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Public Finance

German Länder: Credit Quality Driven by Strong Institutional Framework

Germany's federal states (Länder) benefit from a unique and supportive institutional framework including a financial equalisation system which is, in Scope's view, the strongest among sub-sovereigns in Europe. Involving a number of credit strengths, it ensures that credit profiles between the Länder and the federal government (the Bund) are aligned.

Germany's institutional framework, enshrined in the country's constitution, ensures that extremely strong financial support is available for its Länder. Key features include: (1) a strong multi-step revenue equalisation mechanism; (2) a crucial national role for each Land in the delivery of public services and governance functions; (3) the ability of the Länder to influence arrangements with the Bund on revenue and expenditure mandate-sharing, through their constitutional role of collectively forming the legislative upper chamber, and (4) a solidarity principle (Bundestreueprinzip) that ensures that the Bund and the Länder are jointly responsible for extraordinary support of a distressed Land, hence ensuring that all federal members share common interests.

The recent reform of the equalisation mechanism, to be introduced in 2020, will abolish explicit equalisation transfers among Länder and increase the role of the Bund. Fiscal equalisation will be achieved mainly through a higher proportion of allocation of the Länder's share of VAT revenue. In addition, the Länder will also receive higher compensation via vertical transfers from the Bund. The reform will redistribute some competencies between Länder and the Bund, and, in Scope's view, will further underpin the strength of German fiscal federalism, ensuring compensation for financial disparities across Länder.

German Länder also operate through a safe and predictable cash management system based on established practices of thorough planning for intra- and multi-year cash flows and diversified sources of liquidity. They also benefit from superior and timely market access, thanks to the depth of German capital markets. Both of these systems ensure efficiency and liquidity at any point in time and make liquidity risk negligible.

The budgetary performance of German Länder has improved since 2012, having reported positive balances before debt on average, which has remained in positive territory, leading to a reduction in the overall direct debt burden. This was underpinned by budgeted revenues outpacing expenditures in term of growth and by the decline in interest costs. However, compared to other European sub-sovereigns, the average debt/revenue ratio of German Länder remains high, although unevenly distributed. This sizeable debt, in Scope's opinion, will only be reduced gradually, despite recent reforms and improvements in budgetary consolidation efforts, but will be supported by strong economic activity across Germany.

Finally, Scope also notes that Länder debt levels could be further challenged by contingent liabilities, a result of growing municipal debt, potential liabilities emerging from Länder-owned entities and high implicit pension liabilities.

Credit strengths

- Strong institutional framework
- Safe cash management system
- Solid access to capital markets
- Improved budget performance

Credit weaknesses

- High debt to revenues ratio
- Contingent liabilities

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Extremely strong operational and political powers

German Länder revenues and expenditures are enshrined in the constitution

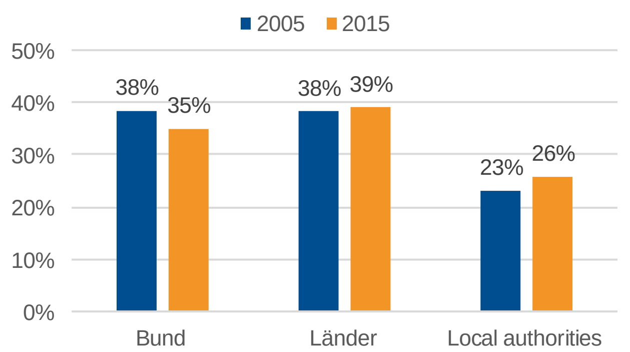
The key role of Länder in the German political system and autonomy in managing their responsibilities make them unlikely to face unexpected, sharp and unfavourable changes to either expenditures or revenues, or unfunded mandates and give them an important control and oversight of their budget balance.

Indeed, Länder representatives sit in the Bundesrat, the upper house of the national parliament, that plays a major role in national legislation and whose two-third majority is required to modify Germany's constitution (Basic Law). The federal constitutional court is, as well, half composed by members elected from the Bundesrat. This underscores the weight of the Länder in decisions taken at national level. Moreover, major parameters of Länder revenues – in particular tax-sharing arrangements, a range of regional taxes and VAT redistribution – and expenditures are mandated by Germany's constitution.

Finally, the importance of the Länder is further boosted by their role as an executor of national policies. This has led to high concentration of the public sector's institutional and process apparatus at Länder level, with only some functions delegated to municipalities. Their ability to influence reforms affecting the intergovernmental system, give Länder a strong hand in negotiations with the Bund, and creates necessity for them to cooperate.

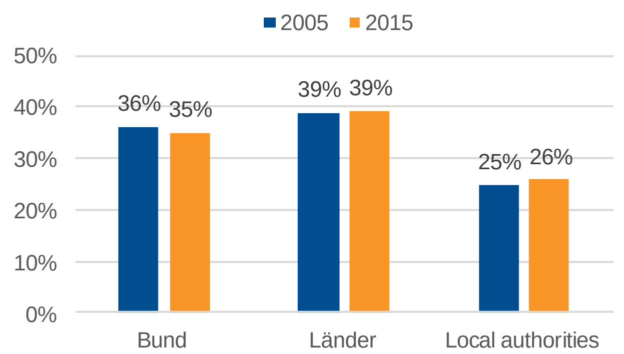
As phase I of the inter-budgetary reform, passed in 2006, significantly decreased the scope of legislation that Länder can veto in the Bundesrat, this redistribution of responsibilities between the Bund and Länder did not decisively shift the distribution of expenditure (Figure 1) and revenue (Figure 2) among the different governmental layers.

Figure 1: Expenditure distribution by layers of government



Source: Ministry of Finance

Figure 2: Revenue distribution by layers of government



Source: Ministry of Finance

Strong revenue equalisation among Länder

Germany's inter-budgetary relations involve a strong multi-step process of revenue equalisation, designed to bring the financial strength of weaker Länder closer to the level of the stronger ones (measured by budget revenue per capita). All things being equal, this not only strengthens the creditworthiness of weak Länder, but also delinks their credit profiles from regional economic fundamentals, aligning these instead with the macroeconomic characteristics of the whole country.

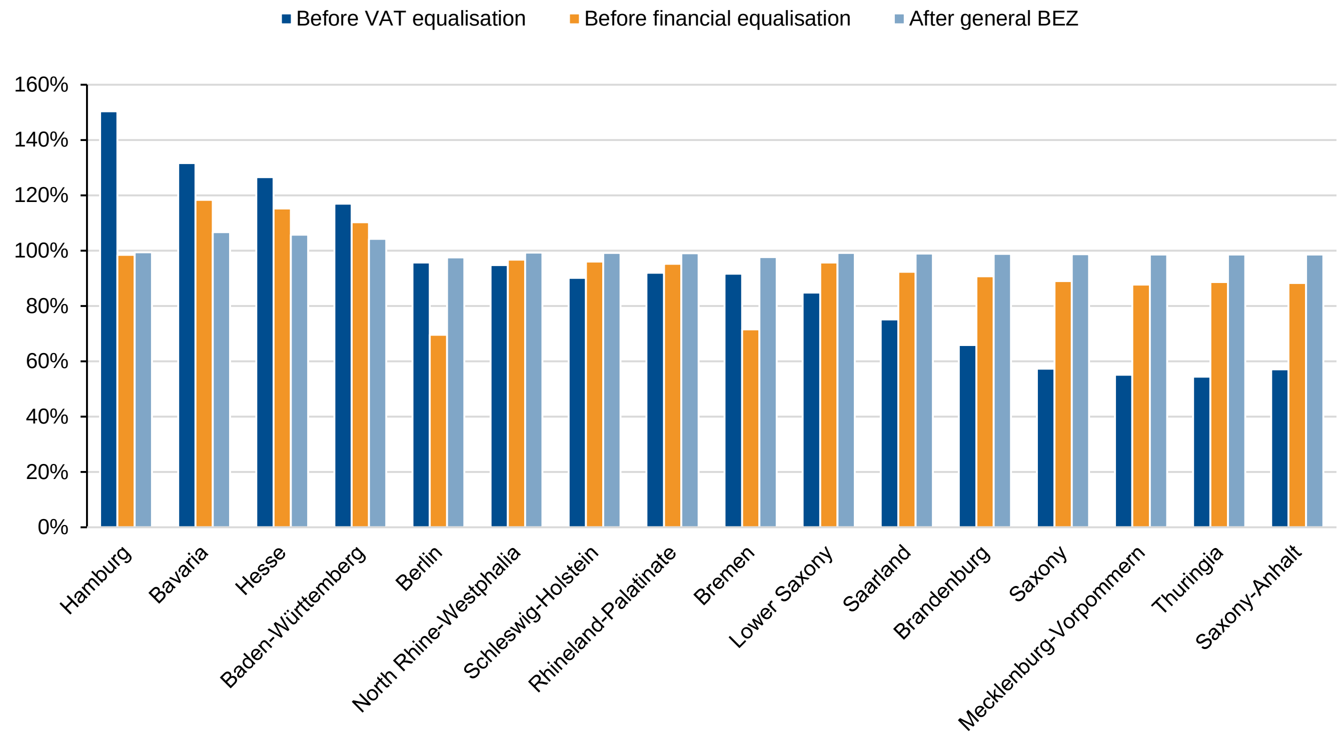
Deep, multi-stage process of revenue equalization brings poorer Länder on par with wealthier ones

The revenue equalisation process involves the redistribution of both income tax and value-added tax (VAT) across the Länder, combined with horizontal (inter-regional) and vertical (from the Bund to the Länder) equalisation steps. The details of tax revenue re-distribution, and horizontal and vertical equalisation steps, are described in Appendix 3.

As a result of various stages of equalisation, the financial strength of the Länder, as measured on per-capita basis, has being aligned more closely (Figure 3). Wealthier

Länder (Hamburg, Bavaria, Hesse, Baden-Württemberg) have had financial resources cut to the average level, whereas poorer Länder (all others) with weaker financial resources before equalisation have seen significant improvements to their financial capacities.

Figure 3: German Länder, financial strength per capita (% of the average) after various stages of equalisation in 2016



Source: German Ministry of Finance

The equalisation system will be modified, starting in 2020, in accordance with Phase III of the inter-budgetary reform. The main changes consist of eliminating the interregional stage of equalization and the modification of VAT redistribution (see Appendix 3 for details). Another change is that the Bund will increase its contribution to the equalization pool and therefore replace the eliminated horizontal equalization in two ways: (1) by bringing federal money into the equalisation pool through general grants and cash transfers; (2) by committing to bring poorer Länder slightly closer to the average than that currently done under the vertical step of equalisation.

Scope's assessment of the reform is that it is unlikely to change the ultimate result of the equalisation process, that is, to bring weaker Länder closer to the financial strength of stronger ones. However, by enhancing the Bund's role in providing resources for the equalisation pool, it will alleviate the burden on the wealthier Länder, which are currently the current donors.

Bund's role in equalisation system will increase

Beyond the equalisation system, the Bund has further committed to providing additional grants to the Länder with disproportionally small municipalities (or weak financial strength) and spending on research and development (Lower Saxony, Schleswig-Holstein). In addition, permanent and annual financial assistance of EUR 400m will be provided to Bremen and Saarland each, with the expectation that they will maintain tight budgetary discipline.

Moreover, this reform entails the redistribution of some key competencies between the Federal Government and the federal states to improve the efficiency, reduce the delays in infrastructure projects, and limit the use of additional amount provided by the Bund. This will help to overcome the current split of competencies between the Bund and the Länder regarding infrastructure project, in particular federal motorways. In this regard, a transport infrastructure company will be established at the national level that combines all relevant competences for the funding planning and construction of federal motorways.

Very high likelihood of extraordinary support

Extraordinary support is available for Land in financial difficulties.

An important element of the German Länder institutional framework is the extraordinary support available for financially distressed Länder. This mandatory element is grounded in the solidarity principle and ensures early and precautionary support. Furthermore, Scope believes that the strong willingness of the members of the German federation (the Bund and the Länder) to support each other is amplified by strong financial and reputational considerations, as well as the country's interest in protecting its standing and credibility as a 'safe haven' within global capital markets. In addition, the Bund's strong ability to support the Länder is reflected by the Federal Republic of Germany's AAA rating.

Under the Basic Law, all members of the federation (the Bund and the Länder) are jointly responsible for supporting a Land in financial distress. This solidarity principle applies only to Länder under 'extreme budgetary hardship', taking into account that the three criteria legally accepted to define that situation are (i) the ratio of interest to tax revenues, (ii) net borrowing requirements to the budgetary revenue and expenditure (credit financing ratio) and (iii) the primary balance. However, no specific thresholds are set for either of these measures.

The solidarity system has been tested previously

The Länder of Saarland and Bremen set the precedent for extreme budgetary hardship, with the FCC ruling in their favour in 1992. It took the FCC almost two years to make the ruling, by which time both Länder had already accessed the capital markets. Another precedent is the city-state of Berlin, which appealed to the FCC in October 2006 for additional support to tackle high debt levels, but was refused. While rejecting Berlin's bailout claim (because the city had not yet reached extreme hardship and had not adequately and independently improved their budgets and debt), the FCC reaffirmed that the Bund and the Länder are jointly responsible for providing support to federal members that cannot financially perform their constitutional duties. Similar to Saarland and Bremen, Berlin's appeal did not prevent normal day-to-day functioning nor the ability to tap capital markets.

Safe and predictable liquidity management

Liquidity management prevents sudden cash shortage and ensures timely payments

In Scope's view, the liquidity management system of Länder, together with their solid access to capital markets, is a credit-positive factor that makes any temporary delay in payment or the provision of support highly unlikely. Liquidity risk at Land level is negligible, due to the bilateral and mutual agreements and assistance among the Länder themselves as well as among the Länder and the Bund.

Länder plan their cash inflows conservatively, taking into account the tax payment calendar for its key taxes – VAT and income tax. Moreover, their status as a tax collector gives them additional leeway. As for cash outflow, the major part of their expenditure are salaries and local government transfers, which are relatively stable and predictable. Länder cash management, which covers one year, is consistently monitored which minimises the risk of a sudden shock to revenue or expenditure.

Diversified sources of liquidity support include:

1) Unlimited intraday credit line at the Bundesbank. Länder can make payments through accounts with the Bundesbank, which opens a free intra-day credit line. This account should, however, be balanced at the end of the day.

2) Liquidity management by interacting with other Länder and the Bund. Regional liquidity is enhanced by short-term money market transactions between all Länder and the Bund's treasuries. Länder can place their excess cash with peers, and this is transferred daily between the Länder. Cash transferred from another Land is not necessarily repaid by the end of the day and can be extended if the two Länder agree. These short-term transactions are independent of political contingencies and may occur among all Länder.

3) Additional liquidity access in the euro market. The 16 Länder have good access to liquidity if needed through negotiated credit and back-up lines with their respective Landesbanken and/or commercial banks, which in turn can be refinanced by the ECB, making the liquidity pool very deep.

Deep and diversified capital market funding

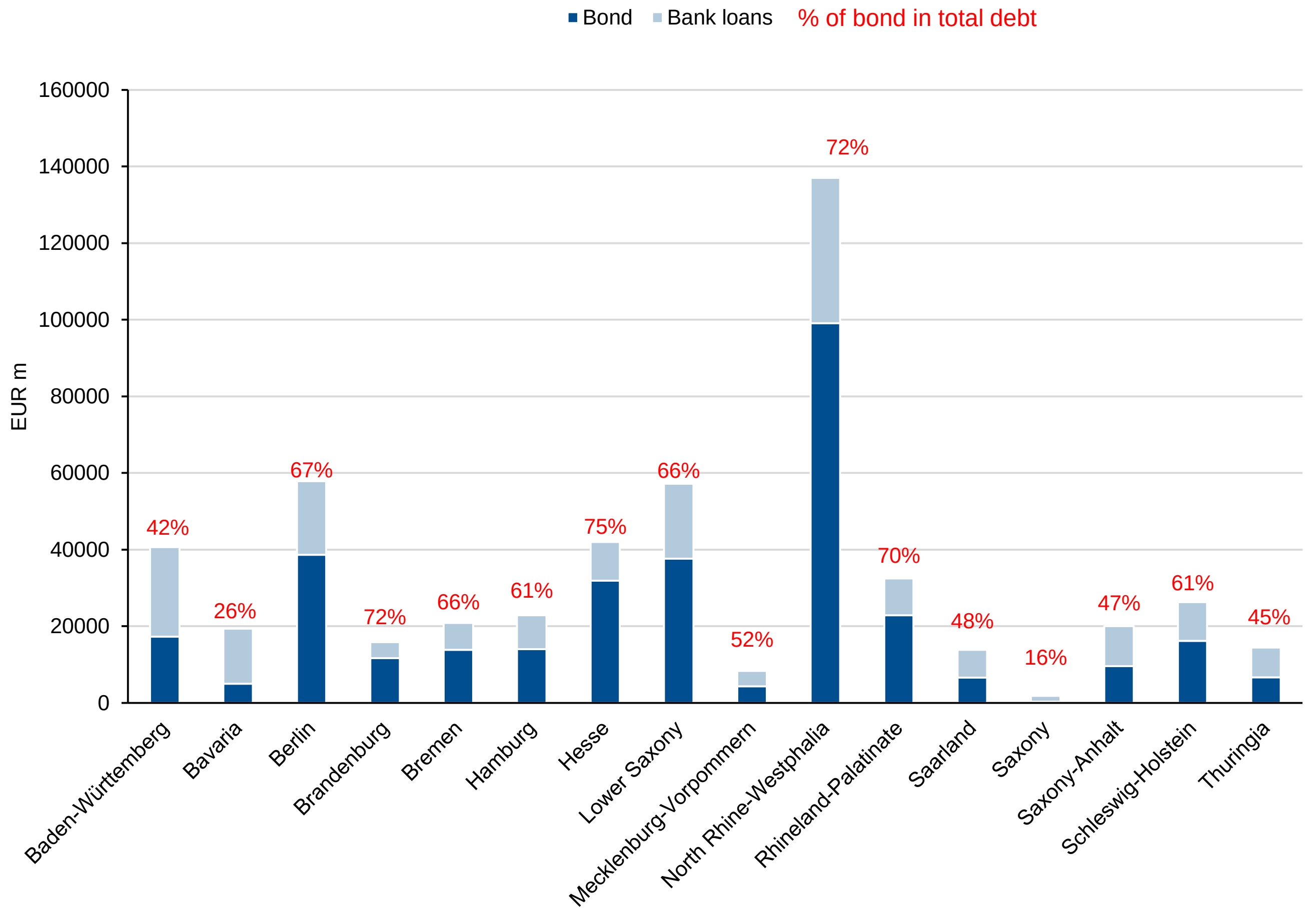
The Länder enjoy access to deep and liquid capital markets that benefit from stable and (at least under the currently low interest rate environment) inexpensive funding. Relative to European sub-sovereigns, German Länder are the most active issuers, with significantly higher refinancing needs. The annual gross borrowing of the Länder in 2016 was approximately EUR 61bn.

Scope believes that the use of capital markets as a major financing source reinforces the solidarity principle: stronger Länder, which currently transfer funds to the weaker ones, have a vested interest in keeping strong and open access to capital markets for the weaker members, minimising potential contagion risks. Further, Germany's strong equalisation system is also reflected in the good quality of Länder joint bond issues.

Länder capital market is deep, which is credit-positive

Bonds make up almost half of regional debt, with some Länder more dependent on these markets than others (Figure 4). The share of North Rhine-Westphalia bonds in financing was as high as 72% at the end of 2016. Other major sources of funding, though increasingly less so, are German Schuldschein (promissory notes) and private placements. Länder securities have 'safe haven' status. German regional bonds are included in the ECB's public-sector asset purchase programme, which increases demand for securities issued by Länder while lowering borrowing costs.

Figure 4: Sources of funding for German Länder at YE 2016



Source: Staistisches Bundesamt

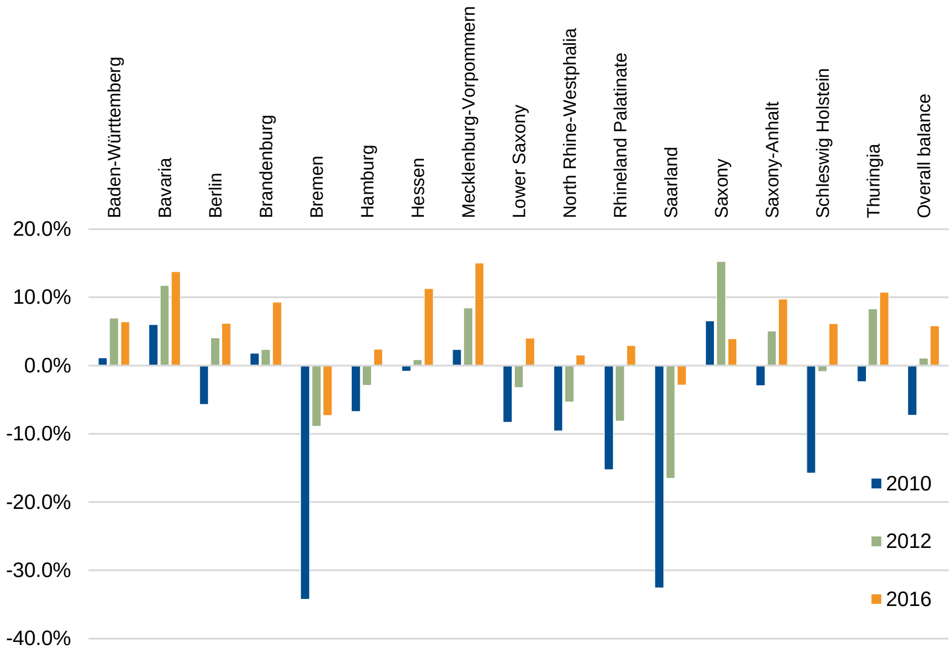
Several German Länder routinely place benchmark issues that exceed nominal amounts of EUR 1bn. Another interesting feature of the German regional bond market are joint bond issues: these are jointly issued by several Länder, or by the federal government jointly with other Länder (one bond so far), paving the way for Länder and the Bund to borrow on behalf of those with difficulty accessing the capital markets, with the purpose of subsequently on-lending the proceeds..

The exceptional access to market funding by the Länder is underscored by the fact that it was the only sub-sovereign market that remained open during the 2008 financial crisis. The spread differential between the Länder and between the Länder and the Bund is small and is currently strongly influenced by the ECB's asset purchase programme. During the worst period of the 2008 financial crisis, spreads widened, yet Länder had little difficulty in raising funds in the capital markets.

Budgetary performance is continuously improving

The budgetary performance of German Länder has improved since 2012, as Länder, on average, reported positive balances before debt, which has remained in positive territory leading to a reduction in the overall direct debt burden. This was underpinned by budget revenues growth rates outpacing expenditures as well as declining interest costs. A number of outliers decreased, too. In 2012 seven of out 16 Länder had negative balance before debt, whereas in 2016 only two had deficits.

Figure 5: German Länder budget performance (balance before debt, % total revenue)



Source: German Ministry of Finance

Yet the debt burden remains high

Exceptionally high debt levels accumulated by German Länder and their uneven distribution pose a concern. At the end of 2016, the average level of German Länder direct debt was 176.6% of total revenue but these figures vary widely among Länder: Bremen's debt as a percentage of total revenue was 398%, while the figure for Saxony and Bavaria were only 10.7% and 34.0% respectively (Figure 6).

High debt level is result of historically high deficits

High debt was the result of persistent budget deficits, which the majority of Länder have recorded for more than a decade (2000-2016, with exception of 2007). Persistent budget deficits were driven by a number of factors, including limited flexibility in raising revenue, weak incentives to increase tax bases, and low efficiency of tax collection. Also, the combination of politically sensitive matters of autonomy and 'soft' budget constraints plays an additional role. These soft budget constraints provide little intrinsic incentives for budgetary discipline, as prudent fiscal solutions under the equalisation environment are discouraged by the possibility of bail-outs.

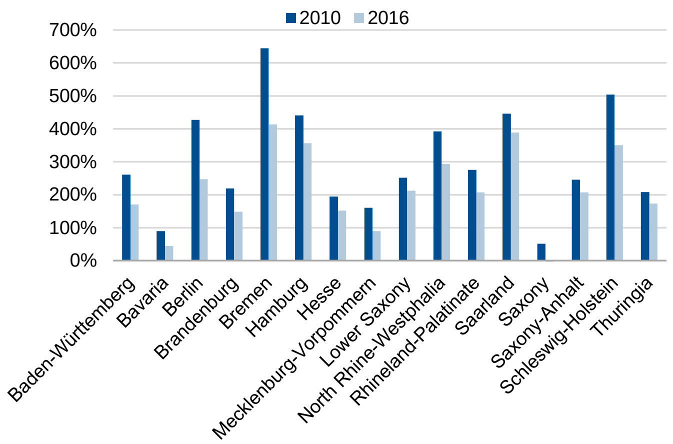
Consolidation efforts are strongly determined by the 'debt brake'

Though debt levels started to decline in 2011, deleveraging has been slow and uneven among the Länder. Moreover, it is still very high compared to European peers' levels (Figure 7). Scope expects further declines in Länder debt levels, underpinned by (i) current favourable economic conditions, (ii) the adoption in 2009 of a constitutional 'debt brake' as part of Reform II, and (iii) the creation of a Stability Council in 2010.

The debt brake is a legal framework that does not permit deficits from 2020 onwards; article 109 (3) of the Basic Law stipulates that Länder can only have deficits that are cyclical or driven by natural disasters, provided that the debt incurred is repaid as soon as the situation improves. The debt brake replaced the principle allowing Länder to borrow only for investment, which in practice turned out to be inefficient at curbing debt accumulation.

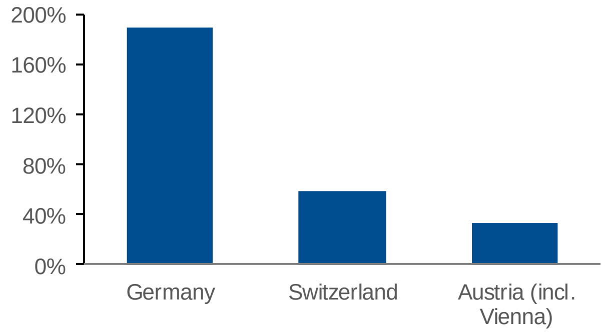
Secondly, the Stability Council, which includes the federal ministers of finance and economic affairs as well as the federal state ministers of finance, was authorised to regularly monitor the sustainability of federal and regional budgets. In a recent statement the council concluded that, of the four Länder under budget restructuring programmes, only Bremen and Saarland were expected to extend their adjustment programmes.

Figure 6: Direct debt-to-revenue ratio, %



Source: German Ministry of finance

Figure 7: German Länder vs Swiss and Austrian Länder (average direct debt-to-revenue ratio,% at YE 2015)



German, Austrian and Swiss Ministries of Finance

'Debt brake' rule and Stability Councils are tools to tackle high debt

Though there are visible advantages in this new framework – regular monitoring, better transparency in the assessment process, and publicity in the announcements of the Stability Council's conclusions – the high political weight of Länder significantly weakens the Stability Council enforcement power. In addition, Länder can also bypass the zero-debt principle through the right of a regional parliament to vote on allowing deficit budgets under extraordinary circumstances such as extreme macroeconomic crisis and natural disasters. Both were one of the most common reasons to run deficit budgets in the past.

Thus, even if budgets continue to be balanced, Scope expects deleveraging to be slow due to the constrained enforcement powers of the Stability Council and limited budget flexibility of the Länder. Hence it will take decades for most indebted Länder to substantially reduce debt burdens and be on par with European peers.

Contingent liabilities

German Länder have strong links and ultimate responsibility for the financial health of financial institutions and municipalities whose liabilities might crystallise on the already-burdened balance sheets of the Länder.

Banks

Development bank's business model provides certain comfort

The involvement of Länder with financial institutions is twofold. First, it includes fully owned development banks (Förderbanken) (Appendix 1). With the exception of Bavaria, which guarantees two development banks, most Länder guarantee at least one development bank, which could generate potential contingent liabilities. These are public law institutions that are guaranteed by Länder, which means the latter are unconditionally liable for all of the development banks' obligations and are legally required to provide maintenance obligation guarantees for them. However, development banks business model, focused primarily on providing loans to SMEs, to real estate developers (typically for social housing), or for municipalities' infrastructure projects, generally present moderate risk. Moreover, development banks, as guaranteed entities, enjoy a low cost of funding. Still, by the end of 2015 total liabilities of development banks amounted to EUR 365bn, or 107.8% of total Länder revenue[1] and 12% of Germany's GDP. The liabilities of the development banks range from EUR 141bn accumulated by NRW Bank to EUR 1.4bn accumulated by SIKB Saarländische Investitionskreditbank AG. Second, it includes some participation to the capital of regional commercial banks (Landesbanken), though the level of this varies significantly (Appendix 2).

Municipalities

Rising volume of Kassenkredite debt

Though municipal debt started to decline in 2012, a high proportion of short-term debt (Kassenkredite) remain a burden that could put pressure on Länder budgets. As at the end of 2015, 27.1% of the overall municipal debt was attributable to Kassenkredite, versus 8.1% in 2002. Another area of concern is the decline in local investment, which, if addressed by debt funding, may then also cause problems.

German municipalities are largely run by Länder, which are responsible for balancing municipal budgets via recurrent transfers and grants and through emergency funds for extraordinary expenditures. In the last five years the third layer of the government has managed to keep books balanced, with exception of 2014. However, overall budget performance varies across the Länder[2]. At the same time the pressure on Länder budgets is growing, as they are expected to increase the share of expenditures in order to keep the municipal budgets balanced (Figure 9).

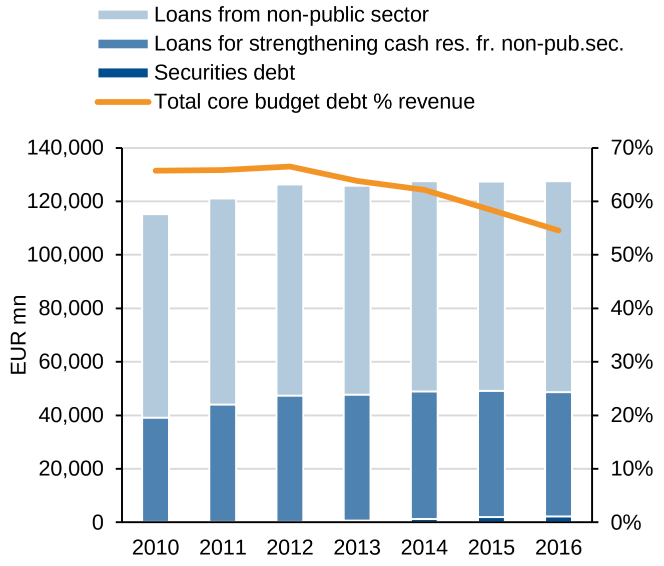
By the end of 2016 total municipal debt amounted to EUR 142bn, or about 54% of total municipal revenue[3] and 7.4% of GDP (Figure 8). There are significant differences between the municipalities in the Länder: over one-third of total debt is associated with municipalities in North Rhine-Westphalia.

However, there are a number of mitigating factors that Scope takes into account. The risks associated with rising municipal debt are partially mitigated by the 'sinking' funds initiated by the Länder. These are funds specifically established to gradually repay debt or replace assets by periodically setting aside money to repurchase bonds in the open market. However, the Länder with the highest debt levels, such as Saarland, have made the least progress in this regard (as measured by the size of such funds relative to outstanding debt). In addition, the Bund has set up an extra fund for municipal infrastructure, therefore reducing the necessity for municipalities to tap capital markets. Between 2017 and 2020, for instance, the Bund will provide EUR 3.5bn to the municipal educational infrastructure fund to support financially weak municipalities.

[1] Excluding extra budgetary funds.
[2] A study from KFW reports that over a third of municipalities (35%) have had an overall negative financial situation for more than 10 years, with no expectation of improvement. www.kfw.de/PDF/Download-Center/Konzernthemen/Research/PDF-Dokumente-KfW-Kommunalpanel/KfW-Kommunalpanel-2015.pdf

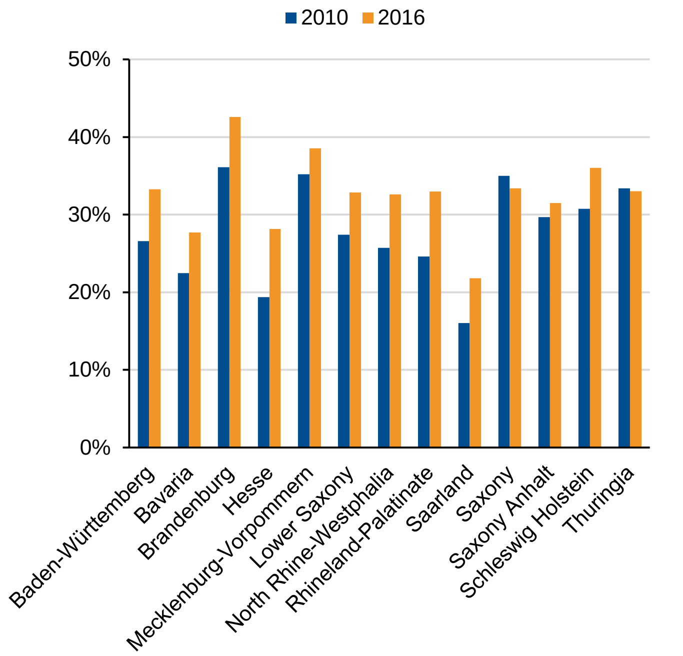
[3] Excluding extra budgetary funds.

Figure 8: Municipal debt, % revenue (core budget only)



Source: German Ministry of Finance

Figure 9: Allocations to municipalities from Länder, % of operating expenditures



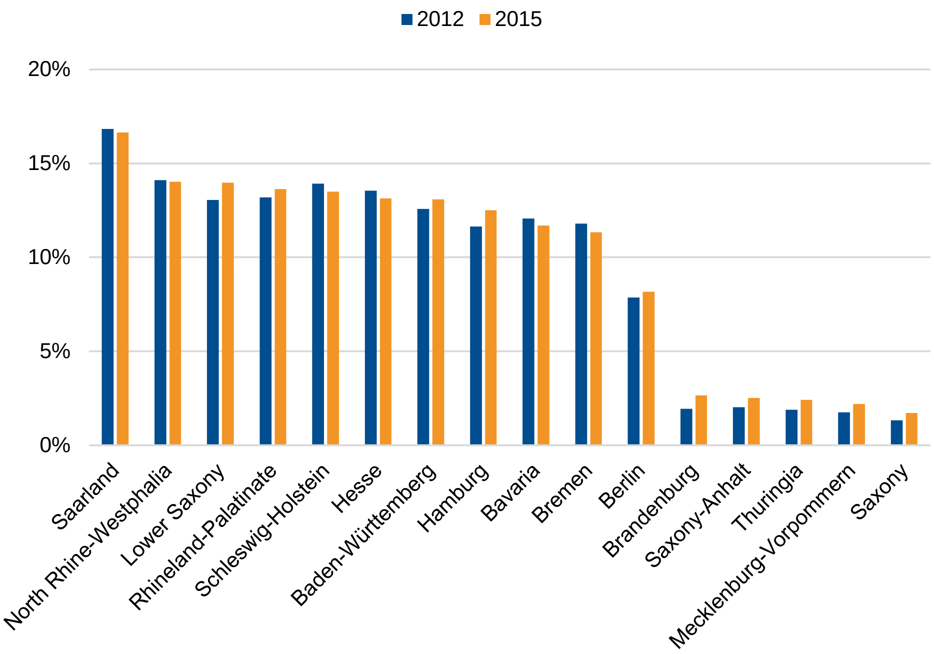
German, Austrian and Swiss Ministries of Finance

Pension obligations

As the majority of the civil servants[4] are funded by regional budgets, the pension obligations of the Länder represent a noticeable amount of revenue, which has continued to grow over the years, and is expected to rise even further. Apart from that, pensions for civil servants qualify as defined benefits, which gives additional uncertainty for the future obligations.

[4] Scope refers to the Beamte, an index-linked pension of 71.25% of the last salary, which is a budget item of the state.

Figure 10: Pension expenditure, % of revenue



Source: Ministry of Finance
Note: Pension expenditures is equal to Versorgungsbezüge plus Beihilfen & Unterstützungen

Pensions as a percentage of expenditure varies significantly across Länder, from Saarland, with almost 17%, to Saxony, with less than 2% (Figure 10). In addition, pension obligations are much higher in the western Länder than in the eastern ones, reflecting a continuing divide between the two parts of Germany, coupled with a different starting point for pensions' countdown for the eastern Länder after the German reunification. At the beginning of 2015, the number of pensioners supported by regional budgets was 822,450 vs the 1,586,785[5] supported by the whole budgetary system, including federal and municipal budgets.

Facing this increasing pension bill, Länder are pre-funding future obligations in order to ease upcoming obligations, as well as reduce the effect of temporal peaks in the coming years from demographical changes. Another factor which may help mitigate the effect of such large obligations is the financial effects of the 2006 Federalism Reform I, which gives Länder full discretion over salaries and wages, as well as retirement ages and other related conditions. As a result the retirement age has risen from 65 to 67 years, with a reduction in retirement pay from 75% of the final salary to 72%, and growth of pensions against salaries has slowed.

[5] German federal statistical office (Destatis).

I. Appendix: Landesbanken: regional ownership and outstanding liabilities

Name	Ownership Structure		Total liabilities, EUR bn as of 31 Dec. 2016
Bayerische Landesbank	75%	Freistaat Bayern	212.15
	25%	Sparkassenverband Bayern	
Landesbank Hessen-Thüringen	8%	Land Hessen	165.2
	4%	Freistaat Thüringen	
	69%	Sparkassen- und Giroverband Hessen-Thüringen	
	5%	Rheinischer Sparkassen- und Giroverband	
	5%	Sparkassenverband Westfalen-Lippe	
	5%	FIDES Alpha GmbH	
	5%	FIDES Beta GmbH	
HSH Nordbank	95%	HSH Beteiligungs Management Gmbh 12% Freie und Hansestadt Hamburg 11% Land Schleswig-Holstein 72% HSH Finanzfonds AoeR Gemeinsame Anstalt der Laender 6% Sparkassen- und Giroverband Schleswig-Holstein	84.4
	5%	Neun Trusts (J.C. Flowers & Co. LLC)	
Landesbank Baden-Württemberg	41%	Land Baden-Württemberg*	243.6
	19%	Stadt Stuttgart	
	41%	Sparkassenverband Baden Württemberg	
Landesbank Berlin AG	89%	Erwerbergesellschaft der S-Finanzgruppe mbH & Co. KG	45.874
	11%	Beteiligungsgesellschaft der S-Finanzgruppe mbH & Co. KG	
Norddeutsche Landesbank (NORD/LB)	59%	Land Niedersachsen	174.797
	6%	Sachsen-Anhalt	
	26%	Sparkassenverband Niedersachsen	
	5%	Sparkassenbeteiligungsverband Sachsen-Anhalt	
	4%	Sparkassenbeteiligungszweckverband Mecklenburg-Vorpommern	
Landesbank Saar	25%	Land Saarland	14,043 **
	75%	Sparkassen-verband Saar	

*Note to Landesbank Baden-Württemberg: Land Baden-Württemberg (Land) 24,988379% + Landesbeteiligungen BW 15,545739%

** Data on Landesbank Saar as of 31 Dec. 2015

Source: Individual Landesbank institutions, Scope Ratings AG

II. Appendix: German development banks

Länder	Name	Total liabilities, EUR bn as of 31 Dec. 2015	Total liabilities, EUR bn as of 31 Dec. 2016
Baden-Württemberg	Landeskreditbank Baden-Württemberg L-Bank	73.294	-
Bavaria	BayernLabo Förderinstitut der BayernLB	24.04	24.022
	LfA Förderbank Bayern	22.016	-
Berlin	Investitionsbank Berlin	19.133	17.979
Brandenburg	InvestitionsBank des Landes Brandenburg	13.7	-
Bremen	Bremer Aufbau-Bank GmbH	1.192	-
Hamburg	IFB Hamburg Hamburgische Investitions und Förderbank	5.135	-
Hesse	WI Bank - Wirtschafts- und Infrastrukturbank Hessen	16.8	17.4
Mecklenburg-Vorpommern	Landesförderinstitut Mecklenburg-Vorpommern	-	-
Lower Saxony	Investitions- und Förderbank Niedersachsen - Nbank	4.921	-
North Rhine-Westphalia	NRW.Bank	141.2	142.1
Rhineland-Palatinate	Investitions- und Strukturbank Rheinland-Pfalz (ISB) GmbH	10.116	-
Saarland	SIKB Saarländische Investitionskreditbank AG	1.437	-
Saxony-Anhalt	Investitionsbank Sachsen-Anhalt	2.141	-
Saxony	Sächsische Aufbaubank - Förderbank	7.958	-
Schleswig-Holstein	Investitionsbank Schleswig-Holstein	18.5	-
Thuringia	Thüringer Aufbaubank	4.011	-

Source: Individual Development institutions, Scope Ratings AG

III. Appendix: Multi-step revenue equalisation among German Länder and its changes in 2020

Revenue equalisation steps in the current system

Step 1: Income-tax revenue redistribution. Revenues from corporate income tax (CIT) and personal income tax (PIT) are disaggregated. The CIT paid by a corporate headquarter in a region is distributed by the tax authorities among Länder where the corporation operates, provided that the CIT to be paid by the corporate exceeds EUR 500,000. PIT is also distributed among the Länder, based on the taxpayer's residence and not the workplace, in order to reduce revenue disparities between residential and commercial/office areas.

Step 2: Distribution of proceeds from value-added tax (VAT).

Step 2a: Distribution between the Länder and Bund. Länder retain 44.5% of VAT collected in the region, municipalities retain 2%, with the rest transferred to the Bund.

Step 2b: Redistribution of retained VAT to weaker revenue regions. In line with article 107.1 of the Basic Law, up to 25% of the VAT allocated to Länder is distributed to those Länder whose tax revenues (PIT, CIT and regional taxes) per capita are lower than the average of all Länder. The process involves prescribed linear-progressive coefficients, which are used to calculate VAT grants for weaker regions and notional contributions from wealthier ones. This means that the wealthier regions' VAT 'contribution' to the equalisation system depends on deviation of a Land's financial capacity from the average: the bigger the gap, the bigger the contribution. This step partially closes the gap between the tax revenue of weak Länder and the overall Länder average.

Step 2c: Redistribution of retained VAT among Länder on a per-capita basis. The remaining at least 75% of VAT retained by each Land is distributed according to a per-capita basis across all Länder.

Together, steps 2b and 2c ensure that most VAT revenues are shared according to the population distribution in Germany, with exceptions of Länder with weaker revenues from all taxes.

Step 3: Horizontal/inter-regional distribution according to financial strength. The horizontal equalisation step of tax revenue redistribution from wealthier to poorer Länder aims at further reducing financial differences by bringing any below-average Länder closer to average financial strength. At this stage, the financial strength of each Land is measured as the sum of VAT, PIT and CIT revenues, plus 64% of municipal revenues and other minor regional taxes. This step also involves linear-progressive coefficients that are used to calculate revenue to be received by poorer regions and to be given by the wealthier. The horizontal equalisation further reduces the difference in financial resources among the Länder, but does not equalise the financial resources of the Länder fully.

Figure 1: Equalisation of differences in financial strength by financial equalisation and additional federal transfers (2015)

Financial strength before interregional equalisation, in % of the average financial strength per capita	Financial strength after financial equalisation, in % of the average financial strength per capita	Financial strength after financial equalisation and additional federal transfers, in % of the average financial strength per capita
70	91	97.5
80	93.5	98
90	96	98.5
100	100	
110	104	
120	106.5	
130	109	

Source: German Ministry of finance

Step 4: Vertical transfers from the Bund. These are executed by transferring general grants from the centre to financially weaker Länder in order to fulfil the equalisation requirements of article 107 of the Basic Law. This stage of equalisation is applicable to Länder whose financial strength per capita, after interregional steps of equalisation, remains below 99.5% of the average. The shortfall is made up proportionally by 77.5%. As Figure 1 above shows, the vertical transfer steps results in weaker Länder with financial strength of 70%, 80% and 90% of the average before horizontal and vertical stages of equalisation being brought to 97.5%, 98% and 98.5% of the average, respectively.

Enhanced per capita focus. All calculations for these transfers and distributions are calculated on a per-capita basis. To take into account larger financial needs of a number of Länder, including city-states such as Berlin, Hamburg and Bremen, the population is artificially increased by 35% to provide a larger share of distributed revenues. This also applies to three of the eastern Länder, to adjust for the low population density in Brandenburg (3% increase), Mecklenburg-Vorpommern (5%) and Saxony-Anhalt (2%)

The current equalisation system will be modified starting in 2020. The main changes are as follows.

Changes to Step 2a (above): A shift of VAT allocation between the Bund and the Länder. The current split of 53.5% for the Bund, 44.5% for the Länder, and 2% for the municipalities will change to 52.80%, 45.19% and 1.99% respectively, increasing the Länder share in overall tax proceeds. This change will benefit all regions, with the weakest gaining the most, and will bring an additional EUR 3.6bn for all regions at the expense of the Bund.

Changes to Step 2b (above): Changes to VAT redistribution. The partial redistribution of retained VAT to weaker revenue regions will involve coefficients that are calculated on a linear basis and will involve less progressive redistribution. The portion of VAT receipts and dedications will be capped at 63%.

Elimination of Step 3 (above): Horizontal, inter-regional step of equalisation will be eliminated. This means stronger Länder are no longer required to contribute directly to the system to support the weaker Länder.

Changes to Step 4 (above). Vertical grants provided to Länder with financial capacity below 99.9% of the average; gap coverage increased to 80%. Currently the criteria for vertical grants is 99.5%; the gap coverage, which is the difference between the average and individual financial strength, is currently 77.5%. This will benefit weaker states and will partially replace the source of equalising transfers as currently provided by the wealthier regions. The Bund will instead step in for wealthier Länder.

To cover the gap made by elimination of the interregional step of equalisation, the Bund will contribute more to the equalisation system. Apart from already-mentioned VAT portion, the regions will receive EUR 2.8bn in general grants and EUR 1.6bn as a cash transfer in 2020. Scope understands that these vertical grants will be for general purposes, with no conditions attached.

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