

## CONGRESS OF LOCAL AND REGIONAL AUTHORITIES OF EUROPE

### **Recommendation 64 (1999)<sup>1</sup> on the situation of local finances in the Federal Republic of Germany**

(Extract from the Official Gazette of the Council of Europe  
– June 1999)

The Congress,

Bearing in mind the proposal of the Chamber of Local  
Authorities;

1. Having regard to its Bureau's decision, following the German delegation's request to the Chamber of Local Authorities, to prepare a report on the situation of local finances in the Federal Republic of Germany;
2. Having considered the report diligently drawn up by Mr J-C Frécon, rapporteur, with the assistance of a consultant, after several visits to Germany during which opinions were obtained from the federal associations which represent local authorities (*Städtetag, Landkreistag and Städte- und Gemeindebund*), from representatives of the federal Ministries of the Interior and of Finance, from representatives of the governments and associations of local authorities of several *Länder* (North Rhine-Westphalia, Bavaria, Baden-Württemberg and Thuringia) and from some towns and district governments;
3. Notes that Article 28 (II) of the federal Constitution and all *Land* constitutions guarantee the right of local self-government;
4. Notes that, on 22 January 1987, the Federal Republic of Germany was one of the first countries to ratify the European Charter of Local Self-Government (the charter);
5. Nevertheless bearing in mind the reservations in respect of application of Article 9 (3) of the charter to *Landkreise* and, in Rhineland Palatinate, to federations of municipalities;
6. Particularly welcoming the fact that the recent constitutions and legislation of the five new *Länder* draw on the principles of local self-government laid down in the charter;
7. Having noted that the situation of local finances in Germany has very much deteriorated over recent years, as a result of:
  - an exponential increase in welfare expenditure (elderly people, crèches, single-parent families, asylum-seekers,

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1. Debated by the Chamber of Local Authorities on 16 June 1999 and adopted by the Standing Committee of the Congress on 17 June 1999 (see doc. CPL (6) Recommendation revised 2, draft Recommendation, presented by Mr J.-C. Frécon, Rapporteur).

disabled persons, the unemployed, and so on) for whom local authorities are obliged to provide because of the laws decided at the federal and the *Länder* level (such expenditure has more than doubled in ten years);

- the extraordinary show of solidarity made in order to assist the development of the five new *Länder*, to which local authorities contribute 33%;
- the decline in tax revenue resulting from the poor economic situation, although there was a slight improvement in 1998, especially in some large towns in the western part of the country, mainly thanks to a higher yield from business tax (an increase of 2.6% in receipts in the west);
- a decline in income tax also resulting from tax concessions granted to people investing in the new *Länder* and to tax reductions in respect of child allowances;

8. Noting that local authorities have been forced considerably to reduce optional expenditure which, in fact, represents their actual margin for financial independence, and, in particular, that this has entailed a large reduction in investment, while local authorities traditionally make two-thirds of public investments;

9. Also noting that local authorities are obliged to rebalance their budgets by drawing on their own resources or by realising their assets (property, shares in companies, and so on) and that, despite these financial consolidation efforts, a growing number of towns and municipalities can no longer balance their budgets (the average deficit of towns and municipalities between 1993 and 1998 was 10,000 million marks), notwithstanding their statutory obligation, especially in certain *Länder* – such as North Rhine-Westphalia, Rhineland Palatinate and Lower Saxony – and not forgetting the structural problems being experienced by the new *Länder*;

10. Noting that the ensuing rise in indebtedness places these local authorities in a tense financial position, the heavier burden of debt making it necessary for them to make greater use of bank overdrafts, whereas they have no power to make use of long-term loans for operational expenditure;

11. Noting that, in spite of the considerable effort made to help the five new *Länder* financially, local authorities in the eastern part of the country have had to make significant cuts in their investments in comparison with the 1992 situation, especially because they have insufficient funds to pay the operating costs of new facilities; local authorities in the new *Länder* also have difficulties because of their low tax base (31% of that of local authorities in the west), their backwardness in infrastructure, the need to start to provide services previously offered by state enterprises and the higher numbers of unemployed. In 1998 they had to cut expenditure by 1.6% in order to offset an income reduction of 1.7%, while they still have a large amount of ground to make up;

12. Takes the view that it is necessary to put forward the following observation and recommendations which

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highlight, particularly, the areas not in conformity with certain paragraphs of the charter:

A. In relation to Article 9 (1) of the Charter:<sup>1</sup>

1. Taking the view that local self-government is measured in terms of the resources of which local authorities have unrestricted use, believes that the considerable rise in local authorities compulsory expenditure means that the local margin for financial independence has been much reduced in Germany in recent years;

2. Considering that local own resources average around 50% of expenditure, a rate which is nevertheless far lower in the eastern *Länder* (between 13 and 37%), representing an unsatisfactory level if it is borne in mind that the proportion of shared taxes (proportions of income tax and VAT, ie of those taxes, the rate of which cannot be influenced by local authorities) is roughly half of own resources;

3. Noting that local authorities have been obliged considerably to raise their charges for the services they provide to citizens and firms by around 70% over ten years;

4. Considering that numerous towns and *Landkreise* believe their resources to be insufficient, in spite of efforts to increase taxation and charges, and have taken proceedings against the *Land* of which they are part, precisely on the grounds of insufficiency of resources;

5. Noting that transfers offsetting the low level of own resources are larger in the eastern than in the western *Länder*, but that these subsidies are tending to decrease and will have to be offset by a rise in own resources, still uncertain at the moment;

6. Very concerned about the increase in the indebtedness of numerous towns, which may well weigh heavy on future budgets, many of these towns and municipalities being unable to consolidate their accounts until four to five years or more have elapsed, whereas the statutory provision is for consolidation over two years (in Rhineland Palatinate, for instance, cumulative municipal debt totals 1,200 million DM);

7. Persuaded that German local authorities' financial situation has become critical, and that they ought to be given sufficient room for financial manoeuvre to carry out their tasks;

8. Concerned about the possible negative effects on local finances of the reform plans intended to reduce income tax, reform family allowances, further increase welfare expenditure and raise energy taxes;

9. Notes that in December 1998 the Heads of Government of the German *Länder* agreed to subject the allocation of federal state tasks, expenditure and revenue, covering all cash-flows, including where local authorities and their associations were concerned, to critical regulation

1. Local authorities shall be entitled, within national economic policy, to adequate financial resources of their own, of which they may dispose freely within the framework of their powers.

and to involve the local authorities in work concerning local authority finances;

10. Recommends that the federal German authorities consider reforming local taxation with two aims: that of restoring strong local taxation in application of Article 28 (2) of the Constitution, particularly bolstering those local taxes, the rate of which can still be set by local authorities, and that of revising the arrangements for the transfer of resources for that compulsory expenditure of local authorities which is linked to the implementation of federal and *Land* legislation (see item B above).

11. Recommends, to this end, that an Institutional Committee be set up which brings together representatives of the Bundestag and the Bundesrat and representatives of municipalities, towns and *Landkreise*; this should be made responsible for reviewing local authorities' financial situation, for proposing new ways of improving it and assessing this situation on a permanent basis.

B. In relation to Article 9 (2) of the Charter:<sup>2</sup>

Convinced that the constant tendency of the Federation (and the *Länder*) to lay down rules and standards at a very high level, equally where the execution of tasks falling within the remit of local self-government is concerned, and to deprive local authorities in this way of virtually all margin of appreciation constitute a violation of Article 9 paragraph 2 of the European Charter of Local Self-Government, given the lack of any direct funding obligation on the part of the Federation *vis-à-vis* the local authorities;

2. Noting that the considerable rise in local authorities' compulsory welfare expenditure is insufficiently offset by the transfers authorities receive from the *Länder*, which in their turn receive transfers from the federal government; according to the city of Munich, the compensation equates to just 40%, while the Association of Bavarian municipalities says that the figure is 50%;

3. While accepting that, at *Landkreis* level, account also has to be taken in some *Länder* of the staff and/or buildings made available, although these are not made available to the free towns of the *Kreise*;

4. Noting that certain *Länder* have introduced the principle of concomitance into their constitutions, especially Baden-Württemberg (Article 71 (3) of the constitution of the *Land*), Thuringia (Article 33 of that *Land's* constitution), Schleswig Holstein (Article 49 paragraph 2 of the *Land's* constitution) and the *Land* of Brandenburg (Article 97 paragraph 3 of its constitution), and that this provision enables local authorities, if necessary through a court application, to receive appropriate financial compensation for implementing *Land* legislation; this, however, does not solve the problem of the implementation of federal legislation;

5. Also considering that the *Länder* of Rhineland Palatinate and Hessen make no provision about the rules on

2. Local authorities' financial resources shall be commensurate with the responsibilities provided for by the constitution and the law.

the proportionality of resources to delegated tasks, and that the *Länder* of Bavaria and Saxony provide only for an obligation to provide resources, without reference to “appropriate” compensation; the same is true of the *Länder* of Lower Saxony and Mecklenburg-Vorpommern, whereas more favourable provisions are included in the constitutions of Saxony, Saxony-Anhalt and North Rhine-Westphalia;

6. Recommends that all *Länder* introduce into their constitutions provisions relating to the principle of concomitance, drawing on the models set by Baden-Württemberg and Thuringia, Schleswig-Holstein and Brandenburg, which make explicit provision for compensation which is “corresponding” or “appropriate” to the new tasks delegated to local authorities;

7. Nevertheless takes the view that the introduction of the principle of concomitance must not lead to a decrease in financial equalisation transfers to weaker municipalities;

8. Recommends that the Committee, the setting up of which was advocated in paragraph A.11 above, examine the possibility of also introducing the principle of concomitance at federal level (as recommended by the Assembly of German Jurists in 1996), as well as machinery for evaluating the actual costs incurred through implementation at local level of federal legislation;

9. Invites the federal government to consider the possibility of federal financial participation in those welfare services which require nation-wide harmonisation, with local authorities and *Länder* taking responsibility only for supplementary local or regional services, as proposed by the OECD in 1998 and by the Union of German Towns and municipalities.

C. In relation to Article 9 (3) of the Charter:<sup>1</sup>

1. Noting that, in principle, municipalities in Germany may set the rate of business tax, of two land taxes, of minor local taxes (Bagatellensteuer) such as the entertainment tax, the tax on second homes and the dog licence fee;

2. Concerned that the tendency of recent years, following a series of business tax reforms (the tax has been partly replaced by a 2.2% share of VAT), and the contribution which has to be paid to the *Land* and the federal government for redistribution on the basis of equalisation criteria (20 to 30% on average of the proceeds of the business tax) led to an appreciable decrease in the taxes, the rate of which can effectively be set by local authorities;

3. Consequently recommends that federal and *Land* authorities consolidate this expression of financial independence, particularly by:

– avoiding any more infringements of municipalities’ right to set the rates of their own taxes, especially in the context of the proposed reform of business tax, which might be replaced by proportions of VAT;

1. Article 9 (3): Part at least of the financial resources of local authorities shall derive from local taxes and charges of which, within the limits of statute, they have the power to determine the rate.

– restoring where they have been greatly reduced in number in Bavaria, minor local excise taxes, in pursuance of Article 106 (6) of the federal Constitution, which provides that these taxes go to municipalities;

– introducing, as allowed under Article 106 (5) of the federal Constitution, the provision that local authorities may take a higher proportion of income tax;

– amending the federal Constitution to make it possible for a local tax for the benefit of *Landkreise* to be introduced, so as to remove the relevant reservation expressed by Germany at the time of ratification in relation to Article 9 (3) of the charter.

D. In relation to Article 9 (4) of the Charter:<sup>1</sup>

1. Considers that the Federal Republic of Germany is complying fairly well with the requirements of this paragraph, municipalities’ own resources coming from (from the largest source to the smallest) a proportion of income tax, real estate tax, a proportion of VAT and minor local taxes (at least in the majority of *Länder*);

2. Takes the view that German local authorities’ own resources are therefore diversified, some of them stable and some flexible in line with economic development.

E. In relation to Article 9 (5) of the Charter:<sup>2</sup>

1. Noting that financial equalisation is an integral part of German federalism, the federal Constitution providing that the State has a duty to guarantee equality of treatment for all citizens in their places of residence;

2. Noting that this constitutional principle is applied at all levels, with several financial equalisation instruments operating vertically between federal government and *Länder* and between *Länder* and municipalities, as well as horizontally between *Länder* and municipalities (although only in certain *Länder*, such as Baden-Württemberg and North Rhine-Westphalia); the distribution of shared taxes also takes the equalisation criteria into account;

3. Noting that this equalisation system is comprehensively applied within the framework of solidarity for German unity, and is starting to give rise to criticism from:

– the OECD, which, in its report, said that equalisation which compensated for 99% of fiscal resources between *Länder* had the effect of deterring the rich ones from trying to raise tax receipts, which would only be used for transfers to other *Länder*, as well as offering less well-off ones no reasons for making maximum use of their fiscal capacity,

1. The financial systems on which resources available to local authorities are based shall be of a sufficiently diversified and buoyant nature to enable them to keep pace as far as practically possible with the real evolution of the cost of carrying out their tasks.

2. The protection of financially weaker local authorities calls for the institution of financial equalisation procedures or equivalent measures which are designed to correct the effects of the unequal distribution of potential sources of finance and of the financial burden they must support. Such procedures or measures shall not diminish the discretion local authorities may exercise within their own sphere of responsibility.

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as the effect would be to reduce the transfers from which they benefited;

– the large contributors (Bavaria, Baden-Württemberg and Hessen), which have lodged an application with the Constitutional Court;

4. Notes that the vertical – and in some *Länder* horizontal – financial equalisation instruments between municipalities are operating very efficiently, on the basis of criteria linked to municipalities' financial capacity and actual needs; the compensation rate varies, being 100% in Thuringia, for instance, 95% in North Rhine-Westphalia, 90% in Baden-Württemberg; one feature of Germany's equalisation system is that it takes account of the amenities needs of major towns, to which an index of up to 140/160% is applied, reflecting financial needs per resident (recognition of the role of central towns which provide services to other, neighbouring municipalities);

5. Recommends that the federal German authorities and the *Länder* in future strive, once the solidarity campaign for German unity has faded, to achieve a better balance between, on the one hand, the needs of financial equalisation, and, on the other, the benefits to *Länder* and to local authorities of reasonable financial independence;

F. In relation to Article 9 (6) of the Charter:<sup>1</sup>

1. Is pleased to note that the right of consultation in a number of *Länder* is written into their respective constitutions (Saxony – Article 84 paragraph 2, Brandenburg – Article 97 paragraph 4, Baden-Württemberg – Article 71 paragraph 4 and Thuringia – Article 91 paragraph 4);

2. Notes with concern, however, that associations of local authorities – not only in those *Länder* where the right of consultation is not constitutionally or legally established – complain that they are not always consulted; the government of the *Land* of Lower Saxony has even been asked by the constitutional court to co-operate more fully with the associations that represent local authorities;

3. Having noted that it is the unanimous opinion of representatives of federal associations of local authorities that consultation at federal level is insufficient and largely ineffective, despite the fact that there is provision for it in the rules of procedure of the government and parliament, although not those of the second chamber;

4. Recommends that those *Länder* which have not yet done so introduce the right of consultation for associations which are representative of local authorities, preferably in their constitution, but at least in their laws establishing local authorities, following the model of Saxony, Brandenburg and Thuringia;

5. Taking the view that the right to be consulted must also be guaranteed at federal level, as 80% of federal laws are implemented by local authorities;

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1. Local authorities shall be consulted, in an appropriate manner, on the way in which redistributed resources are to be allocated to them.

Recommends that the federal authorities strengthen the right to be consulted on laws concerning them or to be implemented by them of the associations which represent local authorities, through legislation or through the introduction of this right into their constitutions.

G. In relation to Article 9 (7) of the Charter:<sup>1</sup>

1. Notes that transfers paid to local authorities by *Länder* – as the federal government pays no grants directly to local authorities – are of the order of 40% on average, these transfers being larger in the five new *Länder* (up to 70%) than in the west;

2. Also notes that, where their form is concerned, an average of 75% of these transfers take the form of general grants, which local authorities are free to use as they wish, the rest comprising specific grants which limit local authorities' financial independence, it being stated that the volume of specific grants allotted to fund infrastructure is far greater in the five new *Länder* than in the west;

3. Is forced to note that, in certain *Länder*, use is made of the system of special funds (*Sondertöpfe*) used by the administrative departments of ministries in certain sectors, such as construction, economic development and education, and which in practice have something in common with specific investment grants for purposes not necessarily corresponding with those chosen by the local authorities; there are approximately 800 special funds in North Rhine-Westphalia, for example, 240 in Bavaria and 150 in Baden-Württemberg; if account is taken of these special funds, specific grants in certain *Länder* exceed the general grants, a situation incompatible with Article 9 (7) of the charter;

4. Recommends that the *Länder* which pursue the policy of special funds in excessive numbers convert at least some of these into general investment grants to local authorities, also taking into account the needs of small rural towns and municipalities.

H. In relation to Article 9 (8) of the Charter:<sup>2</sup>

1. Notes that in Germany the use of borrowing is strictly regulated, and furthermore, that it is limited to the financing of investment expenditure, because of the criteria laid down in the Treaty of Maastricht with a view to the single European currency, backed by the stability plan; thus German local authorities cover an average of just 3 to 4% of their total expenditure through borrowing, a proportion which is very low;

2. Takes note that the associations of German local authorities complain about the debt ceiling calculated on the basis of the local authorities' financial capacity, in other words, by reference, in practice, to the income-per-resident

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1. As far as possible, grants to local authorities shall not be earmarked for the financing of specific projects. The provision of grants shall not remove the basic freedom of local authorities to exercise policy discretion within their own jurisdiction.

2. For the purpose of borrowing for capital investment, local authorities shall have access to the national capital market within the limits of the law.

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index, which amounts to lending mainly to prosperous local authorities ;

3. Recommends that the federal authorities and the *Länder* ease borrowing limits, especially over this period during which numerous German local authorities are facing a local financing crisis ;

I. In relation to Article 11 of the Charter:<sup>1</sup>

1. While noting that, at the formal level, local authorities may lodge applications with the judicial authorities, ie :

- administrative courts, on the basis of legislation,
- constitutional courts, on the basis of federal and *Land* constitutions ;

2. However, having regard to the fact that certain provisions on financial independence are worded in such a way as to make it highly improbable that local authorities'

interests are taken into account (see paragraphs B.5 and 6 above) ;

3. Recommends that the associations which represent German local authorities advise municipalities, towns and *Landkreise* also to take account of the European Charter of Local Self-Government if applications are lodged with judicial bodies ;

J. Invites the authorities of the Federation and the *Länder* to respect fully the provisions of the charter by implementing the above-mentioned recommendations ;

K. Invites the German delegations to the Chamber of Local Authorities and Chamber of Regions to keep the Congress informed in detail about changes in the situation of local financial independence in their country.

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1. Legal protection of local self-government : Local authorities shall have the right of recourse to a judicial remedy in order to secure free exercise of their powers and respect for such principles of local self-government as are enshrined in the constitution or domestic legislation.