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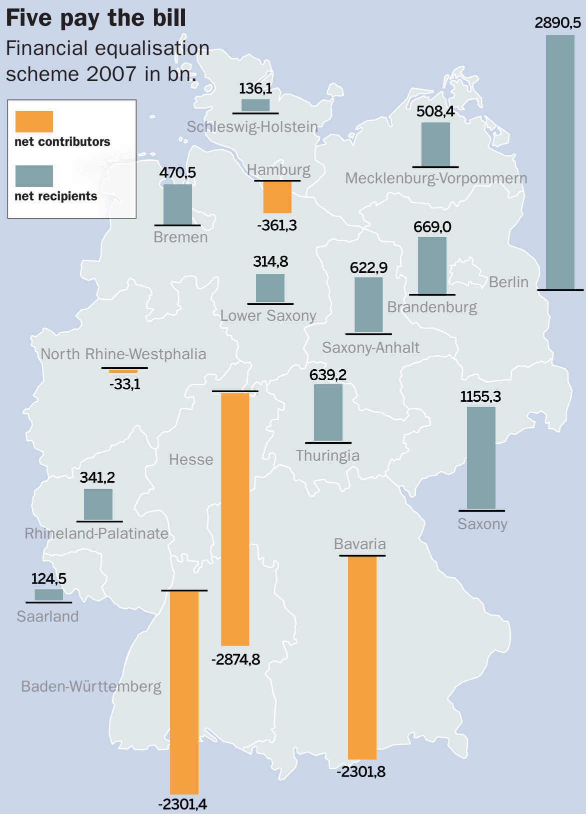

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Reform of the financial equalisation scheme in Germany: A never-ending story?

Thomas Lenk

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Contents

1. Some preliminary remarks on the German financial equalisation scheme and the model of competitive federalism

Since the Second World War the federal German financial equalisation scheme has undergone a process of perpetual development and, as the title suggests, is in a constant state of flux. Given the social changes taking place in the country, this is both understandable and essential. Financial equalisation is thus affected by the (changing) tasks of both the Federation and the states, as well as by revenue development, including the national debt. As Germany (now) has an extremely complex equalisation system, questions are repeatedly asked about making the system more efficient and transparent.

Before describing the existing German financial equalisation system and its pending reform, we must first examine the relationship between the constitutional regulation and the frequently cited notion of competitive federalism if we are to make an intelligent assessment of the system. The German financial equalisation system primarily pursues the distributive objective (based on the Basic Law or the German Constitution) of establishing 'equivalent living conditions throughout the federal territory'.[1] That this objective, which is often questioned in the political debate, should be achieved as efficiently as possible is beyond dispute in this context. However, frequent misconceptions have led people to believe that some of the arguments about allocation and growth that underpin the academic discourse on competitive federalism can be applied uniformly, that is, without taking into consideration the key assumptions on which the respective models are based.

To avoid drawing the wrong conclusion and to differentiate clearly between the different fields of analyses, the following section briefly outlines the key basic assumptions of the most important models of competition that target efficiency in

1 Until 1994, the Basic Law (BL) used the controversial and rigid term of "uniform living conditions" throughout the federal territory (Article 72, para. 2 BL); after reunification, this was changed to "equivalent" and thus diluted.

allocation and provision.[2] This form of state competition usually involves the (tax-paying) population and entrepreneurs. Most of the economic models in this context are based on the Tiebout model of fiscal federalism (1956), and the following assumptions are imperative if the model is to be implemented:

i. The states must enjoy expenditure and tax autonomy. This very first assumption, if competitive federalism is to function between the states, finds no mention in Germany's cooperative fiscal constitution (Finanzverfassung). In other words, the constitution lacks an essential prerequisite for competition-based federalism.
ii. If the first demand – autonomous expenditure and taxation policies for the states – is met, the states would have different tax rates and assessment bases. Tax revenue would vary from state to state, and the public services offered in the respective states would differ in terms of quality and quantity. This would contradict the constitutional requirement of establishing equivalent living conditions, besides undermining the existing fiscal constitution.
iii. Furthermore, the efficiency gains targeted by the model can only be realised under conditions of 'fiscal equivalence', implying that the citizens of a state should assume the costs incurred for the provision of public goods in that particular state. The expenditure and income side would therefore have to be de-linked in the fiscal constitution, which again would be incompatible with the regulations specified in the current laws.

As Germany's existing constitutional framework prevents these conditions for competitive federalism between the states from being realised, it becomes clear that this form of federalism, even if politically desirable, necessitates sweeping constitutional changes. As such a change was not addressed by the Federalism Commission I or by the Federalism Commission II, for the time being, the premise must be fiscal solidarity between the government units.

2 More recent models that also consider income distribution to be a state task have come to the conclusion that while efficient allocation and provision may be possible, they are not necessarily translated into practice. The results largely depend on how the competitive framework is shaped (see for example T. J. McGuire (1991), Federal Aid to States and Localities and the Appropriate Competitive Framework, in: D. A. Kenyon and J. Kincaid (eds.), *Competition among States and Local Governments: Efficiency and Equity in American Federalism*, Washington, D.C., pp. 153–66; D. Wellisch (1995), *Dezentrale Finanzpolitik bei hoher Mobilität*, Tübingen; T. Besley and A. Case (1995), Incumbent Behaviour: Vote-Seeking, Tax-Setting, and Yardstick Competition, in: *American Economic Review* 85, pp. 25–45).

2. Milestones in fiscal development and fiscal policy in recent decades

As a rule, the public finance sector should aim for a balanced budget, that is, the planned ordinary revenue (without state debt) should be aligned with the planned expenditure in the budget. If this is not the case, there is no option but debt. In recent decades the trend of the federal debt as well as that of the states and the municipalities has meant that the capacity of a budget is already drastically curtailed by the volume of the debt and the consequent interest burden. Although the Basic Law (BL) of 1949 allowed the state to run up a debt 'only in extraordinary need and as a rule only for expenditure for economic purposes' (Art. 115 GG, old version), until 1969, there were few possibilities for state debt. In the wake of the West German economic miracle the fiscal constitution was modified in 1969 and, coupled with the oil price crisis of the early 1970s, it fuelled the implementation of a Keynesian economic policy; the former object-based debt rules now made way for a situation-based debt policy. Because of the debt policy described below (adopted as a result of the economic policy then prevailing) and the expanding welfare state, the levels of debt at each tier of government increased steadily until 1969, and sharply after 1974. Initial efforts at debt consolidation launched in 1983 'only' reduced the net borrowing, so that the debt, slowly but surely, continued to rise until 1989.

The cost of German unity is another key factor in debt development. The rise in federal debt has been primarily due to the German Unity Fund (*Deutsche Einheit*), the Compensation Fund, the Debt Redemption Fund, and the Federal German Rail Property Fund, in addition to the revenue expected (but as yet absent) from the measures aimed at privatising the Trust Agency (*Treuhandanstalt*). The integration of the new states into the federal financial equalisation scheme in 1995, coupled with the high unemployment rate, has put further strain on the budgets.[3] It must however be stated that the commitments following reunification are a financial burden that cannot be erased over a single generation.[4] As to the choice of a fiscal constitution that would have been better able to fulfil the commitments made in the wake of German reunification – the question is open to debate.

Besides the reunification-induced financial burden on the government units, as of the year 2000 revenue increase lagged behind the growth of nominal gross dome-

3 Lenk and Kuntze (2007), p. 35f.
4 Bofinger, Lenk, and Schneider (forthcoming), p. 53.

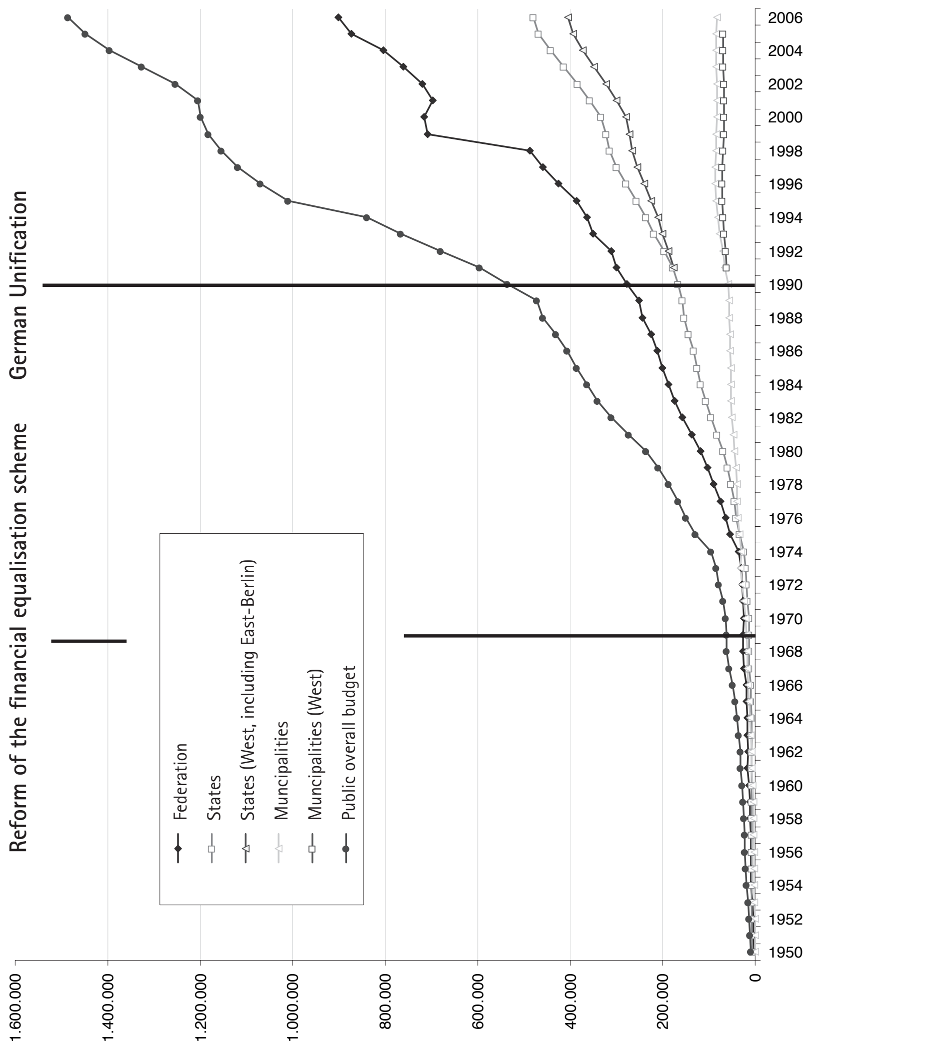


Diagram 1: Debt levels of public overall budget in million euros

Source: Compiled by the author based on information from the Federal German Statistical Office.

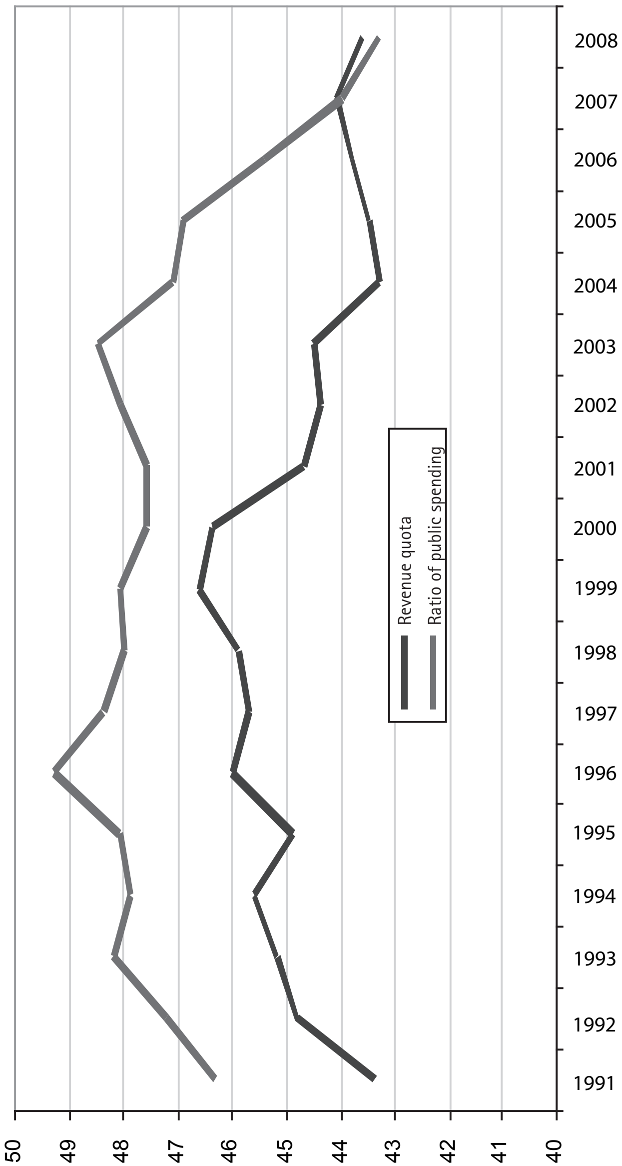


Diagram 2: Revenue quota and ratio of public spending to GNP in Germany, as a percentage of nominal GDP

Source: Joint diagnosis (2007).

stic product (GDP), leading to a rise in debt, as expenditure could not be recouped as quickly as was necessary to achieve a balanced budget. Thus, the share of revenue fell from 46.4 percent in 2000 to 43.5 percent in 2005, while expenditure remained more or less the same (see Diagram 2). This development may be explained in the main as the result of the substantial tax cuts that were undertaken as part of the tax reform.[5]

The consolidation of the federal and state budgets is beginning to take shape only slowly (Diagram 3).

It is significant that by 2010 the states together will have a positive budget balance to show vis-à-vis the Federation. By 2007, five states had managed to balance their budgets: Bavaria, Berlin, Mecklenburg-Western Pomerania, Saxony, and Thuringia. Almost all the other states are aiming for a budget without incurring fresh debts by 2011. Only Saarland and Schleswig-Holstein believe that a debt-free budget will not be possible until 2019 upon expiry of Solidarity Pact II.

Art. 115 of the BL, in conjunction with Art. 109, lays down the options for public borrowing and stipulates that loans shall not exceed the total amount of investment expenditure (Art. 115, para. 1, BL). The intention is to work towards achieving finance-intensive goals that hold out good prospects for the future.[6] This law, which applies to the normal economic situation, is supplemented by another law outlining the procedure 'to avert a disturbance of the overall economic equilibrium'.[7] If there is a threat of such a disturbance, the credit limit is extended – the funds borrowed may exceed the investment expenditures. As the law is ambiguous on the concepts, the pertinent article of the constitution has often been open to an extremely flexible interpretation, making it possible to stretch a loan.

The objectives of the Federalism Commission II are to determine:

- how to limit a normal debt
- whether and how net borrowing is permissible in the case of repeated crises cycles
- the extent to which the instrument of debt should be used in emergency situations, for example, natural disasters.

5 Bofinger, Lenk, and Schneider (forthcoming), p. 44f.

6 See Sachverständigenrat/SVR (expert advisory council) (2006), p. 302.

7 Art. 105, para. 1, BL.

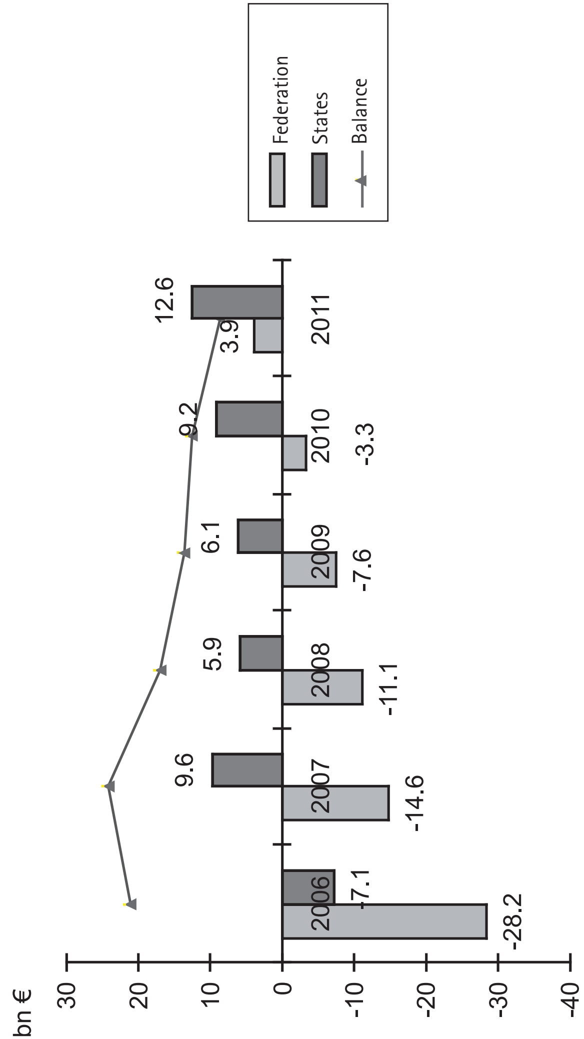


Diagram 3: Federal and state budget balances, 2006–2011

Source: Compiled by the author based on projections of the Central Data Centre of State Finance Ministers (ZDL).

For each of the three constellations, one must define the extent to which public borrowing will be possible. A decision must also be taken on how the current debt can be reduced with a view to achieving a sustainable fiscal policy.

3. Levels of financial equalisation

The Federation, the states, and the municipalities depend on funds to execute their public tasks. The individual tiers of the government are apportioned taxes or, respectively, a portion of the taxes for this very purpose. As state (or municipal) tax revenues vary greatly from region to region, additional instruments are required to ensure that tasks can be fulfilled despite the regional diversity.

The example of the state tax revenue in 2007 illustrates this problem. Of the total state tax revenue, EUR 103 billion was collected in the old states and only EUR 13 billion in the new states. Calculated on a per capita basis in the new states, this means that in the new states it was possible to collect only 45 percent of the average state tax revenue. Based on the premise that a large share of state funds (as a rule over 90 percent of the budget) is bound by federal and state law, federal, state, and EU programmes, and other commitments (for example, wage agreements and other contracts and agreements), certain kinds of expenditure (personnel and general administrative costs, interest payments, etc.) cannot in practice be influenced by state policy. It is therefore obvious that redistribution, especially in favour of those new states with a particularly weak tax base is particularly weak, is still necessary.

Besides transfer payments in the social security system (unemployment benefits, health insurance, long-term care insurance, and old age pension), requisite financial transfer payments are also made in the German financial equalisation system, which has existed in this form since 1969. The issue here is a legally bound redistribution system based on a fiscal constitution that coordinates financial relations between the different entities (Federation and states, along with their municipalities). Despite the fact that the volume of funds to be redistributed has increased substantially because of the integration of the new states, this system has not undergone any significant change even though several of the more detailed provisions have been adjusted and adapted to the new circumstances. This proves that the German fiscal order was – and continues to be – so 'flexible' that it could absorb even the unforeseen financial burden of German unity without the necessity of systemic changes.

3.1. Primary tax allocation

In terms of tax allocation, a distinction must be drawn between federal, state, and municipal taxes, on the one hand, and between joint taxes based on the integrated system, on the other. Federal taxes that account for about 16 percent of the total tax revenue accrue exclusively to the Federation. According to Art. 106, para. 1, BL, these taxes include custom duties, taxes on consumption (excluding beer tax), the solidarity tax surcharge (for aid for East Germany), and insurance contributions.[8]

Some of the tax revenue that accrues to the states includes the revenue in full from property tax, inheritance tax,[9] and transport tax, besides motor vehicle and beer tax (Art. 106, para. 2, BL)[10] In 2007, the volume of state taxes (based on the separation system) amounted to EUR 22.8 billion (4 percent of the total tax revenue). The revenue from local taxes on consumption and expenditure accrues to the municipalities (for example, dog and entertainment tax), as well as the revenue from trade[11] and real property tax. With regard to the latter two, the municipalities have a right to establish the rates at which taxes are levied, and can therefore adjust the taxable amount (Art. 106, para. 6, BL). Municipalities are thus entitled to about 9 percent of the tax revenue.

The revenue from joint taxes is divided between federal and state levels, with the possible participation of the municipalities (Art. 106, para. 3, BL). This body of taxes includes corporation tax, VAT (turnover tax), income and/or wage tax, and interest rebate. Table 1 shows the percentage-wise allocation between the tiers of government.

8 The Federation must, however, pay part of the duties, part of the levies, and part of its own revenue from VAT and GNP to the European Union.
9 If not collected jointly by the Federation and the states.
10 Not a complete list of state taxes.
11 Minus the Federation and the state shares of the receipts from capital business tax.

Table 1: Allocation of joint taxes in 2007 (in %)

	Federation	States	Municipalities
Corporation tax	50	50	-
Value-added (turnover) tax	54.7	43.3	2.0
Income/wage tax	42.5	42.5	15
Interest rebate	44	44	12

Source: Compiled by the author based on information from the Federal Ministry of Finance (BMF).

State tax revenue and the states' share of revenue from joint taxes are allocated within the framework of horizontal (primary) tax distribution based on the principle of local revenue (Art. 107, BL). The tax remains in the state in which it is collected.

The exceptions in the law are the allocation of income/wage tax to the individual states according to the residency principle and the allocation of corporation tax to states where the company maintains a business (Art. 107, para. 1, BL). In accordance with both principles, tax revenue is allocated to the state in which the employee has his/her permanent residence or in which state the company maintains its operations. Hence, of the EUR 538.2 billion in total taxes collected in 2007, EUR 408 billion is allocated to the tiers of government. The remaining EUR 130 billion – the revenue from turnover tax – is allocated as follows:

The percentage-based allocation of turnover tax to the government units is the flexible element of the financial equalisation system. In relation to their tasks, and hence to their expenditure, the Federation and the states can claim funds to cover the expenditure of executing these tasks. The percentage rates with regard to turnover tax allocation are adjusted on a regular basis with due regard to long-term financial planning. Moreover, a 'fair balance'[12] between the Federation and the states must be established, which ensures 'equivalent living conditions'. Both provisions are to be found in Art. 106, para. 3, BL. In the past, the turnover tax allocation had been slow in approaching a fifty–fifty distribution (see Diagram 4). In 1970, the Federation received 70 percent and the states 30 percent of the entire turnover tax revenue. Under this system, the municipalities have been entitled to revenue only since 1998. For them the share of turnover tax is compensation for the elimination of capital business tax.[13]

12 Art. 106, Abs. 3, BL.
13 Cf. Lenk (2001), p. 5.

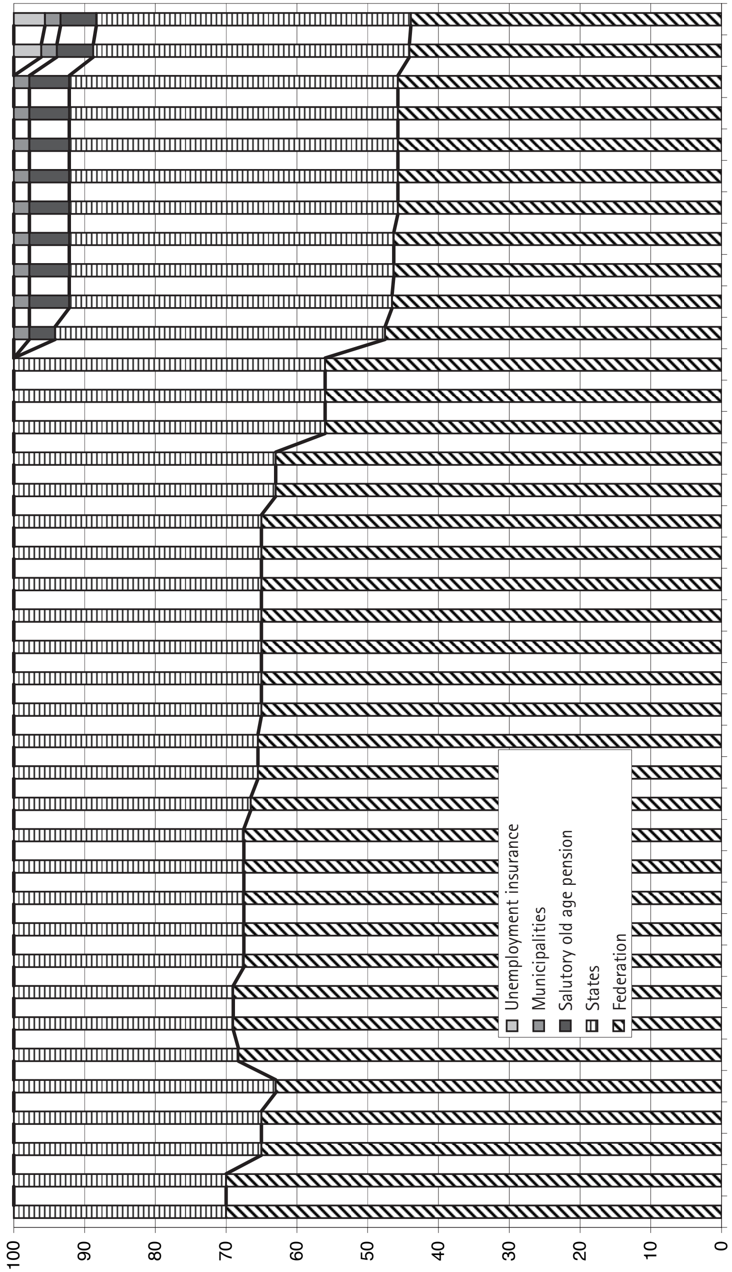


Diagram 4: Federal, state, and municipal share of turnover tax revenue* in %**

* Fixed amounts of turnover tax are not taken into account.

** The advance share of the Federation for statutory old age pension and unemployment benefits is shown separately.

Source: Compiled by the author.

With the integration of the new states into the federal German financial equalisation system, the original apportionment of turnover tax revenue has been adjusted. Initially the Federation surrendered 7 percentage points in order to finance the enormous increase in supplementary shares (Diagram 4).[14]

Turnover tax is allocated in several stages. Prior to allocation, a portion is deducted from the total tax revenue and is used for financing unemployment insurance. This arrangement has been in place since 2007 and currently accounts for 4.42 percent (as of 2009, the figure will be 4.45 percent). It is followed by a grant of 5.05 percent towards old age pensions. Of the remaining revenue, the municipalities receive 2.2 percent. The remaining turnover tax revenue is allocated to the Federation (50.5 percent) and the states (49.5 percent); this revenue allocation has been regularly adjusted in the past through negotiations on coverage quotas (Diagram 4). The states are obliged to give the Federation a fixed sum of EUR 2,262,712,000 from their share, which goes to the fund for German Unity to compensate the Federation for taking on the share of the states. The states' share of turnover tax is allocated to the individual states in two stages:

1. A maximum of 25 percent of the states' share of turnover tax can be granted to financially weak states in the form of supplementary shares (§ 2, section 1, FAG [Financial Equalisation Law]), in order to bring their tax revenue up to the state average. In 2007, a total of EUR 8 billion of the total turnover tax revenue was deployed to this end.

2. The remainder (that is, at least 75 percent) is based on the size of the population in the respective states (§ 2, section 3, FAG).[15] This distribution measure is applicable not only because of the parallels with the regional tax authority but also as a general yardstick to gauge need.

Once the turnover tax has been distributed, the total tax revenue is apportioned to the different tiers of government. The effect of the supplementary shares of turnover tax on expanding taxable capacity is illustrated in Diagrams 5 and 6.

14 Cf. § 1 Legislation governing financial equalisation between the Federation and states (FAG).
15 Cf. Lenk (2008), p. 33.

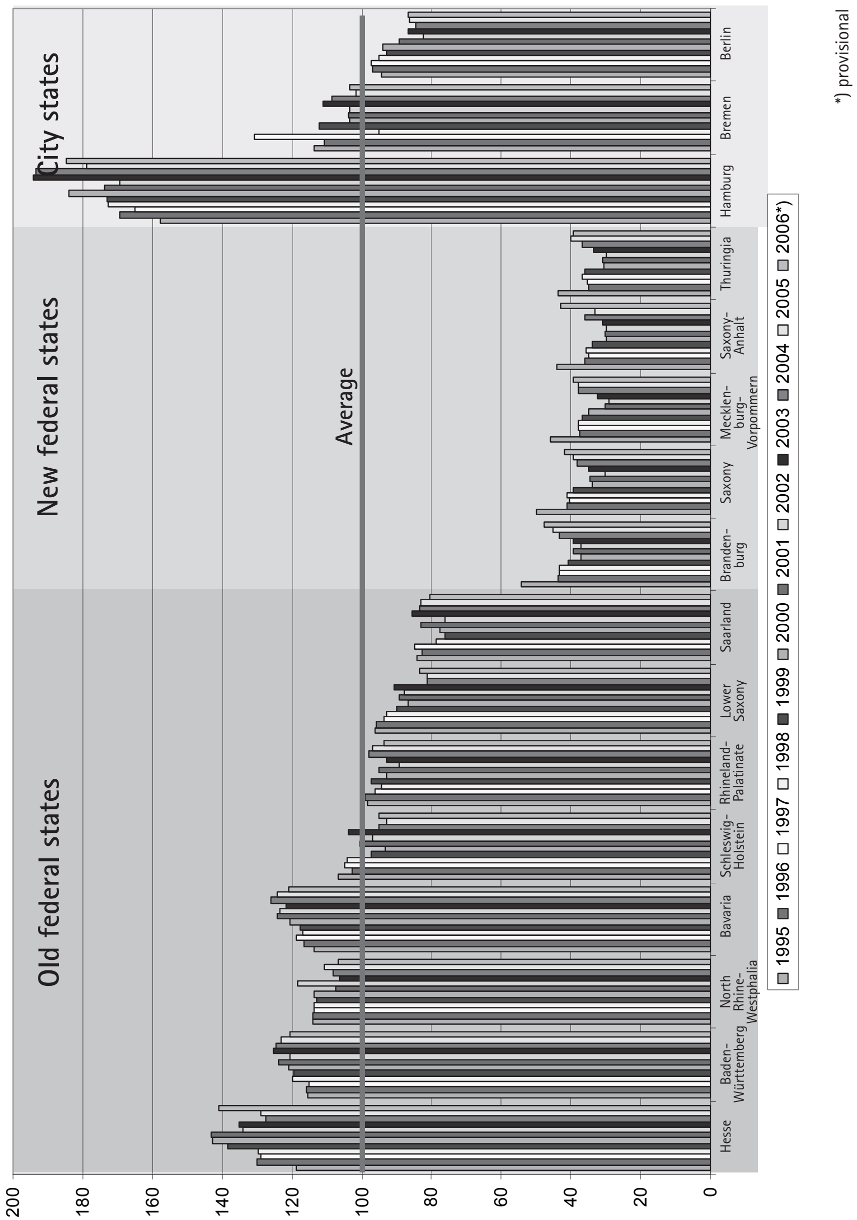
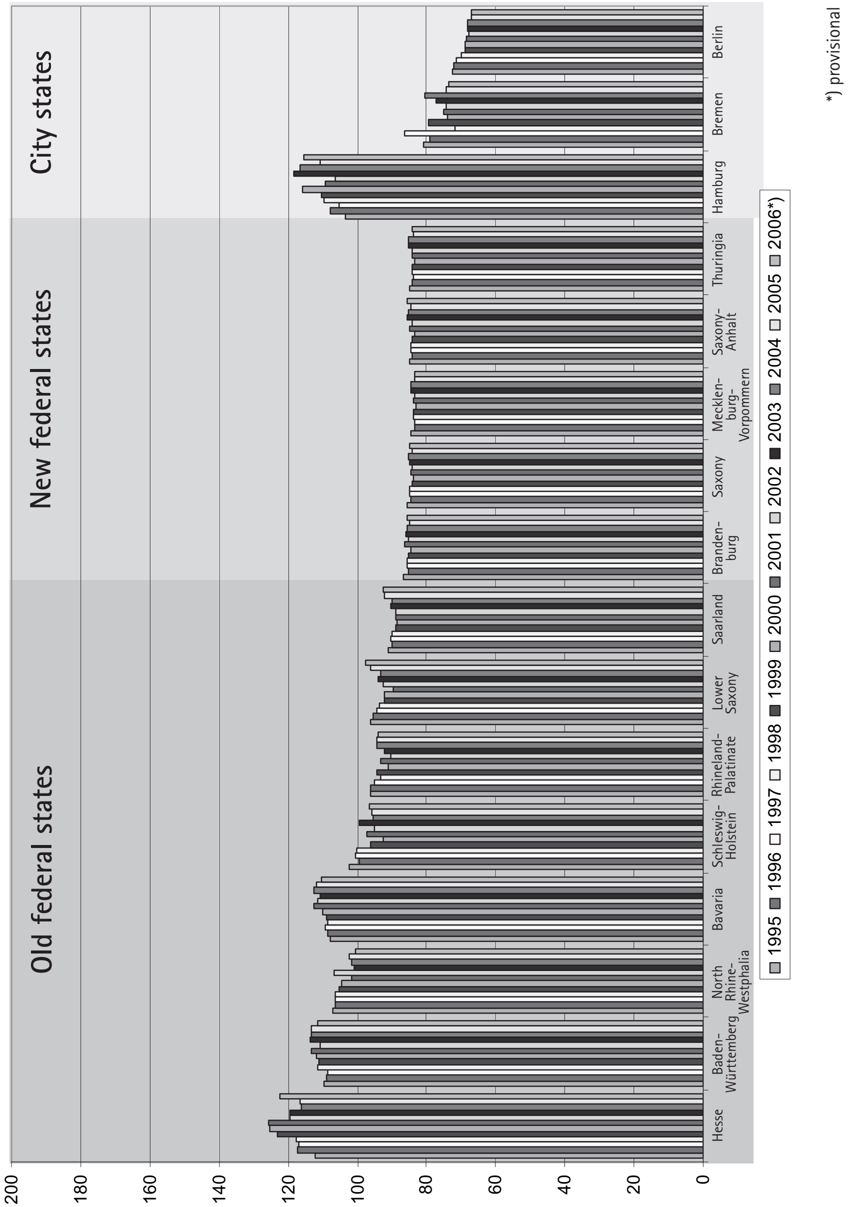


Diagram 5: State taxes based on per capita revenue as a percentage of the average, 1995–2007

Source: Compiled by the author.



Diagrams 6: Financial capacity of the states as a percentage of the Ausgleichs-messzahl* after allocation of turnover tax

Source: Compiled by the author.
* figure representing the target financial power or financial need.

The possibility of adjusting the coverage quota as a flexible element of the turnover tax distribution system has rarely been explored since German reunification. The federal and state finance ministers last agreed on a quota adjustment in 1993, with reference to the tax revenue. It was discussed again in terms of the criteria law that was introduced; parallel to Solidarity Pact II, this law was deemed necessary as a result of the judgment passed by the Federal Constitutional Court. However, the negotiations ended in a stalemate as the Federation was faced by a united stand taken by the states and since then a discussion on the subject has been evaded. The lack of debate on coverage quotas also sidesteps a typically fiscal and pragmatic view of fiscal distribution and of the conditions at the different levels of government. The following section outlines a few explanations as to why the turnover tax distribution system has lost its flexibility.

i. At state level, the use of taxes to cover expenditure has undergone a heterogeneous development since German reunification. It is difficult to achieve a common position among all the states.

ii. The states cannot assume that the Federation will allow itself to be pushed below the 50 percent mark.

iii. The Federation has virtually no prospects of allocating a higher quota for itself, as it has been giving a share of the turnover tax to the states since 1976.

At present one must speak of a temporary state of emergency until 2019. The notion of a normal public budget has disappeared since German reunification.

The former pragmatic implementation, oriented to the federal and state shares of the turnover tax in the form of a single value, is being increasingly undermined by fixed-amount solutions. The attraction of this arrangement can be explained on the basis of the following arguments:

i. Under the FAG, fixed-amount solutions for problems between the Federation and the states do not need to be relevant to a specific matter and neither do they have to be justified. Agreement at the political level alone suffices as a justifiable reason.

ii. Distribution is based on the number of inhabitants.

Fixed-amount solutions create a system for the financial equalisation of interests between the Federation and the states. A trend towards state- and sector-specific convergence of the financial flows is also evident. However, this method becomes problematic when horizontal necessities cannot be met through distribution based on the criterion of population size. The resultant problems can have an impact on specific laws, and even on the fiscal constitution.[16]

3.2. Financial equalisation between the states

After tax allocation, the first stage of the federal financial equalisation scheme is equalisation between the states (in the narrower sense) (see Diagram 7).

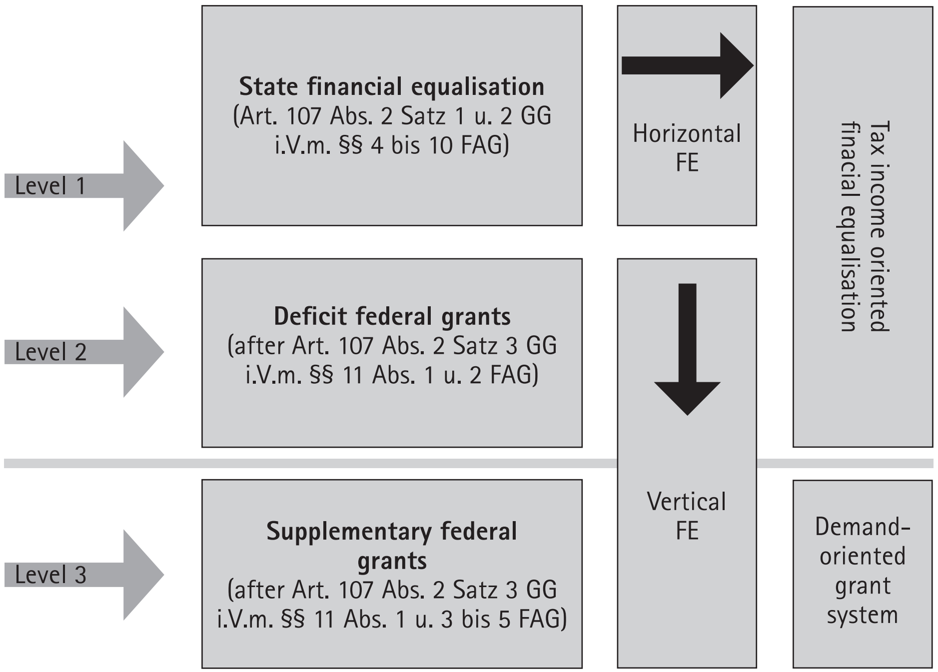


Diagram 7: The German financial equalisation system

Source: Compiled by the author.

FE=financial equalisation

16 See Woisin (2008).

This financial equalisation scheme further adjusts the differences in financial capacity between the states through horizontal transfer payments in accordance with Art. 107, para. 2, BL. What must first be determined here is the actual financial capacity (*Finanzkraftmesszahl*), that is, the financial possibilities actually available and the target figure that should reflect the financial need of a state, including its municipalities (*Ausgleichsmesszahl*) (see §§ 5 and 6, FAG).

Actual financial capacity is determined on the basis of the total revenue of the state in question and on 64 percent of the municipal revenue. In order to provide incentives for economic activity, there is a provision for retaining some of the revenue should a state experience above-average tax growth (premium).[17] Twelve percent of this above-average tax revenue will be free of equalisation, which means that it is not included in the financial equalisation scheme.

The figure indicating financial capacity is based on the financial strength that is expected to emerge if per capita income were to be on a par with the state average in the states (§ 6, section 2, FAG). When calculating the target figure, due consideration should be given to the size of the population of the city states (assessed at 1.35) and to that of the sparsely populated states (Mecklenburg-Western Pomerania 1.05, Brandenburg 1.03 and Saxony-Anhalt 1.02).[18]

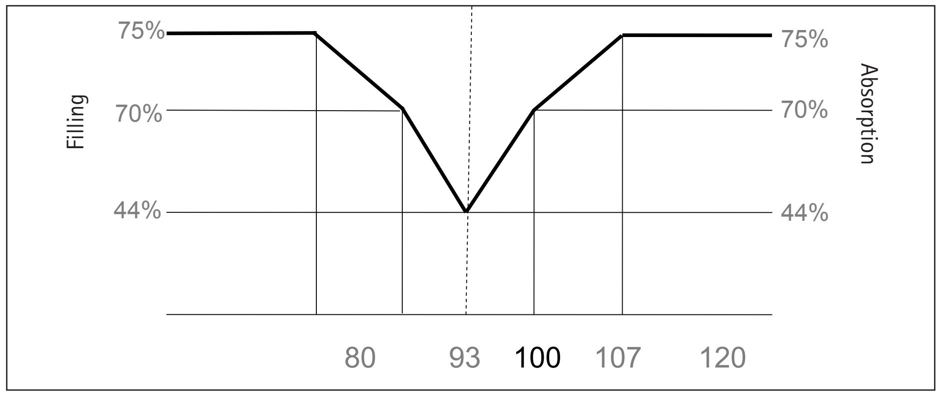


Diagram 8: Tariff under the state equalisation scheme

Source: Compiled by the author based on information from the Bavarian State Finance Ministry (2007), p. 17.

17 A premium is also awarded to a state when its taxes fall at a below-average rate even though there is an overall slump in tax revenue.

18 See § 9, FAG.

The relationship between the financial capacity figure and the target figure that reflects need will determine the relative position of a state. If this figure is less than 1, it follows that financial capacity is less than the target figure, and hence the state is entitled to equalisation; it will receive grants. Conversely, this means that the state is committed to equalisation. The equalisation of these differences is based on § 10, section 1, FAG. The resultant tariff is illustrated in Diagram 8.
Tariff development is to be interpreted as follows: if a state's relative position is less than 80 percent (and/or over 120 percent), the gap in financial capacity will be closed up to 75 percent (and/or 75 percent of the surplus financial capacity will be incorporated into the financial equalisation scheme); if it approaches 100 percent, then only 44 percent will be incorporated.

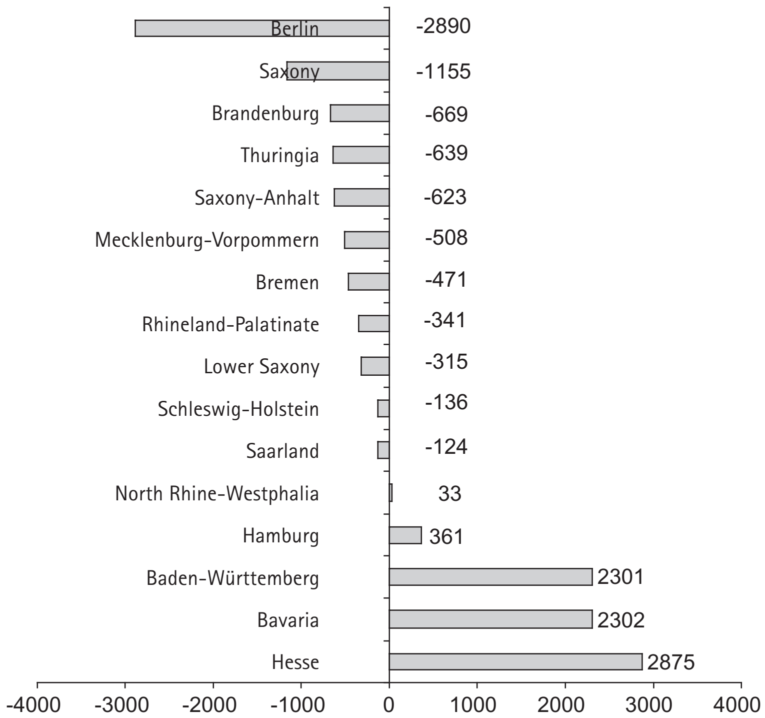


Diagram 9: Financial equalisation among states, in million EUR (2007)

Source: Compiled by the author.

Diagram 9 shows the resultant contributions of the individual states to financial equalisation and/or the amounts allocated by the equalisation scheme; in 2007 the amount for redistribution totalled EUR 7.9 billion. The equalisation system helps the per capita financial capacity of the states to be more on a par with each other (Diagram 10).

At this point in time, the financial capacity of the individual states has been more or less adjusted, as illustrated in the following diagram.

3.3. Vertical financial equalisation

The ensuing vertical financial equalisation differentiates between supplementary federal grants (BEZ) that cover deficits and those that cover special needs as regulated under Art. 107, para. 2, BL and as determined by§ 11, FAG.

1. Deficit coverage serves to equalise the remaining financial deficits. The difference in a state between its financial capacity after state financial equalisation and 99.5 percent of its equalisation figure is equalised up to 77.5 percent. In 2006, this equalisation amounted to a total of EUR 2.8 billion, enabling the financial capacities of economically weak states to approach their respective target figures (Diagram 11).

2. Special-need supplementary grants impact on different areas. On the one hand, they are geared to equalising the excessively high costs of political leadership. Currently, ten financially weak states are receiving this grant. At EUR 0.5 billion, this supplementary payment is the lowest. The far larger part of these equalisation payments goes towards financing the special burdens caused by reunification. Within the framework of Solidarity Pact II, the new states will continue to receive a total of EUR 105 billion until 2019. The payments are designed to be regressive. Starting with EUR 10.5 billion in 2005, the grants decline to EUR 2.1 billion per year until 2019. Eventually, the new states (with the exception of Berlin) will be granted a sum of EUR 1.0 billion to counter the high rates of structural unemployment.[19]

The ranking of states according to their financial capacity remains unchanged until the stage of determining the deficit coverage supplementary grant. Only supplementary grants for special needs can change the original ranking.

19 See BMF (2007), p. 47.

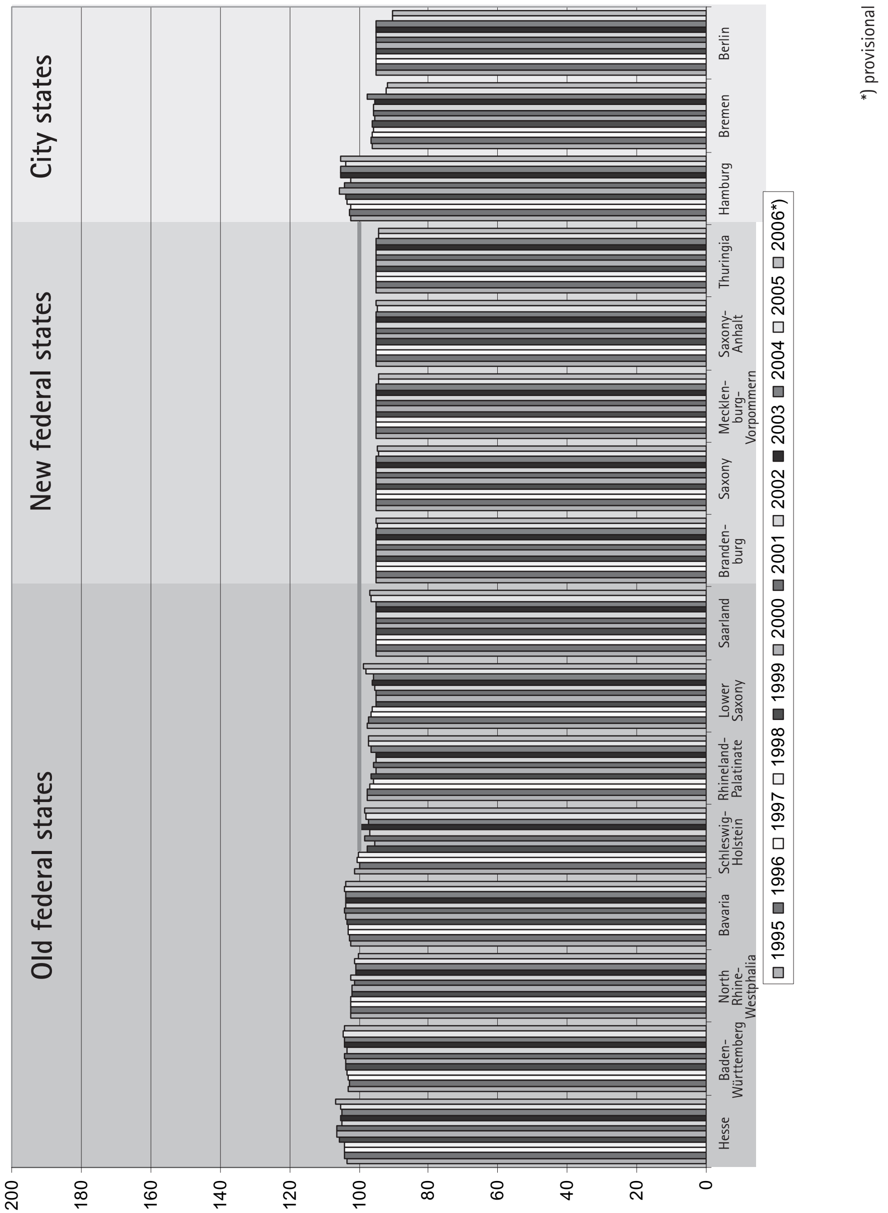


Diagram 10: Financial capacity after financial equalisation, as a percentage of the equalisation figure

Source: Compiled by the author.

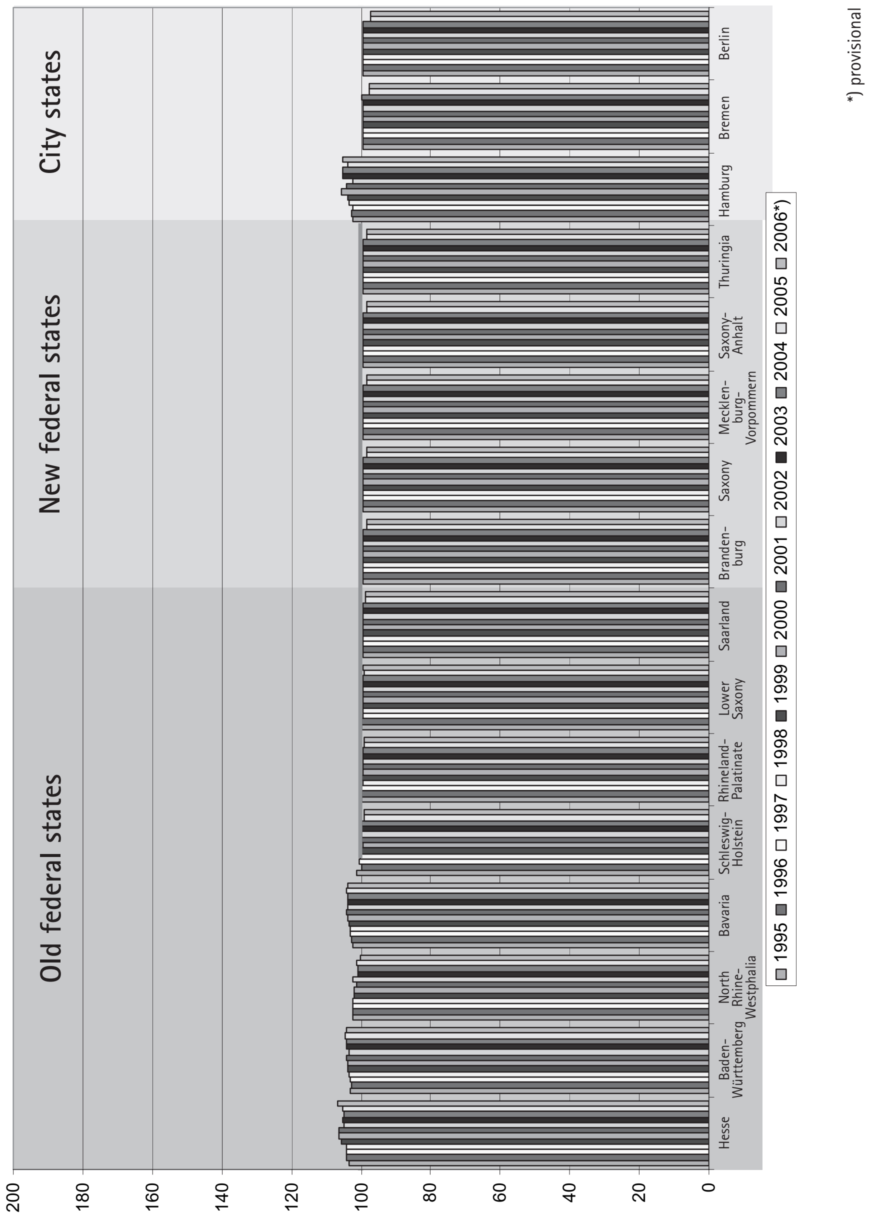


Diagram 11: Financial capacity of the states after state financial equalisation and supplementary federal grants, as a percentage of the equalisation figure

Source: Compiled by the author.

This mechanism not only helps ensure the states are more or less equal in financial terms, but also ensures that special needs are met (the new states with their special burdens resulting from reunification are currently of particular importance). Based on the total tax revenue of EUR 538.2 billion, this (complex) financial equalisation system redistributes a full 5 percent of the revenue among the tiers of government.

4. Proposals for a viable and sustainable financial policy

In the lively debate about readjusting German federalism, there are repeated demands for greater orientation to competition and incentives even in the state financial equalisation system. As described, this kind of competitive federalism presupposes extensive income and expenditure autonomy for the states. If it were to be realised it would mean that the services/programmes offered by states and the income required to carry out these services would vary from state to state; states would also be fully responsible for the debt situation. It would no longer be possible to try and achieve equivalent or uniform living conditions, given the different tax capacities in the states.

Currently, at the time of a Grand Coalition it would be theoretically possible to translate this into practice, as the majority required for constitutional change is given. However, in political terms, this proposal looks unlikely to obtain majority support.

Hence the following section will outline two approaches that may be simpler to realise and are meaningful representations of how the financial equalisation system could develop in the future.

As the detailed description of the financial equalisation scheme shows, the discussion about the key elements of the financial policy touches upon only some aspects of financial equalisation. The pivotal role in financial policy is played by total income and expenditure. In order to meet the demands (emanating from the federalism theory) made on the German financial equalisation system, it is essential for the German fiscal constitution to undergo radical reform. As neither Federal Commission I nor Federal Commission II has addressed this point, the following section highlights two solutions within the parameters of the existing fiscal constitution.

As most of a state's expenditure is determined by laws, decrees, and contracts, and as smaller states, in particular, have no active economic policy that can be pursued reasonably on their own, and as states do not have independent control over their income, it is advisable to stabilise the income side of state budgets in terms of economic policy in order to avoid related debt at this level. This could, for example, be regulated by an economic factor within the framework of the turnover tax distribution that impacts on the percentage-based division between the Federation and the states. The states would then have a steady income base that would lend itself well to planning. Pro-cyclical budgetary policies would be countered and a calculable expenditure policy realised. Equalisation payments can be determined by equalising the difference between actually adjusted and economically adjusted income. In addition to (or independent of) this, income would be oriented to the growth trend and thus stabilised. Fluctuations above or below a 3 percent range would be equalised, resulting in a turnover tax allocation at the state level that would depend on the economy. § 1, FAG would, nevertheless, still have to be broadened in scope.[20]

A further and more comprehensive approach would combine sustainability and future viability with what should be done in terms of finance policy in periods of macroeconomic disturbance. The core of this proposal is a multidimensional understanding of future viability. For one, passive care should provide future generations with a solid financial base. On the other hand, active care in the form of expenditure that promotes growth and sustainability is inevitable. Growth and sustainability related investments aim to strengthen core areas that are relevant for the future and can ensure that the Federal Republic of Germany continues to be competitive at an international level. As Germany is not rich in raw materials and labour costs are high, it must be able to maintain its advantage in the knowledge sector. The education sector, science and research outside the universities, family-policy measures as well as environmental and nature protection are among the core areas of these investments. In order to realise this goal, it should be obligatory for a share of the GDP to be earmarked solely for this purpose. This would also lead to discussions in the political discourse about how much should be spent on safeguarding the future.

Expenditure on growth and sustainability must fulfil the needs of consolidation policies as well as the desire for lower taxes. In other words, the fact that the impacts of potential savings in this area are not felt immediately must also facilitate credit-based financing options, the repayment of which must be fully guaranteed

20 Cf. Bofinger, Lenk, and Schneider (2008), p. 68ff.

and ensured. The current emphasis on passive care in terms of cuts in taxes and duties as a result of party politics is obvious, as medium- and long-term effective investments do not achieve the targeted results. This trend should be arrested with the help of medium-term stability and future programmes designed on an annual basis at federal and state levels. Based on the EU's national stability programmes, growth and sustainability related expenditure should be mentioned in the national programmes and a comparison drawn up between the states, on the one hand, and the Federation and the OECD countries, on the other.

Of special importance here will be the creation of a national stability and future committee comprising the federal chancellor and the state premiers, as well as the federal and state finance ministers, members of the central bank (*Bundesbank*), the German Federal Court of Auditors, the German Council of Economic Advisors, and external experts.[21] The stability programme, which will encompass an income quota for the entire country over the next four years, will be drafted by the committee and will ensure that the Federation and the states have secure income structures. Specifying a debt ceiling applicable only to additional growth and sustainability expenditure will also be addressed by the committee. The highest priority will be given to achieving an interim reduction in the debt status quota and an economically viable situation in an OECD comparison.

The decisions taken by the committee for the Federation will determine the stability and future programmes of the states. The medium-term expenditure paths resulting from revenue development are based on the nominal GDP trend, and the state deficits are therefore subject to economic fluctuation.

At state level too, sufficient funds for growth and sustainability investments must be reviewed and ensured. If there is a lack of funds, it must be possible to take out a fresh loan.

States with high debt levels should be granted a federal subsidy of one percent of the respective state GDP (in line with the expenditure regulation) to settle the existing credit burden. Financially stronger states with low debt levels should be given further avenues for undertaking growth and sustainability expenditure.

In the approach described above, the Federation is the only player able to pursue a discretionary anti-cyclical financial policy. In weak periods it can, therefore, give time-bound loans that go beyond the directives laid down in its stability programme.[22] As economic cycles are variable, it is better to avoid defining a 'sharp economic slowdown'. A decision in this regard should, however, be taken by the committee.[23]

The two approaches briefly outlined above would, without doubt, lead to a more sustainable financial policy. How politicians will set the course for sustainable state finances must remain an open question at this point. The last major amendment of the Federal fiscal constitution was undertaken by a Grand Coalition four years ago. The amendment of Article 115, BL led to a dramatic rise in debt levels. If the fiscal constitution is to be realigned, the Grand Coalition should likewise use the options at its disposal (as constitutional changes require a two-thirds majority) and, in accordance with the great fiscal reform, it should not allow itself to be sidetracked in its pursuit of the current objective of realigning fiscal policy.

21 Cf. Lenk (2007), p. 45.

22 This is also necessary because Germany, in contrast to other large countries, does not lay down its own monetary policy.

23 Cf. Bofinger, Lenk

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