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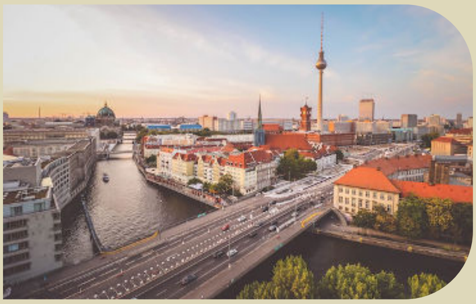
A system wide perspective of local government finance in Germany



LOCAL DEMOCRACY RESEARCH CENTRE

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Foreword

For the last ten years we have been asking council leaders, chief executives, cabinet members for finance and section 151 officers their opinions on how local services are financed in England.

We know from our survey this year that only 14% of senior council figures are confident in the sustainability of council finances. We know that around 8% say pressures on their finances could leave them unable to fulfil their statutory duties – meaning they will be incapable of providing the essential services relied on by local people across the country. We know they are doing everything in their power to make ends meet – raising taxes, cutting services, spending their finite reserves.

Over the last ten years, the evidence that there has been a major sustained failure to properly fund local services in England has become undeniable. The next question is: how could local government finance be different?

This paper, the second in a series of reports on international systems of local government finance by experts at the University of Northumbria, helps us to take the next vital step – examining how the local government finance system could be improved. By building our understanding of the different ways local services are funded across the world – especially outside of the English-speaking world – we can identify the most effective ways to ensure local governments work for their citizens.

This report is a fascinating assessment of local government finance in Germany. It covers the historical, legal and constitutional context, as well as some of the politics and peculiarities of the system. There are already very useful and illuminating lessons to draw for local government elsewhere. Over the next few months we will release further reports looking at Italy and Japan. These will reveal more lessons and insight that will be of real interest not only to readers in England, but to anyone working in or interested in local government around the world.

Jonathan Carr-West
Chief Executive, LGIU

1. Research overview

There has been continual discussion about how the financing of local government works. Particular attention has been devoted to options for fiscal devolution; funding shortages, originating in the UK Government's 'austerity' policy of the early 2010s; and controversies over large-scale borrowing, resulting in a small number of English local authorities experiencing severe financial difficulties. Analysis of these situations typically focus on a single element of the finance system, rather than a wider connected system approach to local government finance. For example, considerations of the local authority take place without consideration of its relationship with central government, or local government autonomy without consideration of equalisation between location. The aim of this research is to counter this situation by placing local government finance in a wider complex system perspective that includes the functions of local authorities; capital finance and its regulation; audit and budgeting practice; funding redistribution and socio-economic variations; and the often-uneven culture of central-local relations.

This *system* is made up of multiple agents: for example, local government officers, civil servants, politicians, thinktanks, audit authorities, lenders and financiers who all have their own objectives and decision-making frameworks. All of these elements interact with each over time to form a whole that is more than sum of its individual agent objectives. It is this complex system of actors, regulations and institutions that enables and constrains local government finance. Calls for additional funding or tax-raising powers, and more recent unorthodox borrowing practices, often emerge from, and are constrained by, this broader and connected context. However, the relationships between the different elements of the system are often disregarded, resulting in a partial understanding or misrepresentation of the local government finance challenge. This research maintains it is not possible to comprehend local government by focusing on one component, authority, or agent. A holistic approach is necessary.

Many of these individual aspects of the *system* are characterised by relatively minor procedural reforms that in turn impact and restrict other elements of the system, often disproportionately. It therefore follows that more considerable changes to individual features in that system – such as a new tax-raising power or a changed approach to redistribution - could have considerable knock-on effects elsewhere within the system. Witness the pains in 2013 when 50% Business Rate Retention was introduced in parallel with unreconciled Business Rate revaluations. Understanding local government finance as a *system* implies that significant changes, such as new taxation powers or a new redistribution formula, would be implemented and potentially restrained within that system, not in isolation. This also implies that the local government finance system consists not only of legal and bureaucratic authority, but also of embedded practices and cultural assumptions that influence how any substantial change is absorbed and managed. Therefore, the contention in this research is that the local government finance discussion, and indeed all of the agents involved in this complex arrangement – all of whom have a stake in resilient local government finance – would benefit from a whole system perspective.

1.1 The research project

In order to reflect upon this situation in England, this project aims to provide a more in-depth understanding of the systems of local government finance in three countries: Germany, Italy and Japan. These countries have been selected for two reasons. First, all feature local authorities with broad responsibilities, a wide range of revenue-raising powers, and an established role within the territorial governance of the state. Elements of practice within those countries are frequently presented as options for change in the English context. Second, these countries are all non-Anglophone. Local government and local government finance systems in Anglophone countries have a common ancestor in English practice and share many historical similarities. These include local revenue consisting primarily of property taxes; a lack of constitutional protection; limited functions; and more restrained legal or financial supervision by central officials. Non-Anglophone systems often feature different characteristics, but these too will be held together by embedded practices and assumptions. Ideas for reform that originate from these systems will benefit from a contextual understanding of how they operate in practice.

It is hoped that examining the operation of these alternative systems will provide new contextual information for future proposals to reform the local government finance system in England. Examples of isolated practices that can be seen in each of the case studies have been featured at points in the English debate; for instance, tax powers and shared revenues in Japan (Kimura, 2015; Bessho, 2016; Breach, 2019), and redistribution in Germany (Werner, 2018; Thöne & Bullerjahn, 2020). However, we are not aware of any analysis (in English) of these systems *as systems*. Without such understanding, it is not easy to comprehend the role and significance of individual elements of these systems, how they interact and, in turn, how they could inform new practices in England.

Previous examinations of international local government finance have typically drawn out features that are exotic by Anglophone standards. That approach provides little sense of how those features operate in the originating national context and financial system, nor how they can be compared to the local government finance system in England. This project is the first known recursive application of such research to the system in England, to inform potential reform. The *system* focus will provide new understanding for practitioners, policy makers and academics engaged with the financing of local services and those seeking a broader understanding of sub-national governance systems and their relationship with the state and politics. The intention is that the insights in the research can be taken forward by local government practitioners and policy makers to help to articulate how new approaches to local government finances could be implemented effectively in England. In turn, the same insights have relevance for the international research locations, which may not have adopted a system-wide perspective before, and indeed any international location that is struggling to finance the increasing demand on local services. This project examined the following features in each country:

- The structure of sub-national governance.
- Local authority functions.
- Local authority expenditure.
- Legal requirements regarding financial management.

- Sources and quantum of revenue, including central transfer grants.
- Powers concerning capital finance.
- Systems of equalising funding between territories.

2. Methodology

In order to examine this situation, a mixed research methodology has been developed and utilised within a cross-disciplinary perspective, blending insights from policy, territorial governance, finance, and real estate studies. Taken together, the empirical and secondary information products lay the foundation for creating a total system perspective of each location that is rarely seen in international literature.

The foundation of the empirical research is a multi-phase interview process. Respondents were identified in each study location (England, Germany, Italy, and Japan) based on their expert knowledge (derived from experience in various tiers of Government, oversight organisations and academia) of the respective local government finance systems. Identifying respondents in each location was not straightforward due to the relative dearth of stakeholders with system-wide knowledge and the generally hidden nature of the sector. In order to overcome this issue, the research made use of knowledge brokers including the Local Government Information Unit, the Japan Local Government Centre in London and the Chartered Institute of Public Finance and Accountancy.

The interview process included:

- initial scoping interviews to provide context for the research and direction towards relevant resources and information on practice within the local government finance system in England.
- subsequent scoping interviews with local government finance experts in the study locations to provide context and direction to relevant information sources.
- the research team then returned to the respondents in the respective study locations with findings, to cross-reference and sense-check the evidence leading to a valuable process of draft refinement and gap analysis.

Alongside interaction with the stakeholders in each location, the research examined information from secondary academic literature, government documentation and legislation regarding the legal structures and institutions underlying local government finance systems in Germany, Italy, and Japan. Concurrently, data was sourced from Government ministries and allied organisations to reflect the quantity and proportion of income sources in each location and to provide an opportunity for comparison. Reflective of the fragmented situation in England, obtaining detailed and accurate information on the operation of local government finance systems was challenging, with sources being difficult to access and sometimes providing contradictory information. In such cases, the panel members were used as a validating mechanism for stress testing the information sources.

The conceptual structure that features in each report was developed via a 2-phase process. First, existing local government finance typologies were examined to determine the key issues and mechanisms that form the local government finance system, for example the OECD Making Decentralisation Work Handbook for Policy Makers (2019). This was then updated and validated with the respective panel of experts to form the interrogative structure of the reports.

3. Outputs

This report provides the first international analysis, a system-wide analysis of the German local government finance system. Germany is often held up as an exemplar of local government financial autonomy and therefore offers a rich comparative resource for local government finance in England. German local government is based upon the principles of decentralisation and subsidiarity, its relative autonomy in managing its own affairs and making decisions enables it to direct resources to place making objectives and social need. Germany also has a long-established system of intergovernmental cooperation, with meaningful and active partnership and coordination between federal, state, and local tiers of government. This cooperation forms a key bedrock to local autonomy in Germany, aligning policies and resources with local need to address complex challenges. The originality in this report is found in the system wide perspective of local government finance in international locations and its comparison to England. In particular it is rare, in English, to find a system wide perspective of the German local government finance system, despite being held up as an example of international best practice – this is the first known analysis of its kind.

4. The political context

In recent years the German local government finance system has experienced several challenges:

- Like England, German local government relies heavily on local taxes, particularly property related income streams and trade tax. They also benefit from shared proportions of income tax and VAT to fund services and infrastructure demands. Even with these financial levers, there is widespread consensus that local income alone is not sufficient to cover local costs, leading to budget deficits and constrained decision making.

- Consequently, despite a relative degree of autonomy, German municipalities rely on intergovernmental transfers. Economic fluctuations or any change in financial policy can impact this type of revenue. This fluctuation is typically counter cyclical with more transfer during recession or emergency. This results in demand for proactive intergovernmental fiscal relations to ensure place-based objectives are achieved.

- Local government financial resilience in Germany is strongly correlated with the regional and local economy (due to its reliance on local business tax) while the Lander are more reliant on the national economy due to their reliance on shared VAT.

- While fiscal equalisation measures exist in Germany, both horizontally and increasingly vertically, significant inequality and uneven development still exists. This has some parallels with the north-south divide in England – particularly in those locations with less economic resource and underlying property market rental conditions.

- This inequality is particularly evident in those locations that have suffered from deindustrialisation. There is also a sharp contrast between the former East and West Germany, with greater financial support from state government demanded in former East German locations.

- Generally, local government has been reducing its debt burden and improving its financial position following constitutional changes in relation to appropriate debt and balanced budgets. In some locations this 'debt break' has led to austerity measures that has constrained investment.

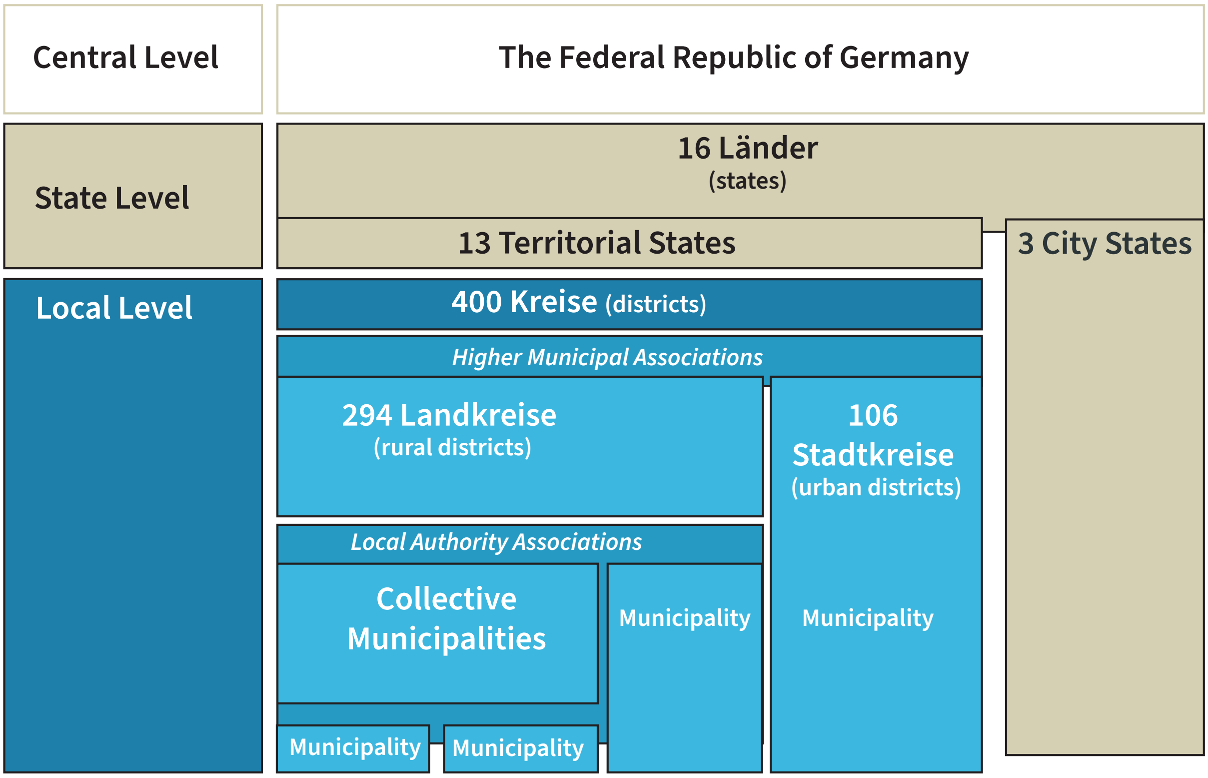
- Covid-19 demanded the suspension of so called 'debt break' rules with sub-national government temporarily allowed to operate with unbalanced budgets.

5. Germany subnational governance structure

The German federal system of government is grounded in the 1949 Basic Law (*Grundgesetz für die Bundesrepublik Deutschland*) and is based on the principle of co-operative federalism (*Bundestreue*). The federal state (*Bund*) is a three-tiered system of subnational governance: 16 *Länder* (regions or states), 400 *Kreise* (districts) and 10,786 *Stadt* and *Gemeinden* (municipalities). The subnational governance structure is displayed below in Figure 1.

Figure 1: Subnational Governance structure of Germany[1]

Below the *Länder* (state) are the *Kreise* (counties) which are divided into 294 rural



10,786 Municipalities (Stadt and Germeinden)

1 Berlin, Hamburg, and Bremen are city-states, thus have a different local government structure.

districts (*Landkreise*) and 106 urban districts / independent cities (*Stadtkreise*). The majority of German districts are *Landkreise* (294), which occupy an intermediate level of administration to act as the primary subdivision between state and local level for a group of municipalities. The remaining are *Stadtkreise* (96), which are single municipalities that have administrative autonomy over a designated urban area and combine the administrative functions of local and district level. The *Landkreise* are then divided into collective municipalities and single municipalities which may be *Stadt* (cities) and *Gemeinden* (town / community).

The Municipal Code in Germany (*Gemeindeordnung*) supports local authority associations between municipalities. This can be on a voluntary basis at the regional or local level (known as *Gemeindeverbände* or *Landkreisverbände*) in order to coordinate information exchange, joint planning, and the implementation of shared projects; Inter-Municipal Cooperation Agreements (*Kooperationsvereinbarungen*) that define objectives, responsibilities, financial arrangements, and decision-making processes between participating municipalities; Joint administrative Units (*Zweckverbände* or *Kommunalverbände*) to coordinate infrastructure and regional planning. In some states, there exist two forms of local authority associations between municipalities and districts: (1) administrative partnerships between small municipalities (*Ämte*), and (2) higher municipal associations of rural and urban districts (*Höherer Kommunalverband*). In these associations, municipalities remain autonomous legally, politically and in terms of budgeting, but delegate the execution of certain functions to the administrative partnership for more effective delivery of services.

The principles of subsidiarity that underpin this system make for an inherently complex and heterogenous system of local government that evolves separately in different *Länder*. This results in, and demands, a dense arrangement of interrelationships between and within tiers of government (Bullerjahn & Thone, 2020).

6. Responsibilities (shared and exclusive)

The Federal Republic of Germany is governed by the rule of law in which the principle of the separation of powers applies. The vertical distribution of power follows the principle of *subsidiarity* in parallel to the principle of *adequate financing* at the lowest levels of government. Adequate financing is enshrined in the complementary principles of connexity, equivalence, solidarity, equivalence of living conditions and loyalty to the alliance (Bullerjahn & Thone, 2020). Of particular importance for the financial position of local government is 'connexity' which insists that centrally imposed tasks must also be aligned with adequate central funding and 'equivalence' which insists that revenues must be in symmetry with local services.

The *Bund* is obliged to assist the lower scale *Länder*, districts and local authorities in carrying out tasks, but is prevented from intervening if the lower scale entity can perform the tasks on their own. This safeguards the power of decision-making at the local level (through a parliament elected by ballot) and plays an important role in local autonomy. Actual autonomy is underpinned by the principles of municipal self-government (*Kommunale Selbstverwaltung*) – it is preserved in the German constitution. Within this principle, local authorities have the right to govern their own affairs, including financial matters, as long as they operate within the boundaries of the law.

According to the division of responsibilities in the Basic Law, the power to regulate local government law lies with the *Länder*. Article 28 stipulates that the constitutional order in each of the *Länder* and municipalities must conform to the principles of the democratic and social state governed by the rule of law. The *Länder* is responsible for ensuring the municipalities perform their functions whilst affording the municipalities the right to self-administration, meaning each municipality has a different constitutional mandate to manage the affairs of their local community. The consequence is that each *Land* has its own local government law and structure, which can sometimes vary considerably from *Land* to *Land*. The respective powers and duties of local governments are detailed in the respective *Land's* municipal laws, explaining the degree of local autonomy and the specific relationship between municipality, *Länder*, and *Bund*.

This is in contrast to England when the division of statutory, mandatory and discretionary responsibility is relatively fixed and also limited in its alignment with the distribution of local government finance income – income is rarely in symmetry with the often-fixed responsibility of local government in England. The financial constitution (*Finanzverfassung*) of Germany ensures this alignment, enabling mechanisms for revenue sharing between the federal and state governments, including tax-sharing agreement (where certain taxes are collected jointly and distributed among the different levels of government) and intergovernmental grants (these grants aim to ensure the equalization of financial capacities among the states and support the provision of public services). The explicit nature of these requirements in the Basic Law provides a different context for sub-national behaviour, in the sense that these requirements are justiciable. A Land that attempted to enforce an unfounded mandate could expect challenge at the constitutional court. Similarly, a Land might more easily implement an initiative to merge small municipalities or to add/reduce local government functions using the Basic Law as a reference point.

The provision of services in Germany follows a 'bottom-up' approach, in that tasks must be completed at the lowest level and are only moved to a higher tier of government when the lower level does not have the means to carry out the task. Functions in England are allocated to counties and districts through Acts of Parliament in a 'top-down' approach, with the central level allocating responsibility for functions at 'subordinate' levels of government. Whilst counties and districts are free to undertake functions for one another, legal responsibility cannot be transferred. This encourages a degree of co-operation between local governments and a degree of local autonomy in delivering certain services; however, this can result in an absence of accountability from the actual service provider. English debate assumes that democratic accountability must sit at the same level as operational delivery. Thus, if operations require a population unit of 600,000, it is necessary to alter the democratic structure to fit this. The German system inverts this logic – the implicit belief is that democratic structures should tack to the small scale and to 'real places.'

Functions may be divided into two large areas of responsibility: the municipalities' own sphere of responsibility and the transferred sphere of responsibility. *Municipality's own sphere of responsibility* relates to its own activities, which are also known as self-government tasks. There are two types of tasks: *voluntary tasks*, which are at the discretion of the local authority and could include establishing a theatre, museum, sports field or municipal hall, and *mandatory tasks* which include local government matters that the municipality must perform, by Federal or Land law. Within the framework of self-government, the municipality is obliged to guarantee mandatory tasks, though the manner in which the municipality fulfils this task is autonomous[2]. The most important mandatory tasks are:

- Providing citizens with water, electricity, district heating and gas.
- Wastewater services and waste removal.
- Planning municipality territory by specifying residential, commercial, and other areas (Town Planning).
- Construction and maintenance of local roads and green areas, parks, and cemeteries.
- The construction and operation of own sports and social facilities.
- Cultural and educational work including the construction or maintenance of own and the promotion of private cultural and educational facilities.
- The construction and operation of hospitals and old people's homes.
- Local public transport.
- The construction and maintenance of schools (although the overall educational framework is held at state level).
- Matters concerning the fire brigade.
- Local authority economic promotion.

Transferred sphere of responsibility relates to tasks that are administered at the lowest possible level of government (subsidiarity) under supervision from the state. The state tasks are administrative and include:

- General security.
- Nationality, registration, passport affairs.
- Social welfare/housing support/services for the elderly and disabled (the funding for these programs is often shared between the local, state, and federal levels.
- Registrar's office and civil status.
- Commercial affairs.
- Construction matters.
- Road traffic.
- Registration of vehicles and vehicle taxation.

2 Note that a number of these tasks do not fall under the responsibility of local government in England, for example the provision of energy, passport affairs, water management.

- Collection of local taxes and revenues (local governments have the authority to levy and collect certain local taxes, such as property taxes and local trade taxes, to finance their operations and services).
- Water legislation and land cultivation.
- Federal and Land parliamentary elections.
- Protection and maintenance of historical monuments.
- Statistics.
- Forestry and fisheries.

These are administrative state tasks that the *Bund* or *Land* may transfer to the municipalities by virtue of law. The *Land* still exert control through legal and expert supervision with the entitlement to issue instructions under certain conditions.

At the local level, the districts, towns, and municipalities must fulfil particular functions. Local government tasks are divided between the district on the one hand and the municipality on the other, according to the principle that supralocal services beyond the capacity of the municipality are provided by the district or local authority association. The district is only responsible when the task exceeds the capacity of a municipality. For example, the construction and maintenance of a waste disposal facility exceeds the financial means of an individual municipality, therefore the district takes on this task. In this instance, the municipality is ultimately responsible for administering the waste removal service, but the district is obliged to assist.

These functions are reflected in the financial arrangements for individual municipalities, coordinated and monitored by the *Lander*. There is also an active element of ring-fenced funding (*Zweckbindung*). *Zweckbindung* takes various forms, such as earmarked taxes, grants from higher levels of government, or specific revenue sources tied to particular services or programs. The purpose of ring-fenced funding is to guarantee that the allocated funds are used as intended and to prevent their diversion for other purposes. Due to the heterogeneity of sub-national government in Germany, that actual division of responsibilities and parallel design of adequate funding provision can vary considerably. This variation can be seen in the funding of services by general or ring-fenced funding from Lander. Funding in one state for a given service could be ring fenced, while in another it is funded by the general block grant from the Land government.

7. The regulatory regime

The financial constitution (Finanzverfassung) is an important aspect of the German constitutional system and is anchored in Basic Law. It refers to all regulations that affect the public finance system of a state including the right to levy taxes and other charges to fulfil its responsibilities and functions. The corresponding provisions are in German Basic Law Articles 104 to 108, regulating:

- The financial sovereignty shared between the Federation and the Länder as well as the financial relations between the Federation, the Länder and the municipalities.

- The distribution of the burden of expenditure.
- Legislative competence in tax matters.
- Tax revenues.
- The responsibilities of the tax administration and fiscal jurisdiction.

Budgetary and fiscal oversight is incorporated in Articles 109 to 115 of German Basic Law and there is an escalating set of instruments to enforce fiscal rules (De Widt, 2017). One of the key laws is the "debt brake". The law was enacted in Article 109(3) and Article 115 and constitutes a fiscal rule that is intended to limit borrowing by the federal and state governments to a budget deficit of 0.35% of GDP – it came into effect in 2011 (Rietzler & Truger, 2019). The aim is to ensure long-term sustainable budget development and to prevent excessive borrowing. This is achieved by countercyclical fiscal policy, which collects surplus funds during an economic boom to offset the deficits of the subsequent recession. The mechanism applies a cyclical factor to receipts to adjust for adverse economic conditions; it is a function of the output gap and defined as the ratio of trend GDP to current GDP. The balancing of receipts and expenditure over the medium term 'flattens' economic cycle fluctuations and enables steady expenditure without the need for liquidity borrowing. Whilst the debt brake was initially met with objections and concerns the law helped reduce Germany's national debt to 59.5% of GDP, below the 60% threshold. In 2012 and 2013 general government net borrowing was close to zero. In 2014 net borrowing was positive and increasing every year to 2019, until the suspension clause was invoked in 2020 for emergency measures during the COVID pandemic.

Some municipalities have even gone on to voluntarily agree additional rules to constrain borrowing (Geissler, 2021; Zabler, 2022), using local byelaws (*Satzungen*) to exceed the debt restrictions already codified in state law. In parallel the Stability Council (*Stabilitätsrat*), a body comprising the Bund and the respective Lander was established in 2010 (enshrined in Article 109a of the Basic Law) to oversee and scrutinise the sustainability of public budgets (Spahn, 2016). The main purpose of the Council is to proactively identify emerging financial emergencies at an early stage and to deploy corrective action before problems materialise.

There is no claim to supervision in the federal constitution; however, local governments in every state must adhere to the balanced budget rule. According to Article 61 of the German Basic Law, municipalities must plan and manage their budgets in such a way that they can always perform the required tasks. State authorities supervise the local budgets to ensure they remain within state regulation/budgetary frameworks. Every Local Government is obliged to hand over its budget plan each year, which is assessed for its general sustainability and violation of the balanced budget rule. If the fiscal rules are broken, the oversight bodies will require the local governments to revise their budget, which is a routine procedure. Though occasionally publicly criticised, research has demonstrated this is a widely accepted system of partnership in the eyes of local government (Ebinger et al. 2018).

In essence, there is a trade-off and interplay between autonomy and integration between the respective municipality and Lander (Bullerjahn & Thone, 2020). Constitutionally, municipalities are part of the Lander, who monitor local budgets on a legal basis. In this sense, autonomy is limited by the state oversight system that ensures public services without fiscal problems (Zabler, 2020). At the same time, municipalities have constitutionally guaranteed autonomy (*Selbstverwaltungsrecht*) which allows them discretion within the budgetary process. In theory, supervisory bodies can do whatever is necessary to proportionately enforce fiscal rules (Roesel, 2017). This means that the constitutional courts – one of which exists in each Land – are very important in managing this trade-off and maintaining autonomy at the lowest level. As the state acts as legislator, leading on scrutiny and ultimate budget sign-off, the codified legal protection for municipalities is an important reference point. While the maximum escalation for Lander would be sending in a state or austerity commissioner to take measures to improve the budgetary situation (e.g., raising taxes or cutting expenditure) of a municipality, in practice this is very rare.[3] Supervisory bodies tend to take an intermediate role to maintain positive working relationships. As part of a local debt relief programme (*Starkungspakt Stadtfinanzen*), the state of North Rhine-Westphalia did send state commissioners (sometimes referred to as austerity commissioners) into three municipalities (commencing 2013-2017) to manage non-compliance with agreed austerity plans (Zabler, 2021). However, the vast majority of financial disputes between municipality and Lander are mediated through the constitutional courts – with municipalities demanding the principle of adequate financing and connexity for any new objective.

There is a system of auditing sub-national government that runs in parallel with this process, which is conducted by special independent public bodies. *Rechnungshofe* (Audit Courts) are responsible for auditing the finances of state government and ensuring compliance with financial regulations, there is one associated with each state. *Kommunale Prüfungsverbände* (Municipal Audit Associations) are established by law to audit local government finance and operate at the level of Lander.

Budgeting processes in England and Germany differ due to financial equalisation methods. In England, local authorities must set a balanced budget for each year by following a procedure laid out in legislation. They must calculate the estimated expenditure in performing its functions and subtract the estimated sums payable into its general fund excluding Business Rates, Revenue Support Grants, and other grant funding, referred to as the ‘budget requirement’. The local authority then subtracts estimated revenue from government grants and Business Rates and the remaining total must be raised in Council tax. Whilst German municipalities must follow the balanced budget rule, there is less burden to balance their budgets at the local level due to the financial equalisation methods.

8. Capital finance

Like England, Germany has strict rules governing capital and revenue spending, which in turn defines how local governments manage their resources, distinguishing how different income sources can be used. A local authority’s capital spending typically relates to money spent on maintaining and investing in land, buildings, infrastructure,

3 There are mechanisms in which the state can provide assistance to Local Governments in England. Section 15(6) of the Local Government Act 1999 permits the state to intervene in the running of a local authority, by taking over the provision of local functions through the appointment of commissioners. There are no policies governing intervention which is undertaken at the discretion of the state. There have been thirteen ‘statutory’ interventions and three ‘non-statutory’ interventions. A joint report from the MHCLG and Birmingham City Council stated that whilst the model was regarded as successful, effective intervention relies upon the local council accepting the need for change, taking responsibility for failings and wanting to pro-actively improve the situation. The process of intervention therefore relies upon Local Government ‘failings’ and may not foster the same universal, ongoing and co-operative approach that is welcomed by municipalities in Germany.

and assets. Public investment is increasingly weighted towards the Lander, accounting for 60% of investment in 20204. In comparative terms, Germany has displayed relatively low levels of debt-based capital investment in recent years (Beznoska & Kauder, 2019). There is a conservative tradition in German local government finance, that municipalities will fund capital investment from their own resources when in surplus. In recent years, even during Covid, the German local government finance system has run a surplus (when contrasting revenue and expenditure). According to the German Statistical agency, in 2022 German Lander spent 522 billion euros (a surplus of nearly 11 billion euros), while German local government spent 326 billion euros supporting public services (an overall surplus of 2.6 billion).. However, there is more demand for capital investment in those locations that have suffered from de-industrialisation or that form part of the former East Germany. To improve this situation, the federal government has directly intervened by providing financial support. For example, in 2016 the federal state provided a 7-billion-euro Municipal Investment Promotion Fund (Kommunalinvestitionsförderungsfonds) in addition to increased funding for Lander and municipalities for urban development and housing. In addition, those locations that have been impacted by de-industrialisation also receive support for economic transformation.

In the main, capital spending is financed through capital grants from Lander and the federal state, and municipalities' own income, reserves and borrowing. Lander account for most sub-national debt (81%) and municipalities (18%). 66% of Land debt is made up of bonds and 34% of loans, while municipal debt is made up almost entirely of loans (OECD, 2022). However, in some locations there is a perceived conflict between the previously mentioned debt brake and the need to invest. Falling local revenues in some locations has led to increased interest in using debt and capital financing to make up for shortfalls in public investment – typically via municipal loans or via capital markets (for example debt loan certificates and bonds). However, due to the parallel concern of consolidating finance, often through austerity plans, local authorities in this position cannot take on additional debt (In contrast to England where there is no formal basis for permitted levels of debt).This leads to perverse behaviour where municipalities with weak economic fundamentals, and inferior infrastructure and services, must increase local tax more than comparatively stronger locations to compensate.

9. Sources of revenue

In Germany, local government has access to various revenue sources. There are four major sources of municipal income / revenue: local taxes, joint taxes, charges and concessions, and grants and transfers. **Local taxes** can be divided into impersonal and personal taxes. Impersonal taxes are the foundation of municipal taxation and predominantly comprise local business tax and property tax. **Local business/trade tax** (*Gewerbesteuer*) is levied against business profits and accounts for approximately 43% of total tax revenue – local authorities set their own tax rate by applying a multiplier (the *Hebesatz*) to the minimum base rate (3.5%). The trade tax revenue is shared between the municipality, the state, and the federal government. The actual rate of this tax currently varies between 8.75% to 20.83% for local authorities with at least 80,000 inhabitants (OECD, 2022). **Property tax** (*Grundsteuer*) accounts for approximately 10% of municipality tax revenue and is the second major municipal tax. There are two types of property taxes, Property Tax A (agricultural and forestry land and properties) and Property Tax B (residential and

4 According to the OECD (2022) World Observatory on Subnational Government Finance and Investment – Germany. Accessed: 23rd June 2023

commercial properties). The municipality determines the multiplier for both property taxes (based on their assessed value) and this multiplier can vary considerably between municipalities in different states – this is because different states/regions have varying economic contexts which afford flexibility to, and/or demand for more from, tax.

These business and property taxes are retained locally, in contrast to Business Rates and associated business rate retention in England, where only 50% of revenue is retained locally. Whilst English local authorities may determine the rate of council tax they charge by law, they have limited leeway to adjust the rates as they depend substantially on council tax revenue. German property tax is similarly based on the property's assessed value. However, the municipality determines their own multiplier. They enjoy a high degree of autonomy over property tax revenue; however, financial equalisation methods are designed in such a way that municipalities that set comparatively low tax rates are disadvantaged during the distribution of central grants. This is to avoid unfair tax competition and a race to the bottom between locations (Geissler et al, 2021). Council Tax valuations in England have not been undertaken since 1993 and are therefore likely to be out of line with present market values. In Germany, in 2018 the Federal Constitutional Court declared the system for calculating property tax as unconstitutional due to underlying values being out of date. Germany has been undertaking new assessments of real property values since 1st January 2022 with new values set to commence in 2025. Until that point the existing valuations of 1964 (West Germany) and 1935 (East Germany) will be used. The reform maintains the three-step system for calculating the real property tax rate but is based upon updated property values. The tax base rate will be set at 0.034 (3.4%) for business property and 0.031 (3.1%) for housing. Municipalities maintain the ability to determine the effective tax rate by setting an additional multiplier, which is multiplied by the base rate, to produce effective rates that vary between local authorities. The same reform will also enable local authorities to place tax on vacant construction land to prevent land banking and catalyse housing supply in cities.

In addition, there are then a variety of relatively minor personal taxes levied by municipalities, for example **Dog Tax, Entertainment Tax, Liquor Tax and Secondary Residence Tax**, that supplement major impersonal taxes. In addition, there are also a wide range of charges and fees for services such as water, wastewater, refuse collection and landfill and street cleaning. They are compulsory but only cover the cost of the services provided. **Concessions** are fees paid by public or private network operators to municipalities in return for rights of way to install electricity, gas, and water infrastructure under public roads. This can then be supplemented by borrowing - municipalities are allowed to take out loans since the above listed income sources are usually not enough to cover all expenditure. Loans may only be taken for investments or investment promotion measures and if no other means of finance is possible (see section 10 for further commentary on local authority borrowing for liquidity purposes).

In terms of local taxes, local authorities in England have powers to raise Infrastructure-related levies and transport levies, Council Tax (up to a capped level), while Business Rates are subject to a national multiplier. Council tax premiums can be charged on second homes under certain circumstances. Revenues from Council Tax and Business Rates may be used for any purpose, whilst revenue from infrastructure levies and transport levies may only be used for those particular matters. Compared to Germany, the proportion of local authority tax revenue in England is far lower. In 2018, the proportion of local authority revenue generated by tax was under 20% in England compared to approximately 58% in Germany. Overall, the majority of local authority tax revenue in England is generated through property, via Council Tax and Business Rates, as opposed to Germany which gathers most of its tax revenue from business profits.

The system of **joint taxation** enables revenue sharing between all three levels of government. It entitles municipalities to a share of joint taxes to supplement their revenue based on population size and fiscal capacity, with each municipality securing a proportion of **Personal Income Tax** (*Einkommensteuer*), **VAT** (*Umsatzsteuer*) while the Lander get 50% of **CorporatationTax**. This shared tax[5] income forms a significant proportion of total local tax (see Section 10) although municipalities do not have any discretion to vary the rate of shared taxation.

German local government is also reliant on **grants and transfers**. Municipalities receive this revenue predominantly from Lander in order to directly finance specific programmes and services – there is no direct federal grant to local government. Most of these grants are paid in the form of an overall block allocation which local authorities are free to use as they wish. For example, **General Revenue Sharing Grants** provide support for operational expenses and public services. **Specific Purpose Grants** to fund infrastructure, social welfare programs, education, and health care, typically determined by state or federal legislation. **Equalisation Grants** aim to account for disparities between the relative economic position of a given municipality – providing additional financial support to those locations with weaker economic fundamentals (see Section 11 for more information). Current revenue grants accounted for 86.5% of grants in 2020 and 13.5% was associated with capital grants.

10. Degree of own budgeting and accounting

In contrast to England, Germany has a more structured sub-national governance system. Intergovernmental finances display complex horizontal and vertical interdependence. As such the degree of autonomous budgeting and discretion must be understood in the context of the Lander and respective municipality (OECD, 2022). Sub-national government in Germany is responsible for half of public spending in Germany. Traditionally, the Lander account for most spending (OECD, 2020) – indicating that the spending responsibility of local authorities is lower than many other countries due to the regional role of the Lander. Within the lowest tier of spending municipalities and associations make up the vast majority of spending, in contrast to districts. In recent years, Lander and respective municipalities have been able to maintain a healthy financial position. While the cost of delivering services has continued to grow due to demographic trends, expenditure has not outstripped revenue with Lander and local authorities continuing to carry significant surpluses even after the Covid-19 pandemic.

However, there is considerable regional and inter regional variance with a significant number of municipalities (Bavaria, Brandenburg, North Rhine-Westphalia, Rhineland-Palatinate, and Schleswig-Holstein) failing to balance budgets in recent years and carrying high levels of short-term debt (*Kassenkredite*) (Heinelt & Stolzenberg, 2014). In Germany, municipalities can apply for short term debt to fill budget gaps; this is not permitted in the English system. However, in some locations this debt is proving persistent and is not being cleared in line with budgetary conventions nor the German debt brake.

5 VAT is shared on the basis of a national redistribution while Income tax is based on the contribution of the inhabitants in a given location.

In contrast to England, recent controversy has been in relation to borrowing for revenue purposes, rather than capital financing. These short-term liquidity tools have largely lost their role as a short-term instrument and have become an indicator for fiscal distress (Zabler, 2020, 2021). In response to this situation, several states have established debt relief programmes (*Starkungspakt Stadtfinanzen*) where local authorities receive financial relief (from the state budget) in return for their own austerity measures which are codified in consolidation contracts (Boettcher et al, 2018; Zabler, 2022). English authorities facing comparable problems have typically sought permission from the UK government to spend capital revenues to fill budget gaps. While there is no formal bankruptcy regulation in Germany, there is an implicit expectation of financial support when local authorities are in distress.

Social care, public services, and education account for most local authority spending in Germany. Health is a notable exception as it is under the purview of the federal government. At the Lander level, public services (26%), education (24%) and social care (22%) accounted for 72% of total spending[6]. At the local government level, social care (34%), education (17%) and economic affairs (14%) account for 75% of total spending. Across all scales of government, the cost for social care is increasing (Färber and Salm 2015). In terms of total revenue, Lander accounted for 62% of total sub-national revenue while local government accounted for 38%. Tax revenue accounted for 52% of revenue, grants (between Bund and Lander) 33% and tariffs and fees (9%). At the local government level, grants (from Lander to municipality) represented 47% of revenue, taxes 40% and tariffs and fees 13%. Local authorities received 15% of total personal income tax and 2% (plus a lump sum share) of VAT.

Personal income tax represented 35% of total tax revenue and 14% of total local revenue with VAT accounting for 22% of total tax revenue and 9% of total revenue. In terms of locally generated income, the local trade tax contributed most, representing 13% of total revenue and 33% of total local tax (it was significantly higher pre pandemic and is expected to increase again). In parallel to shared Income Tax and VAT, local authorities share some of this income with the federal government (4%) and the lander (5%) as part of an upward equalisation process. Property tax accounted for 10% of total tax revenue and 4% of total revenue. In comparison to England, there is considerably less reliance on property tax and by extension the relative buoyancy of local property markets. Finally, fees and charges accounted for 13% of local government funding, while revenue from assets was not a significant part of either Lander or local authority revenue.

6 Figures obtained from OECD World Observatory on Subnational Government Finance and Investment – Germany

Table 1: Revenue breakdown

Revenue type[7]	**% of income**
Transfer Grants (from Lander)	
Block grant and earmarked finance for general activity and specific programmes and services (Largely discretionary but elements are earmarked for specific use – this mix varies between Lander)	47%
Taxes (shared and local)[8]	
Personal Income Tax *(Discretionary in use but no discretion rate as based on intergovernmental sharing model)*	14% (35% of total tax revenue)
VAT *(Discretionary in use but no discretion upon rate as based on intergovernmental sharing model)*	9% (22% of total revenue)
Trade Tax *(Discretionary in use and rate)*	13% (33% of total tax revenue)
Property tax *(Discretionary in use and rate)*	4% (10% of total tax revenue)
Minor taxes (Dog Tax, Entertainment Tax, Liquor Tax and Secondary Residence Tax etc) *(Discretionary in use and rate)*	<0%
Charges and income	
Charges for water, wastewater, refuse collection and landfill, street cleaning and various concessions *(Discretionary in use and rate)*	13%
Income from assets	<0%
Other income	<0%
Total Revenue	100%

7 Information based on adjusted numbers from OECD (2022) World Observatory on Subnational Government Finance and Investment and the German Statistical agency. The actual spread of revenue in each municipality is variegated.
8 Transfer Tax (tax on sale of property and Corporate Tax is not detailed here as it goes to the Lander

Table 1 shows clearly that Germany has considerable income sources at the lowest level of government, and more discretion to vary respective tax rates – particularly in the case of trade and property. In addition, Germany has a more balanced and varied basket of income sources to fund local spending needs. While transfer grants account for a similar proportion of available revenue in both countries, the bigger differences are seen in shared tax and locally generated income. Property related taxes only account for 4% of total revenue compared with nearly 20% in England. In addition, overriding much of the debate in relation to types of funding and discretion is the sheer buoyancy of local government finance in Germany, where the system remains in general surplus. In addition, there is a clear constitutional symmetry between revenue and expenditure, hard wired into intergovernmental cooperation between Bund, Lander, and municipal government.

11. Territorial equalisation methodology

Municipal equalisation is designed to ensure adequate financing, in such a way that it allows efficient financing of tasks, enabling meaningful self-government to all municipalities. When considering equalisation and redistribution, the federal states in Germany are obliged by the Basic Law to perform vertical financial equalisation. An amount of funding is taken from the tax revenues of the federal state and distributed among individual local authorities and local authority associations. Equalisation is based within the principle of solidarity, where municipalities have collective responsibility to support one another. Enabling all local authorities to provide a comparative level of services and investment, irrespective of the underlying financial conditions of the area. According to Bullerjahn and Thone (2020), traditionally there are five different vertical financial equalisation models in Germany:

1. Quota model – is the most widely adopted. It sets the total amount of financial equalisation funds as a share of the federal state's overall tax revenues. Quota rates establish the share of federal state revenue that is passed to the municipalities.

2. Quota model with symmetry requirement – the symmetry requirements add additional elements to consider. These include not only the tax revenue by all the regular revenues from the federal state level and municipal level (without debt) but also the burdens resulting from task responsibility at both levels. The distribution of financing is therefore in symmetry with task responsibility, a key difference to the current situation in England.

3. Stabilisation model – an extended form of the quota model. The aim is to stabilise municipal finances by balancing the potential fluctuations in overall tax revenues from the federal state. These fluctuations are buffered by a stability fund, making it possible to balance deficits and top-up funds when surpluses are available.

4. Principle of uniformity – this runs in parallel to the quota system and considers the revenues at municipal and federal state level. It creates a direct link between finances at the local level and the federal state. If income grows more strongly in one of these levels, it has a positive impact on the other level.

5. Needs-based system – this is geared towards municipal tasks and the expenditure they instigate. Depending on federal state capacity, the minimum financing is topped up. This requires time-consuming and updated data surveys to determine the cost of individual tasks and comparison between expenditure and income.

Traditionally, the principle of horizontal financial equalisation then ensured that the federal state redistributes local authority revenue to individual municipalities according to fiscal needs, derived from financial requirements and fiscal capacity. Historically, the transfer system was designed as a vertical equalisation with a horizontal effect (Bullerjahn & Thone, 2020) – federal state funds were distributed according to the capacity of the individual municipalities to generate their own income. Revenue-weak municipalities therefore received more formula-based grants and revenue-strong municipalities received few if any grants. This was based upon:

- Fiscal capacity – calculated according to the municipal revenue from joint taxes and the standardised revenue from property tax and local business tax.

- Financial requirements - the aim is to determine a needs assessed indicator relative to the municipalities' fiscal capacity, whilst ensuring that all available funding for formula-based central grants and abundance payments is completely used up. The so-called "basic amount" is calculated in each financial equalisation year as a monetary multiplier. A structural needs assessment (total appropriation) indicates the individual municipality's financial requirements to perform its duties and is multiplied by the basic amount to calculate apportionment. The total appropriation is most obviously determined by population size, which is the central factor for determining requirements and forms the basis of inhabitant weighting.

- Formula-based allocations – given by the state to municipalities within the framework of local authority fiscal equalisation. This was designed to balance the large differences in taxable capacity as well as allowing central municipalities to bear the burden of providing services for the surrounding area. A municipality received formula-based grants if its requirements are greater than its own fiscal capacity, which was calculated based on income from joint taxes and standardised income from impersonal taxes. This ensured the financially weak municipalities received the most formula-based grants.

The current equalisation system continues to evolve. In 2020 there was an alteration to the share of VAT between Bund and Lander, increasing the Lander share of overall VAT (an additional 3.6 billion euros) with the weakest regions benefiting most. While the horizontal, inter-regional measure has been discontinued. This means that the strongest Lander will not have to contribute directly into the system to support weaker Lander. Instead, the Bund support the weaker regions via additional vertical equalisation measures.

The German federal states use highly differentiated methods of equalisation that have been developed over time, with a variety of mechanisms to determine fiscal capacity and financial requirements. This multi-layered and often geographically differentiated process exists in sharp contrast to the equalisation process in England. The German methodology is based on a redistribution of tax revenues through actual financial requirements, calculated based on actual revenue and expenditure data. The English methodology is based on a rapidly depreciating Revenue Support Grant and a Business Rate Retention Scheme that has not been rebased since 2013. The UK Government announced a 'fair funding review' in 2016, which would have renewed the needs and resource assessment that underlies some grant funding and the redistributive element of business rates in England. However, this has been repeatedly delayed due to the conceptual and political difficulties involved in achieving an agreed approach to needs and resource assessment.

12. Conclusion

Local autonomy is built into the German Basic Law. It affords local government the right to self-administration through the principle of republicanism (Article 20); thus, each local government has the power to determine its own constitutional mandate to manage its affairs. On the other hand, English local government exists under a system of parliamentary sovereignty. Acts of Parliament form the basis of the UK constitution and must be followed by all Local Governments under the rule of law – rather than a codified constitution.

In Germany, responsibilities and functions are afforded to the lowest level of government and passed up the chain through the principle of subsidiarity, with the higher tiers of government obliged to assist. Local governance in England is directed by parliamentary sovereignty, with responsibilities and functions passed down by central government through Acts of Parliament introduced by the House of Commons. Thus, the governance structure of Germany differs fundamentally to England.

As a federal republic, local and central levels of government share power as equal stakeholders through a written constitution (Geissler et al, 2021). Amendments to the constitution must be approved by both levels of government, meaning that the subnational level cannot be abolished nor have their powers unilaterally altered by the central tier of government. In contrast, the UK is a unitary state. The central government may create or abolish lower administrative divisions in England and has overriding authority to delegate powers to the local level – without recourse to principles of connexity or equivalence. Whilst an overhaul of the current English parliamentary system would be required to implement a German system, devolution of powers and local autonomy could be achieved by affording local governments autonomy through new Acts of Parliament. Previous acts have amended the responsibilities of Local Government (the 1972 Local Government Act laid the foundations for the current structure in England), but as devolution has been afforded in some parts of the UK (Scotland, Wales, and Northern Ireland), the responsibilities and degree of financial autonomy for local authorities differ throughout the UK.

The consequence of asymmetric devolution is that Scotland, Wales, and Northern Ireland each have their own Parliament and manage their own devolved matters, but England does not and therefore is reliant on the UK Parliament to manage its constitution. Therefore, to afford all local governments the benefit of self-administration (i.e. local autonomy), the UK Parliament would need to pass Acts of Parliament that promotes symmetrical devolution from the top down.

The following observations can be made about the German local government finance system, as it relates to the potential for change in England.

- German local government finance is a complex adaptive system that continually evolves to account for regional and local variation and circumstance.

- The concerted attention that the Bund gives to sub-national governance and financing in Germany can be seen in contrast to the thesis of Bulpitt (1983) who described a disinterested attitude in favour of bigger state items (such as foreign affairs – most recently seen through Brexit, the securing of trade deals and energy security) in England.

- Any financial changes that need to be formulated, agreed, and implemented have a fixed reference point in the German Constitution and associated legislation. In England, changes would typically take place through an Act of Parliament which can be difficult if the Government is distracted or cannot rely on its majority.

- German local government function, and associated finance, is based on subsidiarity and empowered local governments. In England the system is based on central framing of organisational structures, with the state allocating responsibility for functions to 'subordinate' levels of government.

- German local government finance is not specifically autonomous, in the sense that a given local government unit will act independently of all other local government units and structures. Rather, German local government can be considered an embedded autonomy. Autonomy is located within, and supported by, continual system based intergovernmental cooperation and interstate relations.

- German municipal revenue is more diverse than England with municipalities receiving a higher share of their revenues through tax, particularly local business tax. Municipalities also share Income Tax and VAT. In contrast, the English system is grounded upon grants afforded by central government and an overriding reliance on increasingly restricted property tax. The reliance on property tax presents a risk as property markets become more volatile and, in the case of Business Rates, the relationship between property size and productivity diminishes. Business Rate Retention does operate a degree of shared income (between state and local authority) and can be considered quite radical in terms of local government finance in England. However, it has been left largely untouched since 2013. It also exposed the challenge of essentially trying to solve fiscal decentralisation through only one tax instrument, rather than a basket of tools.

- The Scottish Government receives a share of VAT revenue and levies its own income tax. To afford local governments greater revenue generation, consideration should be given to the sharing of proportions of VAT and Income tax, based on the principles adopted in the German system. The retention of tax revenues will provide an additional income source to support local authority spending power and reduce reliance on central funding. This supports local autonomy by providing a revenue stream under the control of the local body and can be used for general expenditure.

- In Germany, expenditure deficiencies and surpluses in revenue are redistributed amongst municipalities through financial equalisation methodologies which are based on a local authority's financial requirement. This is underwritten in the constitution with principles of adequate finance and the complementary principles of 'connexity' and 'equivalence.' This can be seen in sharp contrast to the shrinking of the revenue support grant and the lack of statutory obligation for equalisation in England.

- Particularly prominent is the coordinating role of the Lander at the state/regional level, which acts as a symbiotic interface between Bund and municipal government in the overall local government finance system. The equivalent tier of government does not exist in England. This so called missing middle tier of government leaves an ambiguous uncertainty between local state and central state, filled in some areas by Mayoral Combined Authorities.

- Partly in response to high levels of debt in the German local government finance system, a 'debt-brake' for sustainable finance was enforced in 2011 alongside transparent auditing procedures for borrowing. The debt brake is a fiscal rule designed to restrict structural imbalances in federal government finances and limit the issuance of government debt. The federal budget is balanced over an economic cycle through generation of surplus funds during a boom to offset the deficits of the subsequent recession. In proceeding years, this has begun to wean local authorities away from adverse loan exposure in Germany – particularly for liquidity purposes. In England there has been considerable controversy around borrowing and non-standard investment practices. If adopted in England, a similar process would go some way to providing scrutiny, guidance, and limits for local government investment and borrowing strategies.

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