal framework
- 2007-2009: Second attempt to reform fiscal federalism
  - Parallel to outbreak of financial market crisis
  - Results are shaped by that event
- Political quid pro quo: fiscal stimulus against debt-brake in German Constitution
  - Peculiar mixture between short-term macro-economics and long-term institutional design: the two aspects shouldn‘t be related
- Since then: respecting the debt-brake looks challenging
- Euro-area crisis comes on top

Main effects of the crisis on German fiscal federalism

- Debt brake binding for the *Länder* after 2020
- Markets start to doubt the federal bailout guarantee
- Extremely strong fiscal pressure
  - Financial market crisis (Landesbanken)
  - Recession (decline in tax income)
  - Euro area crisis (Germany pushes for austerity)

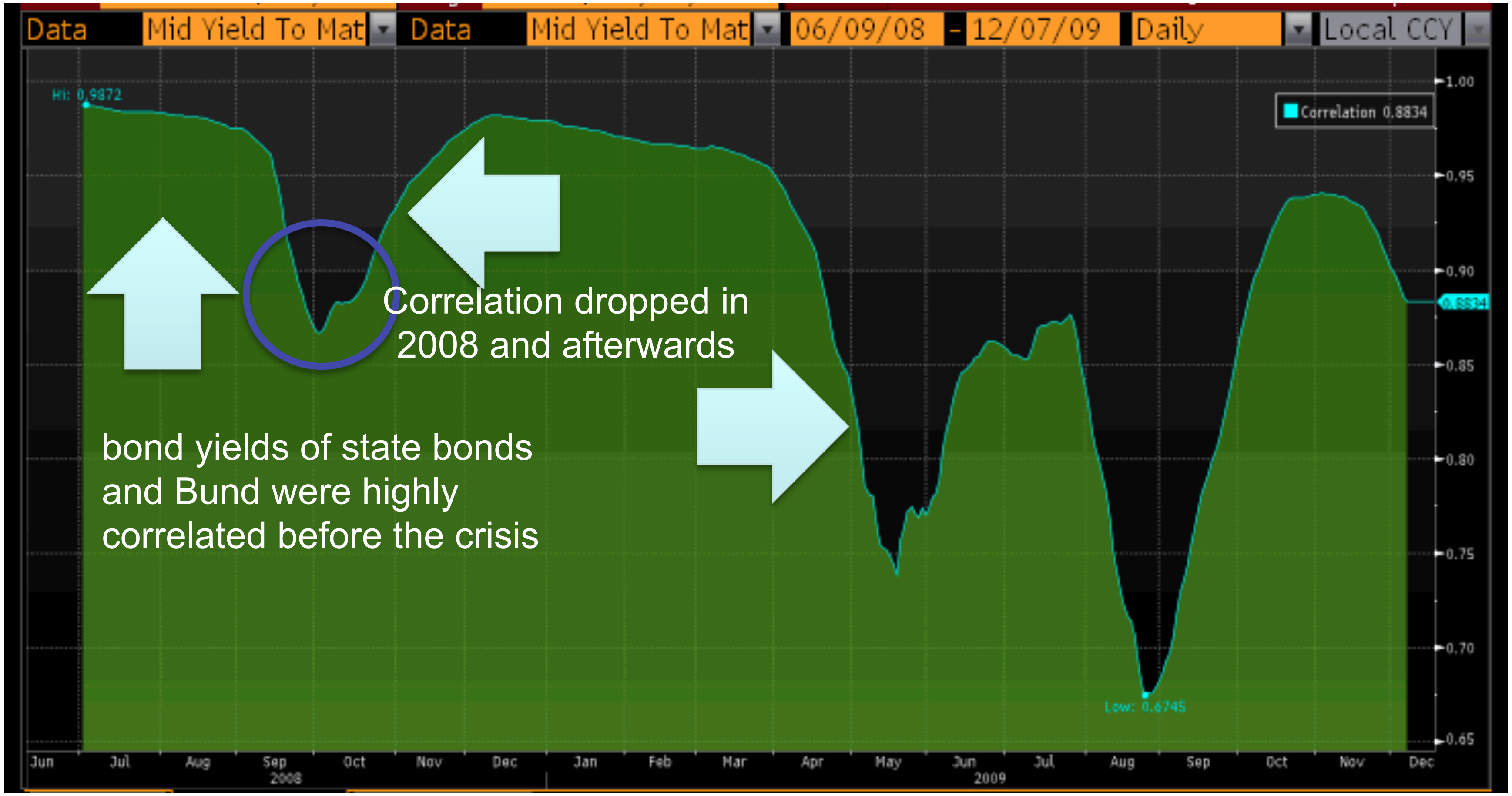
Crisis impact I: Federalism Reform II (2009)

- Debt brake
  - In principle structurally balanced budgets (Federation & *Länder*)
    - Exception 1: Excessive business cycle connections
    - Exception 2: Exceptional circumstances such as natural disasters (single majority decision in *Bundestag*)
    - Exception 3: „Structural component" – up to 0.35% BIP
    - Valid in principle since 2011, but really binding for Federation in 2016, for Länder in 2020
- Consolidation help
  - 5 Länder yearly 2011 bis 2019
    - Bremen: € 300 Mn, Saarland: € 260 MnBerlin, Sachsen-Anhalt, Schleswig-Holstein: € 80 Mn
- „Haushaltsnotlagen" – States under excessive fiscal strain
  - Stability Council (Federal ministries, Länder ministries)
  - Stability programmes, but not legally binding

Crisis Impact II: Markets start to doubt the bailout guarantee (1/10)

Correlation: 10Y Bond (Baden-Wurttemberg) vs. 10Y Bund

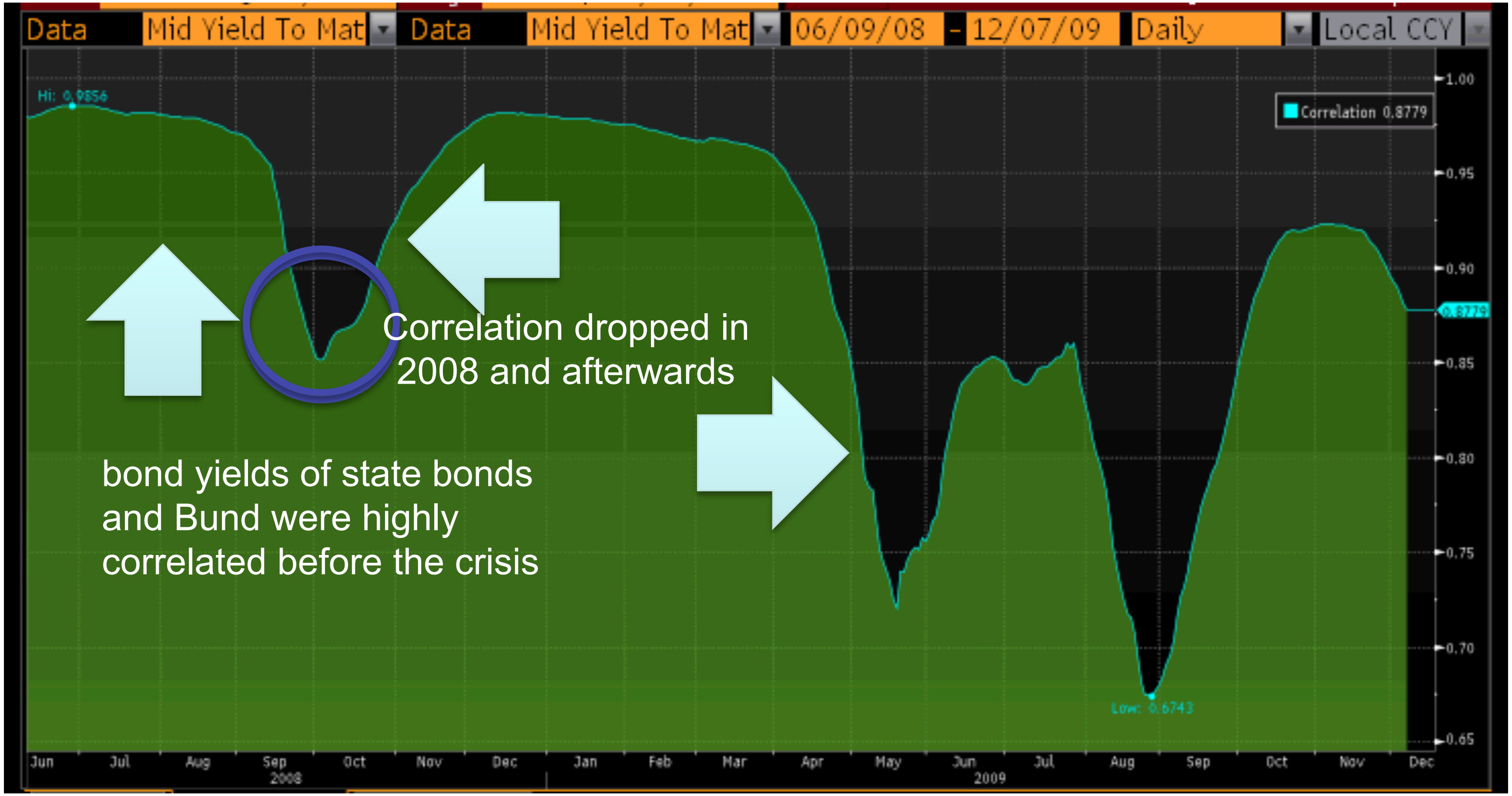
High correlations of state with federal bond yields = investors do not differentiate risks



Crisis Impact II: Markets start to doubt the bailout guarantee (2/10)

Correlation: 10Y Bond (Bavaria) vs. 10Y Bund

High correlations of state with federal bond yields = investors do not differentiate risks



Crisis Impact II: Markets start to doubt the bailout guarantee (3/10)

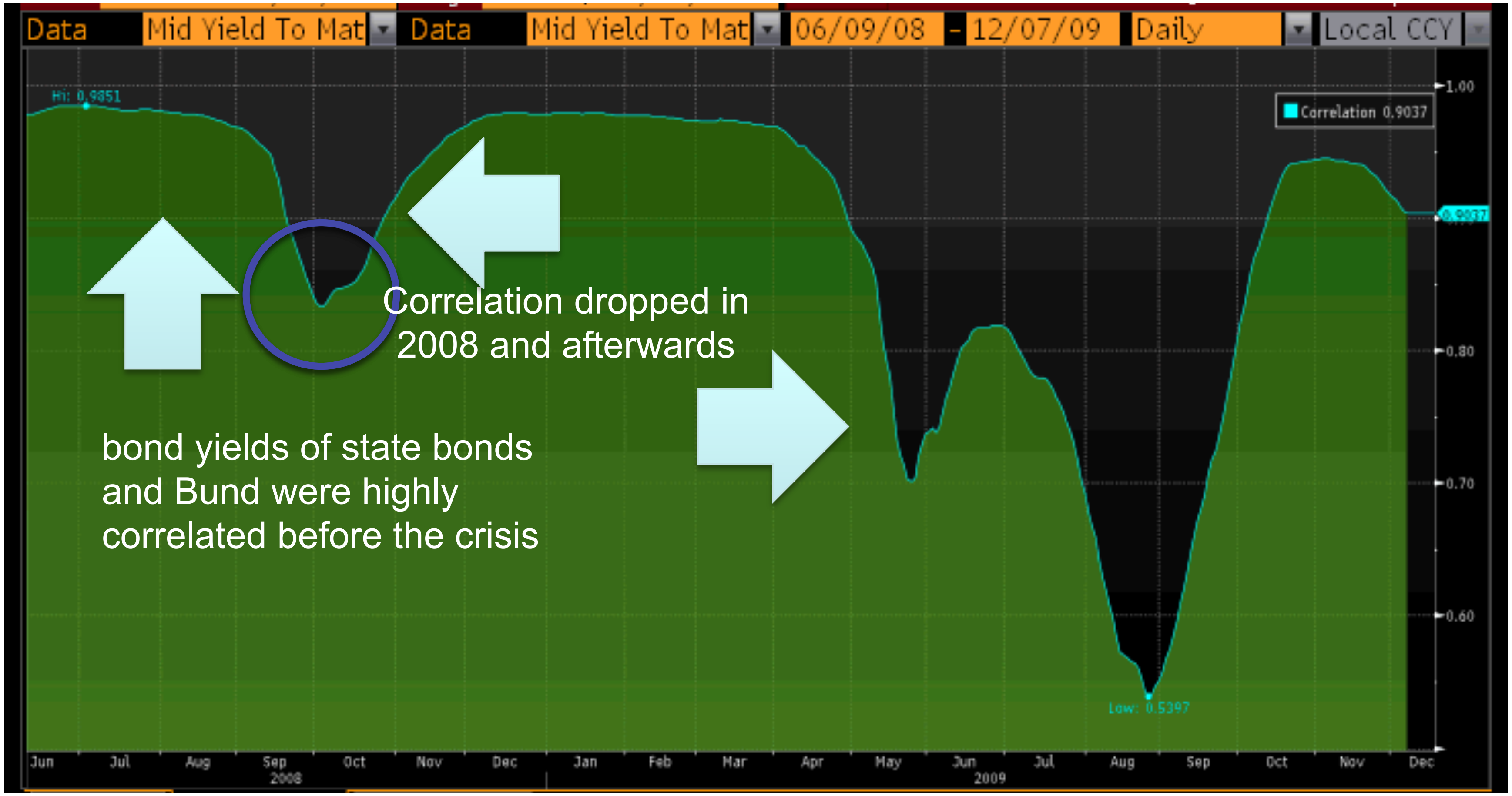
Correlation: 10Y Bond (Berlin) vs. 10Y Bund

High correlations of state with federal bond yields = investors do not differentiate risks

Crisis Impact II: Markets start to doubt the bailout guarantee (4/10)

Correlation: 10Y Bond (Brandenburg) vs. 10Y Bund

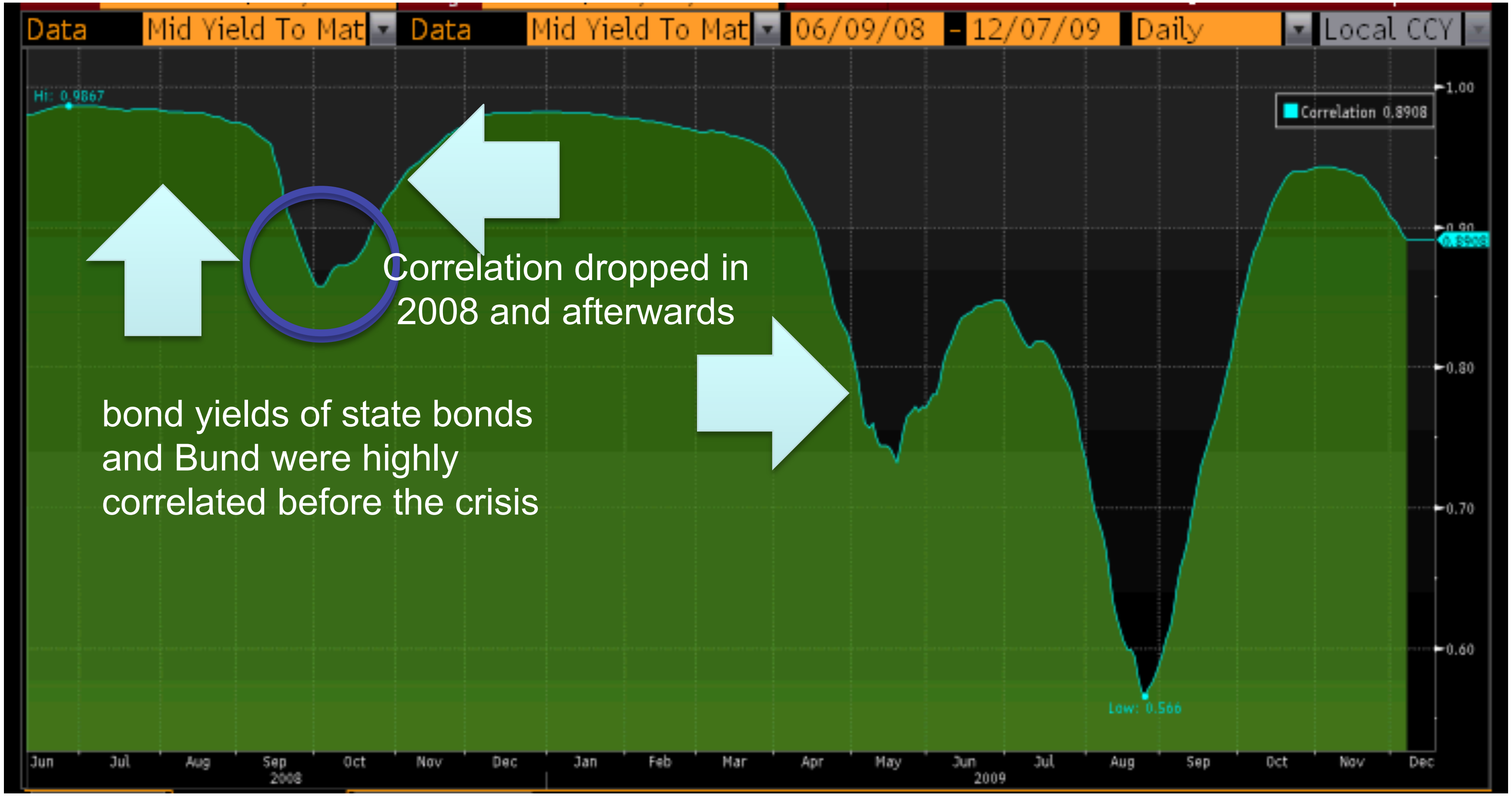
High correlations of state with federal bond yields = investors do not differentiate risks



Crisis Impact II: Markets start to doubt the bailout guarantee (5/10)

Correlation: 10Y Bond (Joint-German States) vs. 10Y Bund

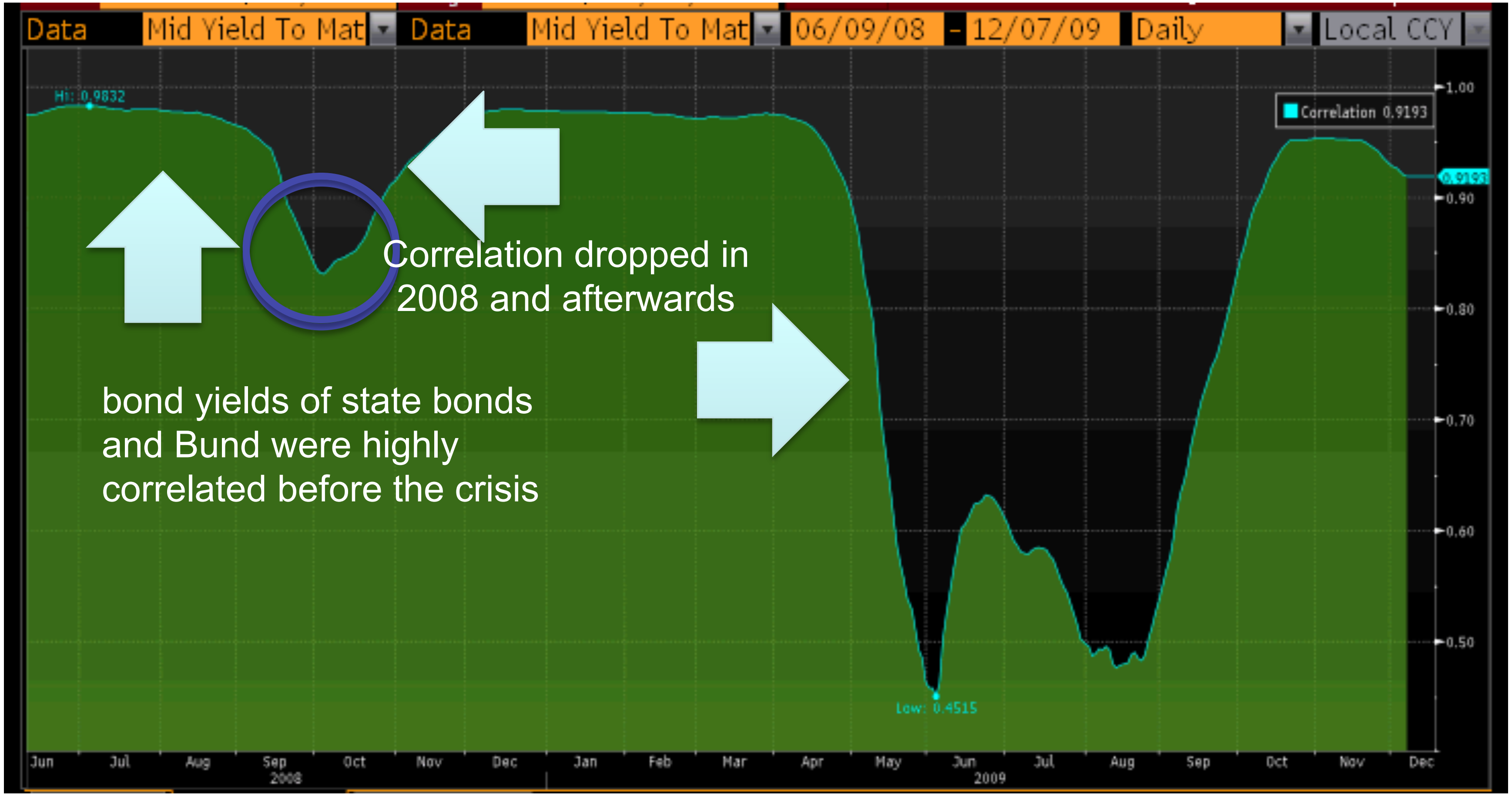
High correlations of state with federal bond yields = investors do not differentiate risks



Crisis Impact II: Markets start to doubt the bailout guarantee (6/10)

Correlation: 10Y Bond (Hessen) vs. 10Y Bund

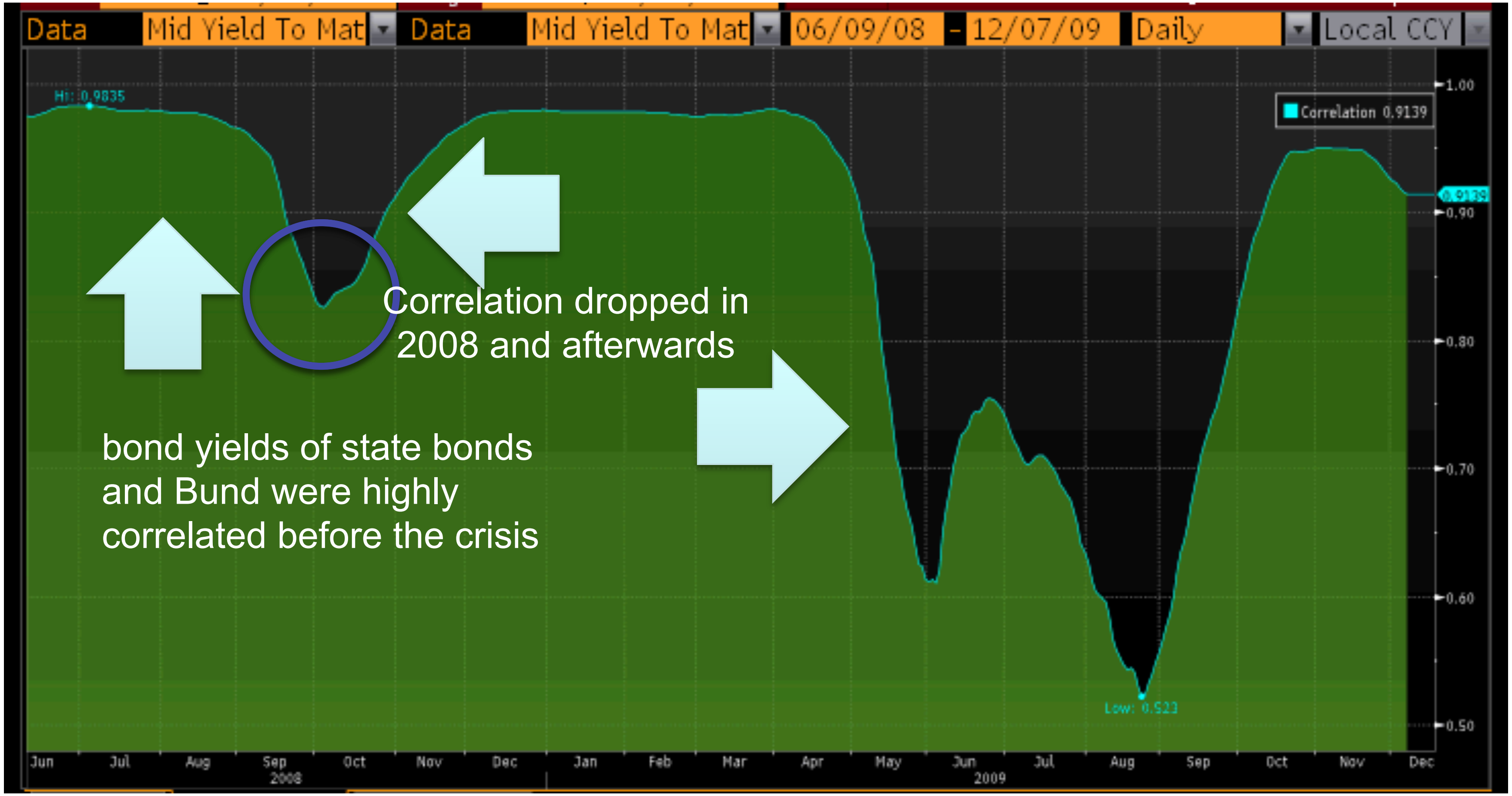
High correlations of state with federal bond yields = investors do not differentiate risks



Crisis Impact II: Markets start to doubt the bailout guarantee (7/10)

Correlation: 10Y Bond (NorthRhine Westphalia) vs. 10Y Bund

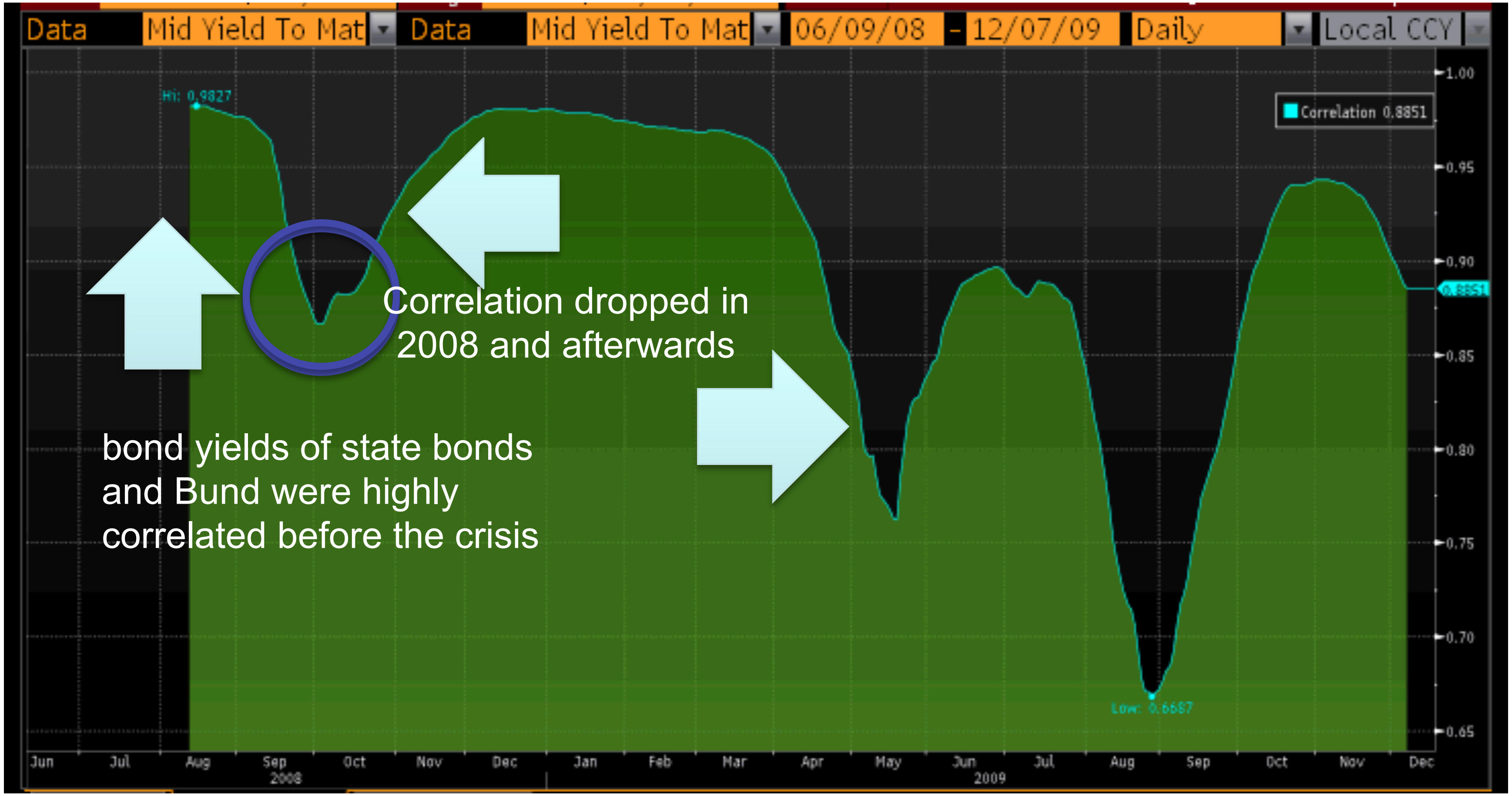
High correlations of state with federal bond yields = investors do not differentiate risks



Crisis Impact II: Markets start to doubt the bailout guarantee (8/10)

Correlation: 10Y Bond (Rhineland Palladine) vs. 10Y Bund

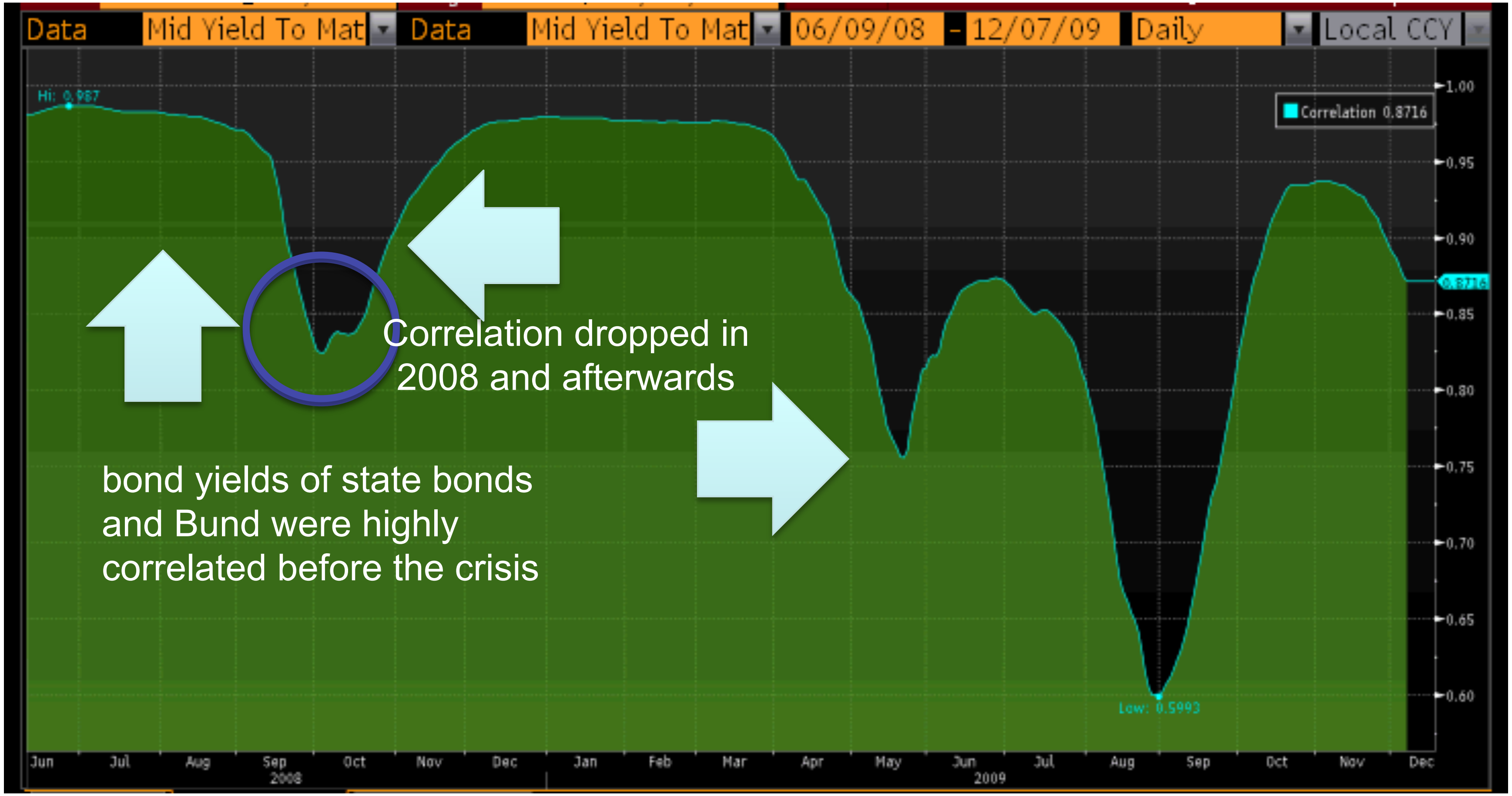
High correlations of state with federal bond yields = investors do not differentiate risks



Crisis Impact II: Markets start to doubt the bailout guarantee (9/10)

Correlation: 10Y Bond (Saxony Anhalt) vs. 10Y Bund

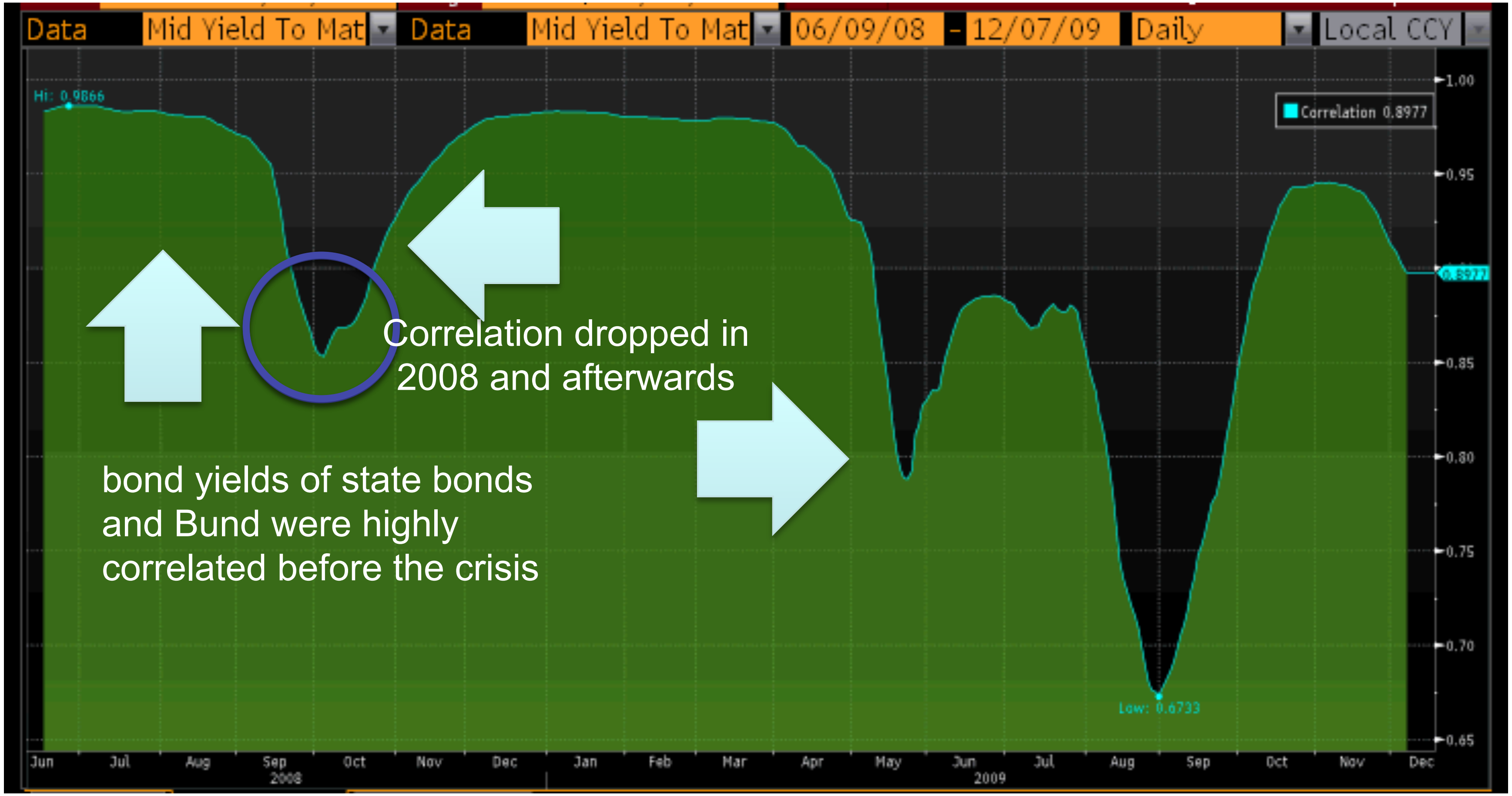
High correlations of state with federal bond yields = investors do not differentiate risks



Crisis Impact II: Markets start to doubt the bailout guarantee (10/10)

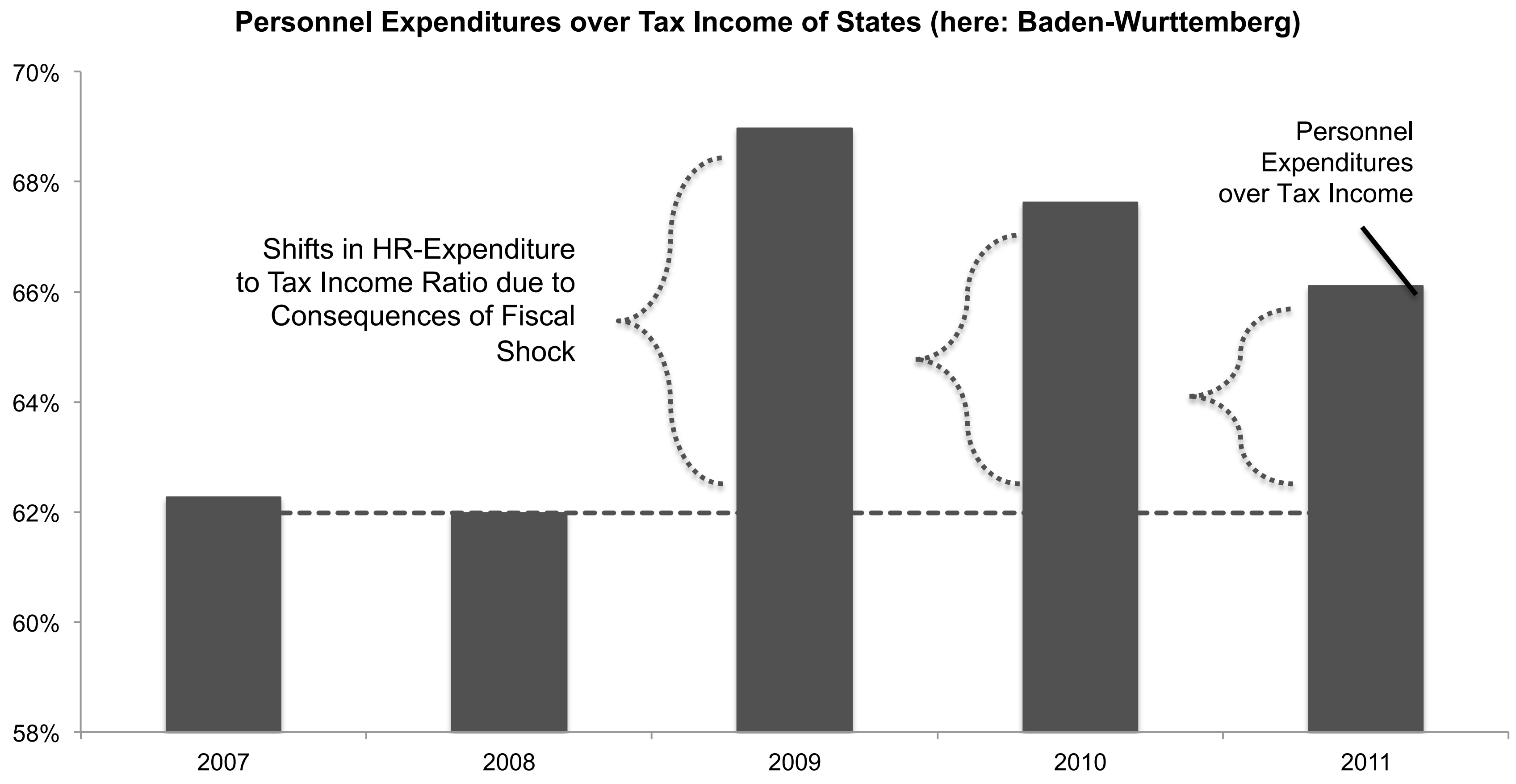
Correlation: 10Y Bond (Thuringen) vs. 10Y Bund

High correlations of state with federal bond yields = investors do not differentiate risks



Crisis Impact III: Fiscal pressure on Länder increases dramatically

The fiscal Illusion became apparent, when states were not able to absorb the fiscal shock through expenditure cuts, or additional tax revenues



III. What‘s next?

Has the crisis changed Germany‘s response to the “Fiscal Trilemma“?

- Many *Länder* will fail to meet the debt-brake requirements by 2020
- Solidarity is decreasing rapidly
  - Complaint to be filed by rich *Länder* at Constitutional Court
- Poorer and neutrally positioned *Länder* push for the introduction of „Deutschland-Bonds“
- Five *Länder* receive „consolidation aid“ and are under direct control of the new stability council, but the actual effects of that hierarchical control by the Federation are yet to be seen
- Landesbanken remain a key issue

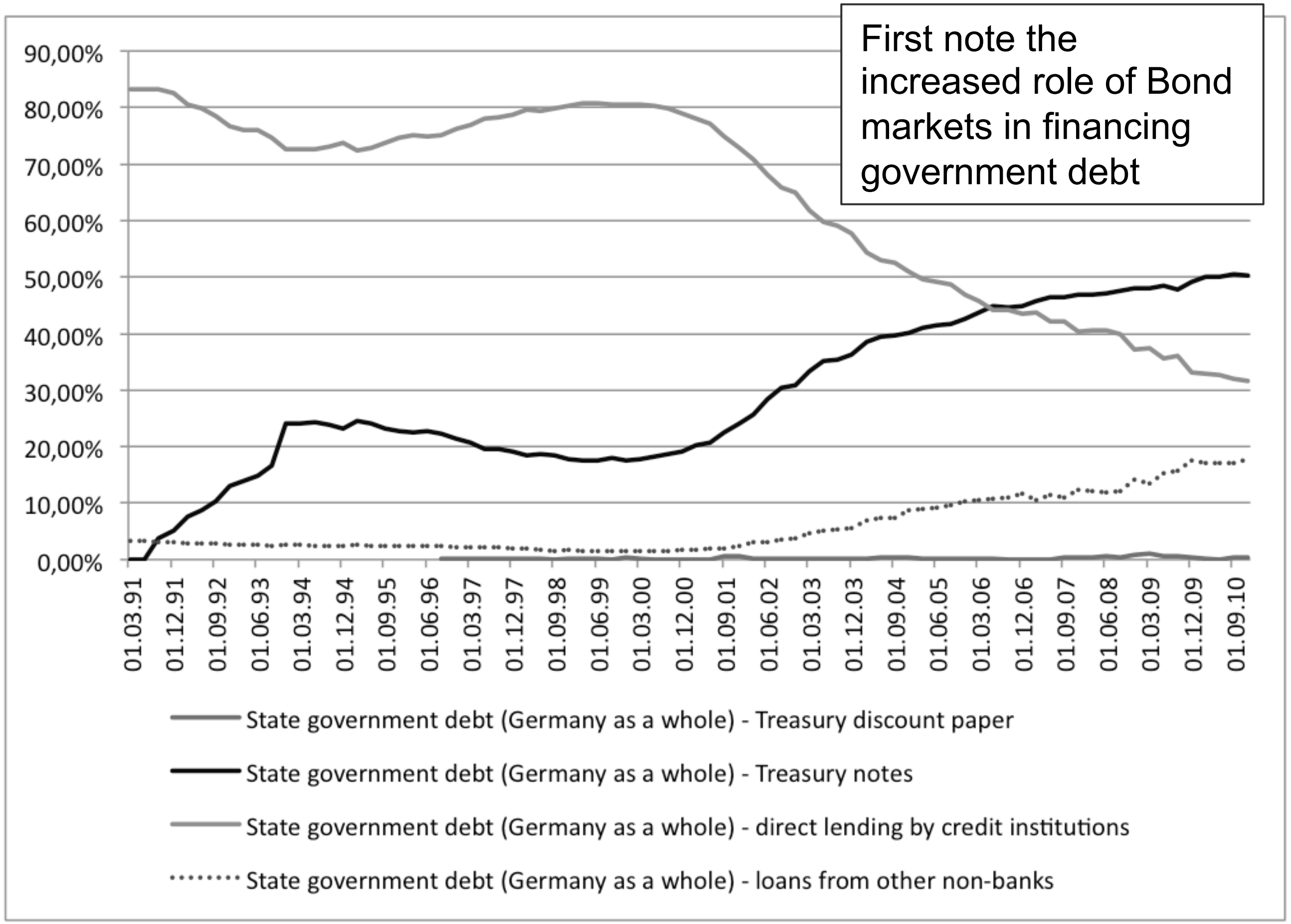
The endgame: 2019/2020 are the decisive years

- Help to the former GDR Länder will stop 2020
- The German equalization system will end 12/31/2019
  - Decision by the Constiutional Court
- Länder budgets will have to in structural balance

- What should we expect?
  - Working hypothesis: German *Länder* will behave more responsibly in the preparation of the end-of-decade endgame

Has the crisis changed Germany‘s response to the “Fiscal Trilemma“?

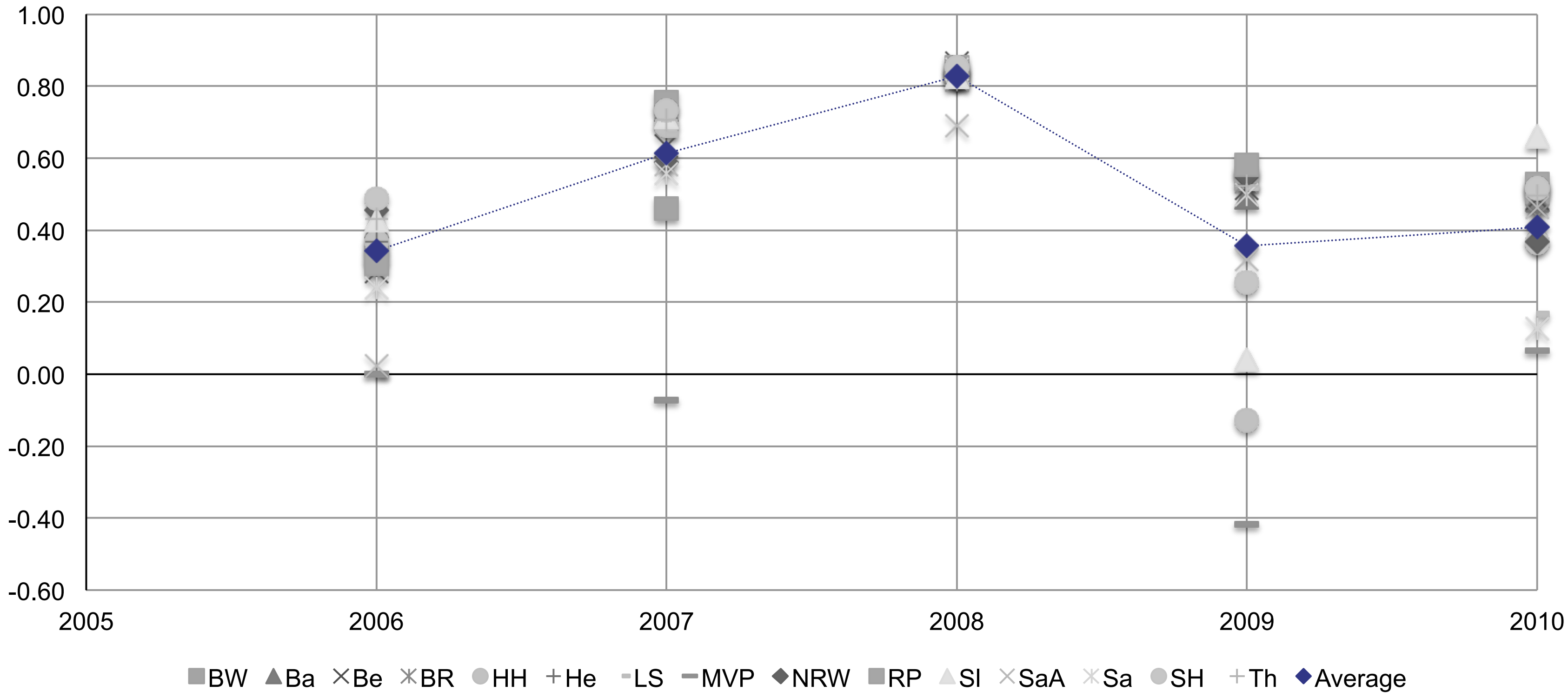
Did Mounting Fiscal Pressures Increase State Level Responsibility? What Do the Markets Say?



Has the crisis changed Germany‘s response to the “Fiscal Trilemma“?

Did Mounting Fiscal Pressures Increase State Level Responsibility? What Do the Markets Say?

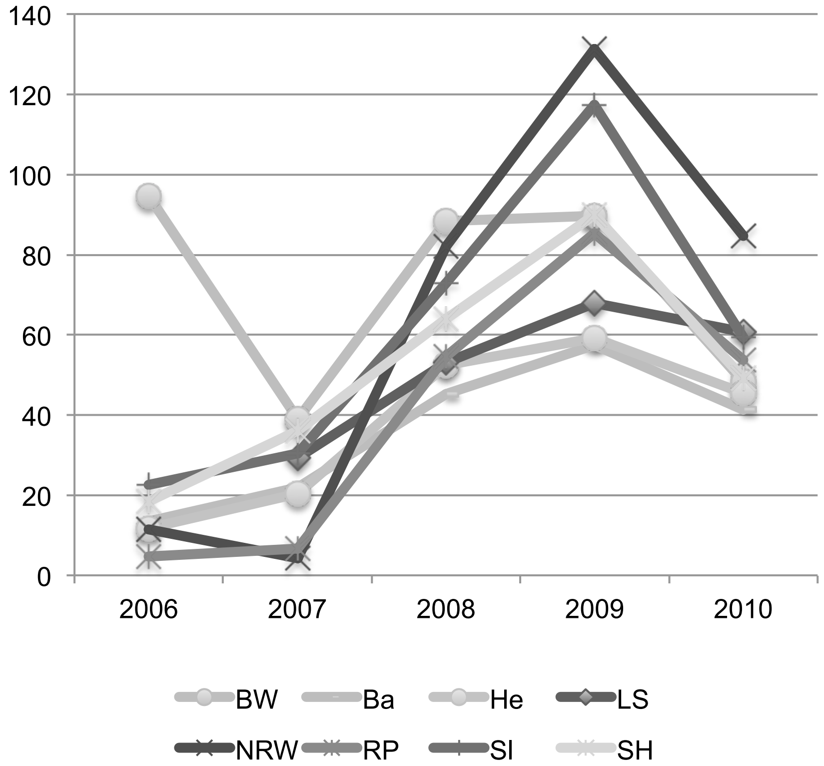
Observation: Correlations among state bond yields increased at the peak of the crisis. I.e. investors seemed to differentiate rather less than more between state specific risks: correlation puzzle?

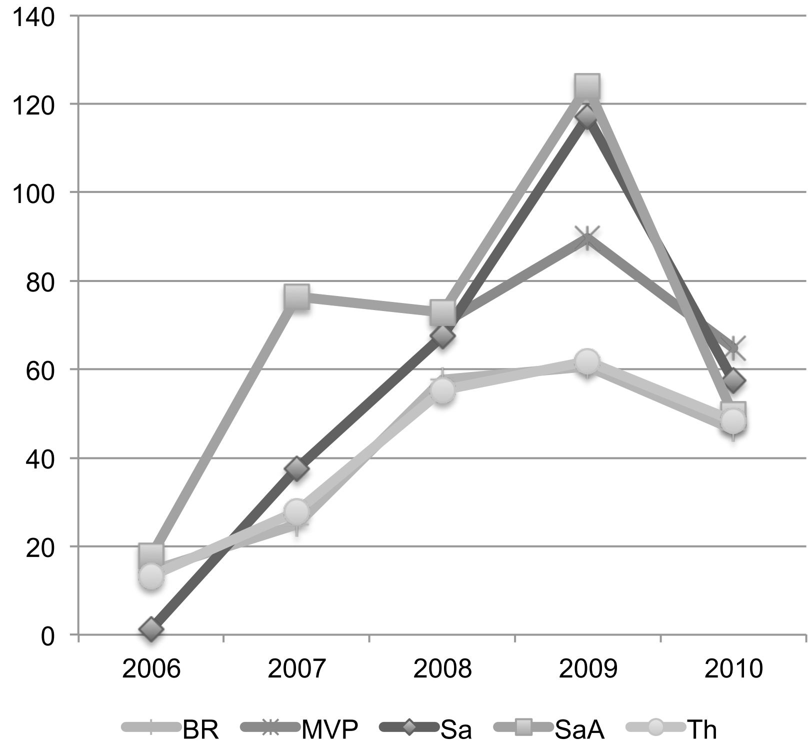


Has the crisis changed Germany‘s response to the “Fiscal Trilemma“?

Did Mounting Fiscal Pressures Increase State Level Responsibility? What Do the Markets Say?

The answer is: No – results only seemingly counter-intuitive: As one would In the course of the crisis, yield spreads between state of bonds issued by states over bonds issued by Bund widened…

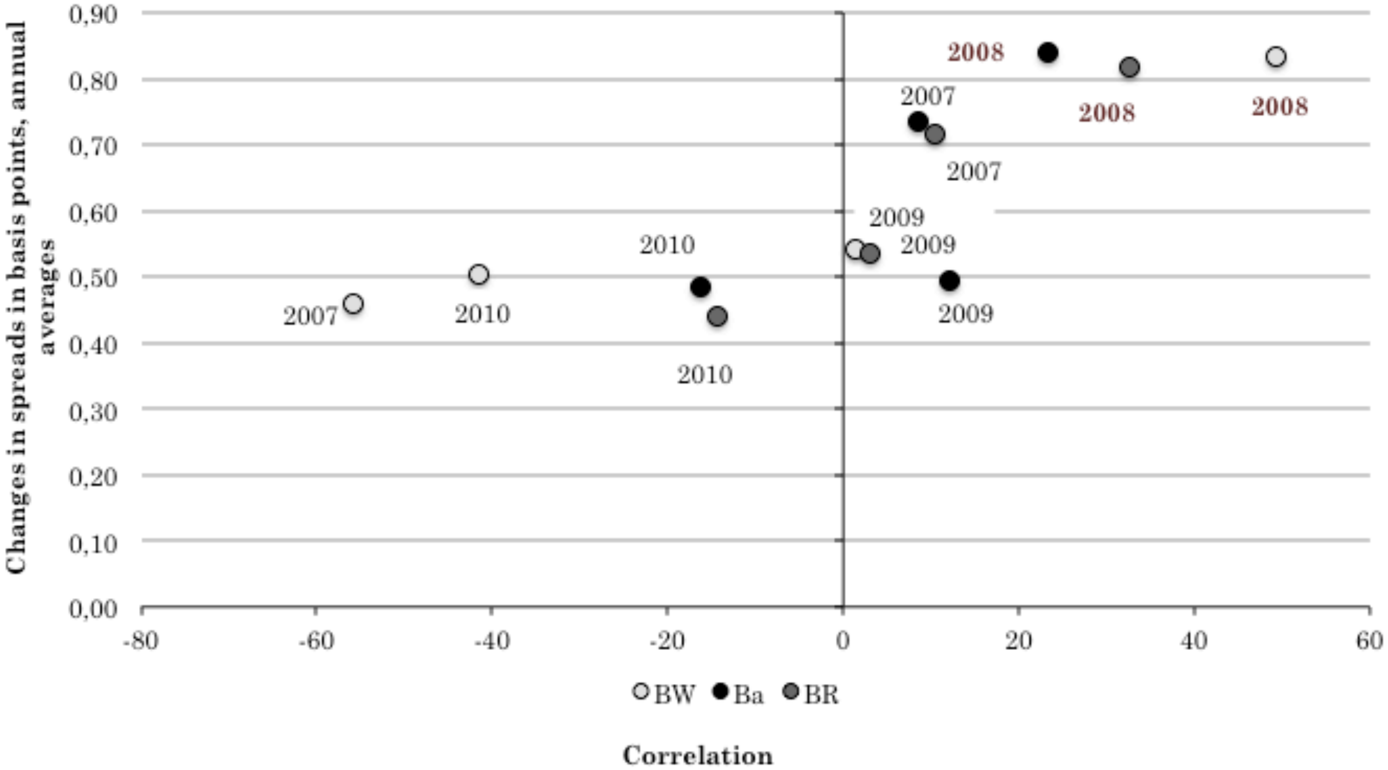




Has the crisis changed Germany‘s response to the “Fiscal Trilemma“?

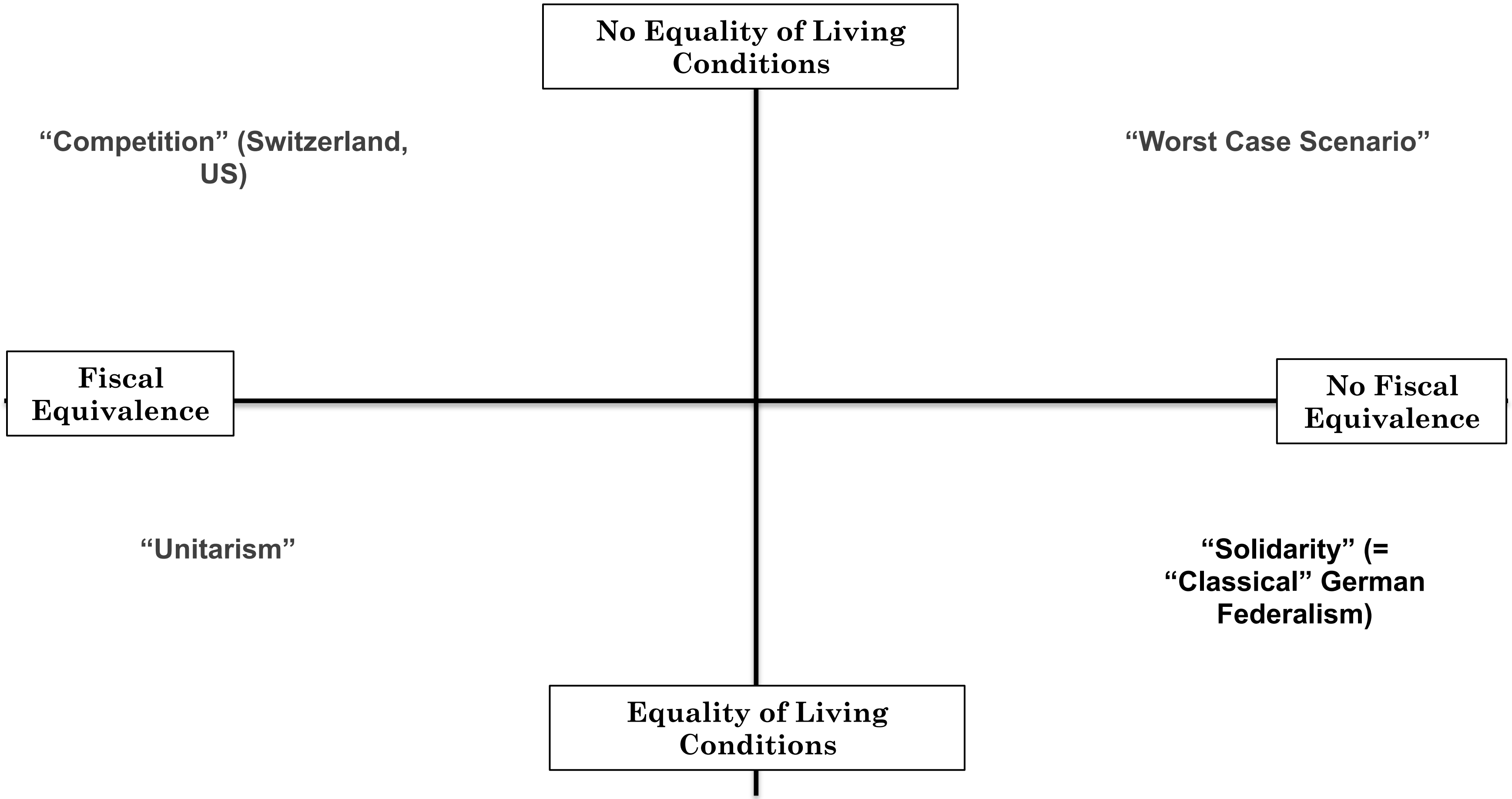
Did Mounting Fiscal Pressures Increase State Level Responsibility? What Do the Markets Say?

…but coinciding state bond correlation can be interpreted as symptom of the fact that markets assumed limits to federal state-liabilities, i.e. limits to Fiscal Solidarity in Germany



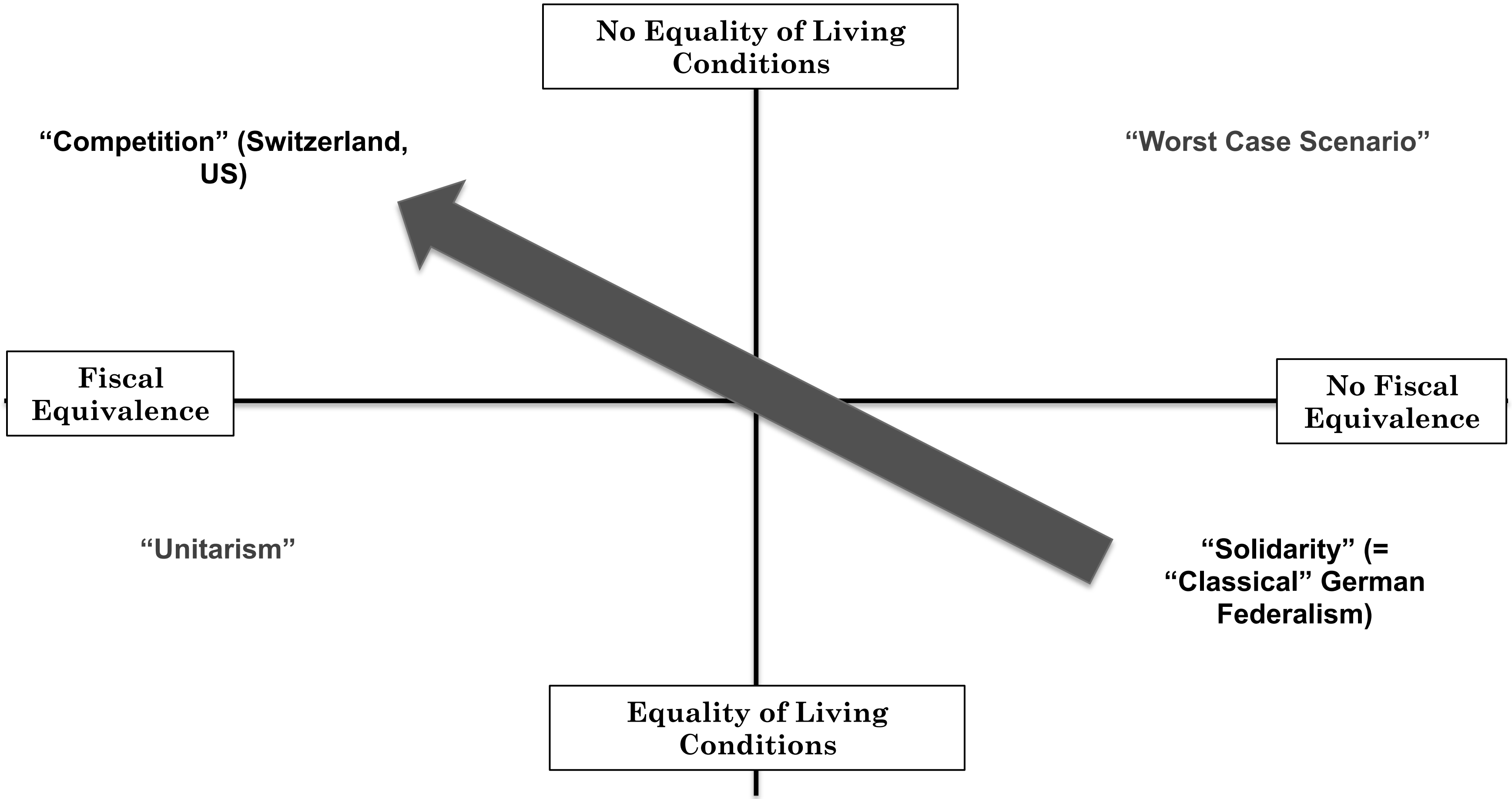
What will be the consequences for German federalism?

Various indicators that allow for a range of possible scenarios – German federalism at crossroads?



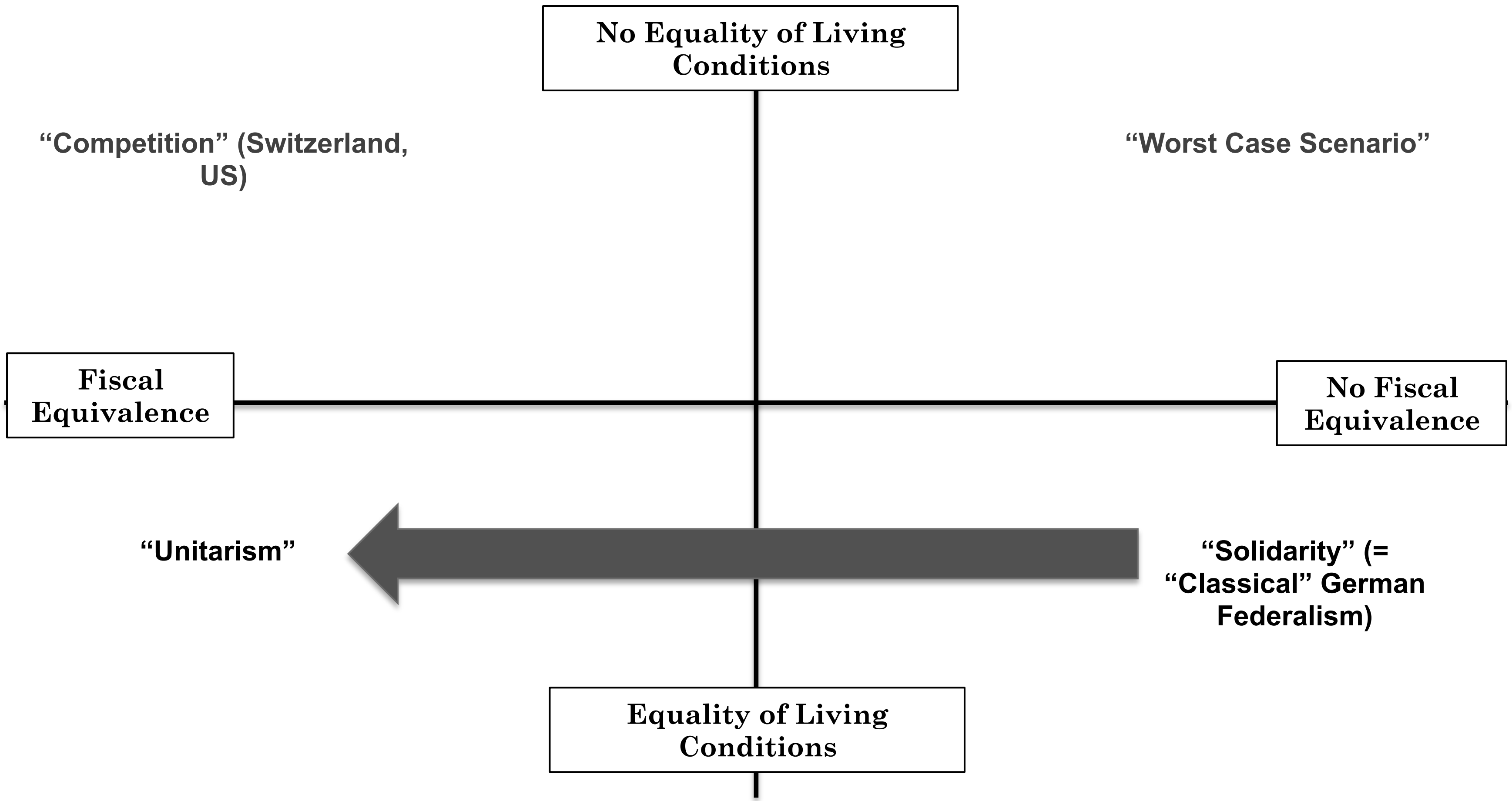
What will be the consequences for German federalism?

Market pressures on government finances (cf. Bond market discussion) can be interpreted as early indicators of shifts toward greater fiscal equivalence and competition



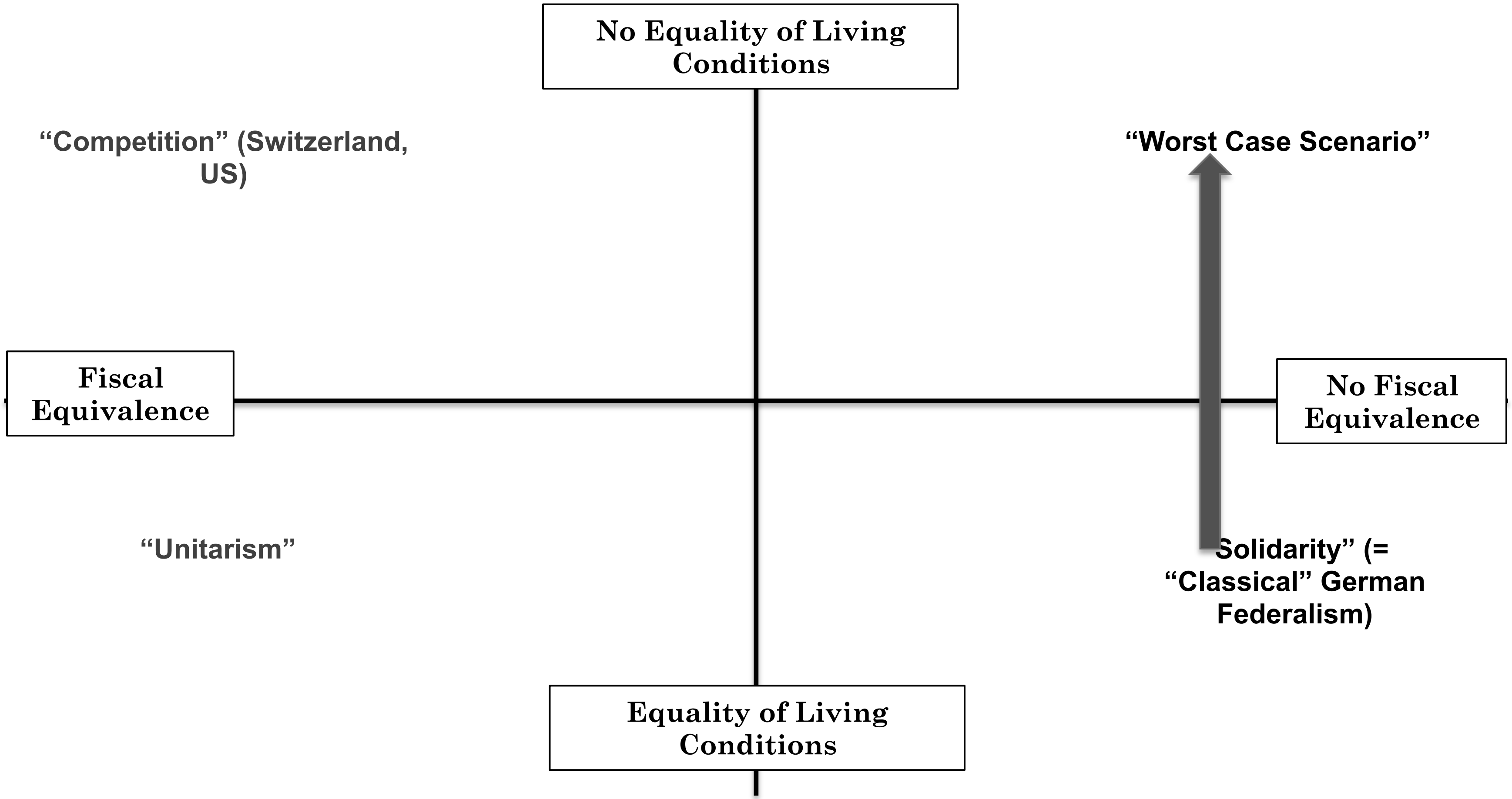
What will be the consequences for German federalism?

An alternative reaction would be tendencies of centralization (fiscal compact, debt brake)



What will be the consequences for German federalism?

Worst case scenario would be a bankrupt solidarity system where states had lost fiscal competences



B A C K U P

BACKUP

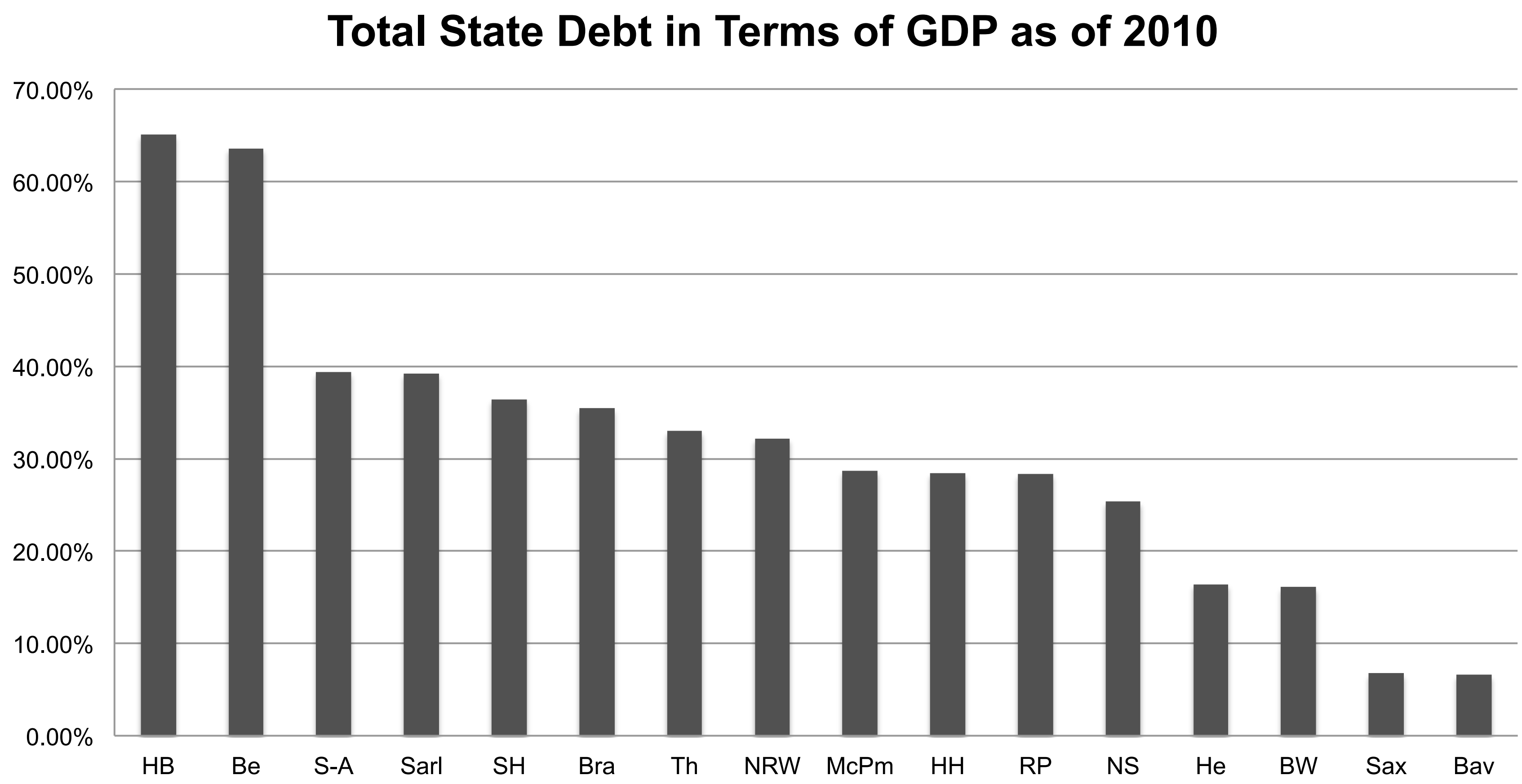
Discrepancies in tax competencies and expenditure obligations of German States result from federal and state-level burden sharing inherent to German (fiscal) federalism

Expenditure	Delivery of Service	Financing	Regulatory Powers
Defense	F	F	F
Environmental Policy	F, S, M	F, S, M	F, S, M
Education			
=> Primary	S,M	S,M	F,S,M
=> Secondary	S	S	S
=> University	S	F,S	F,S
Foreign Affairs	F	F	F
Health	F,S,M	F,S,M	F,S
Health Insurance	F,S	???	F
Immigration Policy	F,S	F,S	F
International Trade	F,S	F,S	F
Interstate Trade Regulation	F	F	F
Justice	F,S,M	F,S,M	F,S,M
Monetary Policy	F	F	F
Public Safety			F
=> Prisons	F,S,M	F,S,M	F,S
=> Police	F,S,M	F,S,M	F,S
=> Roads	F,S,M	F,S,M	F,S
=> Social Housing	S,M	F,S,M	F,S
=> Social Welfare	F,S,M	F,S,M	F,S
Transport			
=> Sea	F,S,M	F,S,M	F
=> Rail (passengers)	F,S,M	F,S,M	F
=> Air	F,S	F,S,M	F
Unemployment Insurance	F,S,M	F,S,M	F

Expenditure Assignments of Federal (F), State (S), and Municipal (M) Governments (after Tommasi 2011)

BACKUP

Net transfer receivers tend to spend more in terms of revenue (or is it that they receive more because they spend more)?



The Three Objectives (I): Representational Equivalence

- Power-sharing between center and units on fiscal matters
  - Decisions at the federal level that trigger a differentiating treatment of sub-national units have to be adopted with input from sub-national units to be considered as legitimate
  - Direct influence of sub-national units on politics at the federal level
- The "essence of federalism"
  - Constitutionally anchored in almost all Federations
  - Second chambers, territorial representation, institutionalized bargains between federation and sub-national entities
  - Key source of legitimacy
- Main indicators: existence of second chamber, legal and constitutional provisions

The Three Objectives (III): Fiscal Equivalence

- Olson (1969)
  - Congruence between the geographical scopes of government actions and their financing
  - “Pay your bills from your own income“
- Can be reached at different levels
  - Low or high degree of fiscal decentralization
- Avoidance of free-riding
  - Incentive not to contribute to the financing of goods
  - Incentive to overspend
  - “No representation without taxation”
- Main indicator: difference between sub-national income from own taxes and sub-national expenditure

The Three Objectives (II): Equal Living Conditions

- Create homogeneity and a national sense of belonging
  - Alleviate discrepancies due to economic, geographical or other circumstances
  - Often based on explicit constitutional provisions ("equal living conditions" in Germany), or implicitly derived from non-discrimination rules.
- Normative basis for horizontal or vertical transfers
  - Horizontal transfers: across sub-national units
  - Vertical transfers: federation to sub-national units
  - Transfers can be discretionary or automatic
- Indicators are not clear-cut
  - Process-based (existence of transfers, amount of money)
  - Outcome-based (degree of inter-regional inequality)

Why this Trilemma? (I)

- Competitive Fiscal Federalism can‘t reach the objective of equal living conditions
  - Main principles: fiscal equivalence and representational equivalence
  - Sub-national units finance a large share of their expenditures autonomously through own taxes
  - If automatic transfers were put into place to alleviate differences in living conditions, this would create an incentive to lower state-taxes
    - End of fiscal equivalence (→ „Solidaristic Fiscal Federalism“)
  - Discretionary transfers („grants“) avoid that effect, since sub-national units participate in the decision on those grants
    - Conditionality: free-riding can be punished

Why this Trilemma? (II)

- „Unitary Fiscal Federalism“ can‘t reach the objective of representational equivalence
  - Main principles: fiscal equivalence and equal living conditions
  - Sub-national units finance a large share of their expenditures autonomously through own taxes
  - Central government corrects inter-regional disparities on the basis of a discretionary scheme
    - Sub-national units are not involved in the decision-making
  - If power-sharing at the central level was put into place, sub-national units would either seek an automatic transfer system…
    - End of fiscal equivalence (→ „Solidaristic Fiscal Federalism“)
  - … or fiscal transfers would be reduced at the cost of higher inter-regional inequality
    - → Competitive Fiscal Federalism

Why this Trilemma? (III)

- „Solidaristic Fiscal Federalism“ can‘t reach the objective of fiscal equivalence
  - Main principles: representational equivalence and equal living conditions
  - Automatic fiscal transfers to alleviate inter-regional disparities
  - To avoid free-riding, state governments do not set their taxes themselves
    - They receive a pre-agreed share of the national tax-income
  - The consequence is a big discrepancy between sub-national tax-expenditure and autonomous sub-national tax resources
  - Fiscal equivalence (i.e. an increase of own resources based on own taxes) would result in a race to the bottom

The indicators

	Representational Equivalence		Equal Living Conditions			Fiscal Equivalence	
	Lijphart	Huber/Ragin/ Stephens	Adjusted inter-regional Gini (OECD)	Disparity of Unemploy-ment	Individual Level Gini	Relative Fiscal Equivalence	Borrowing Autonomy (Rodden)
"Competitive"							
USA	5	2	0.178	28.7	0.355	-0.26	3
Canada	5	2	0.136	29.8	0.291	-0.28	2.7
Australia	5	1	0.054	33.8	0.308	-0.34	2.5
Switzerland	5	2		43.6	0.307	-0.18	3
Average	***5.00***	***2***	***0.123***	***34.0***	***0.315***	***-0.27***	***2.8***
"Solidaristic"							
Germany	5	2	0.145	25.9	0.272	-0.71	2.5
Austria	4.5	1	0.129	26.1	0.277	-0.53	1.6
Spain	3		0.124	26.5	0.353	-0.53	2.5
Average	***4.17***	***2***	***0.133***	***26.2***	***0.301***	***-0.59***	***2.2***
"Unitary"							
Finland	2	0	0.070	18.7	0.217	-0.24	3
Denmark	2	0	0.057	-	0.236	-0.41	1.5
Norway	2	0	0.046	16.9	0.238	-0.37	1.6
Sweden	2	0	0.034	18.2	0.221	-0.14	3
Average	***2.00***	***0***	***0.052***	***17.9***	***0.228***	***-0.29***	***2.3***