A Crisis in Finance and Investment – Local Government Finance Needs Fundamental Reform

One could argue that the financial situation of the local authorities is only a partial cause for concern. In the early 1990s their deficits shot up, but by the end of the decade they were showing surpluses. That was even the case in East Germany. Only in 2001 did they slip back into the red, and this was due to the weak economic situation and the shortfalls in revenue after the tax reform package. This would appear to contradict the statements by the local authority federations, who are warning that local government finance is close to collapse.[1] In fact – unlike the financial situation of the states and the federal government – it is not so much the balance sheet as investment expenditure by which the financial position of the local authorities should be measured. The legislation on local authority finance greatly restricts their scope for borrowing, and so if shortfalls in the budget are likely they have to react by putting a brake on expenditure. And of all the items, investment is the most flexible. The improvement in the financial status of the local authorities up to the year 2000 was thus achieved at the expense of a dramatic fall in investment spending.

A weak position in the federal structure

In the economic view, decentralisation of public tasks is advantageous, since individual needs can be given better consideration and 'frustration costs' avoided through geographical proximity and small local groups of users. Public tasks should be performed by local authorities if those who decide on the supply of commodities, those who bear the costs and finally those who use the public commodity are all in the same place. Typical examples are kindergartens, theatres, libraries, water supplies and waste disposal.

At least in intention, the German financial constitution follows the principle of subsidiarity, and the above considerations are based on it. But 'cooperative' federalism in fact has a strong mix of tasks and financing responsibilities. The local authorities have to perform a large number of tasks that are imposed on them from outside. In principle there is a risk in a mixed system that the higher levels of government may make as many tasks as possible obligatory but not provide the lower levels with the financial means to carry them out: try to pass on the load, in other words. A typical example is the right to a place in a kindergarten, which the local authorities have to provide although they are given no funding for this.

On the revenue side the mix system is reflected in a strongly integrated tax association ('shared tax revenues'). The local authorities are incorporated in this association with the federal states and the federal government, firstly because they receive a share of income tax (15%) and turnover tax (2.2%), and secondly because they hand over a percentage of their revenue from trade tax.[2] The advantage of association systems of this kind is mainly that the local authorities are not too badly affected by the fluctuations in one form of tax, while uniform national tax legislation is possible with relatively low collection costs. The disadvantage is the lack of autonomy for the local authorities in tax legislation. However, they do have the right to decide the rates of trade and property tax.

Compared with the federal government and the federal states the local authorities only finance the smaller share of their expenditure from tax revenue. Measured by adjusted expenditure[3] the ratio was 33% in 2001, while it was 75% for the states and 80% for the federal government. The main source of revenue for the local authorities is trade tax. It is also based on the equivalence principle in the sense of 'group' equivalence. The local authorities have heavy expenditure for local businesses, particularly in the infrastructure, but the only item they can tax is earnings from trade, now that taxation of the wage bill and trading capital has been abolished. Allowing the local authorities a share of income tax revenue was intended to express the element in the local tax system that relates to the place of residence, as an important part of the local authorities' activities are concerned with the supply of 'household-oriented' infrastructure. Income tax now accounts for a larger proportion of the local authorities' budgets than trade tax (after deduction of the allocations they make to other levels of government).

[1] Cf. Hans Karrenberg and Engelbert Münstermann: 'Städtische Finanzen – Kollaps oder Reformen!' Gemeindefinanzbericht 2002, in: Der Städtetag, vol. 4/2002.

[2] Under the financial reform of 1969 the federal government and the federal states were allowed a share of the revenue from trade tax and in return the local authorities received a share of income tax revenue (wage and assessed income tax).

[3] Expenditure after deduction of payments on the same level, e.g. allocations to the federal state districts by local authorities in the same district.

The local authorities finance much more of their expenditure from charges and contributions than the federal states or the federal government – the figure is 11%. However, it was 13% in the mid-1990s. The decline is mainly due to the removal of facilities financed by charges, for sewage and waste disposal for example, from the local authority budgets. The relatively high share of finance from charges reflects the greater market proximity of municipal services and so the equivalence idea as the principle of financing.

Neither tax nor charges revenues suffice to finance all the spending by local authorities. Hence, there is also an extensive financial compensation arrangement between them and the federal states. The first objective of this is to provide the local authorities with sufficient funds, and the allocation is spread between the individual authorities according to special keys. Secondly, the federal states give tied funds to finance specific tasks. In many cases they will deliberately use these tied funds as a steering instrument, e.g. to promote certain investment projects. The level of the allocation from the federal state largely depends on the development in its own tax revenue (hence the tax association).[4] The regulations differ from one state to another, both in regard to the basic arrangements within the association and the ratios, and in regard to the necessary expenditure for which the local authorities can claim. Generally, a standard average level of expenditure, the 'standard requirement', is used as the basis for calculation, and it is assumed on the basis of experience that the need for funds grows over-proportionally as the size of the municipality grows. In many federal states the need for funds is expressed through the main calculation scale, as it is called, which is based on an artificial 'rating' of the number of inhabitants.[5] In addition, specific needs are taken into account in supplementary calculations, such as expenditure on school children, social assistance or expenditure in connection with central local functions. It is in the nature of the situation that fixing the need for expenditure is controversial, for there is neither a list of items of expenditure that applies to all local authority areas, nor can the local authorities be subject to instruction on how to fulfil their tasks.

[4] In East Germany, on account of the low tax revenue to the local authorities, revenue from the state financial compensation scheme and the supplementary allocations by the federal government are included in the tax association.

[5] The rating of the number of inhabitants is derived from the need for supplementary funds, which, to put it simply, is the difference between current expenditure and the general cover funds (taxes and allocations according to the key).

Development trends in local government finance – Improving the financial situation by 2000 – The decline in investment

The development in local authority budgets since reunification can be divided into two phases. Up to the mid-1990s the budgets were greatly in deficit, with the local authorities ending each year with a shortfall on average of euro 7 billion (cf. table 1). In East Germany they rapidly slipped into the red because the revenues were not sufficient to cover the administrative transition process or to expand and modernise the infrastructure. The hope that the East German economy would catch up rapidly and the local authorities' tax revenue would increase accordingly proved vain. In West Germany the reunification boom filled the coffers and led the local authorities to indulge in unwise spending. After 1995 consolidation was started in the West and in the East, and as a result from 1998 to 2000 the local authorities were able to show a surplus. The development was slightly less favourable in East Germany than in West Germany. But in 2001 the local authorities had to take shortfalls of euro 4 billion, owing to the weak cyclical trend and the loss of tax revenue after the tax reform package. They are facing big shortfalls this year as well.

The improvement in local government finance up to 2000 cannot be explained by a favourable trend in revenues alone, for revenues did not rise from 1995. Rather, expenditure was cut, by nearly euro 5 billion to euro 148 billion. This was mainly at the expense of investment, which fell during that period from euro 29 billion to euro 24 billion. Savings in personnel expenditure also greatly helped to ease the situation in local government finance. Despite the increase in wage and salary scales in the public services – by a total of 14% since 1995 – personnel expenditure has not risen over the past decade, but has fallen slightly. This is because the number of employed persons has been reduced during that period from 1.74 million to 1.47 million. This partly reflects the modernisation process on local level, but the influence of special factors was even greater: firstly a large number of facilities have been taken out of the core budgets, although it is only possible to speculate on the full extent.[6] Secondly, the East German local authorities reduced the level of their personnel, which was excessive by West German standards.

[6] Charges, which fell by as much as 17% from 1995 to 2001, can be taken as an indication. It is not very likely that charges were lowered across a broad front, but there can have been little scope for any real increase. In the early 1990s revenue from charges to the municipalities was rising by nearly 5% a year.

Table 1
Local Authorities' Expenditure and Revenues by Items
Million euro

	1992	1995	1996	1997	1998	1999	2000	2001	Change in percent	
									1995/ 1992	2001/ 1995
Personnel	39 919	40 332	39 778	39 112	38 940	39 316	39 504	39 319	1.0	–2.5
Current expenditure on material and equipment	25 667	26 348	26 320	26 412	26 274	27 514	27 997	28 549	2.7	8.4
Interest payments to other areas	4 921	5 626	5 720	5 592	5 474	5 226	5 084	5 183	14.3	–7.9
Current allocations to	11 015	14 098	14 498	15 030	15 397	15 513	12 596	17 162	28.0	21.7
Federal states	3 041	3 836	3 696	3 630	3 676	3 467	3 638	3 822	26.1	–0.4
Associations	1 970	2 382	2 340	2 355	2 262	2 192	2 201	2 243	20.9	–5.8
Federal Government	120	110	172	161	153	171	150	152	–7.7	38.0
Companies	2 461	3 021	3 103	3 309	3 503	3 576	100	4 064	22.8	34.5
Social facilities	3 424	4 749	5 187	5 576	5 803	6 106	6 507	6 881	38.7	44.9
Social benefits etc.	22 076	30 163	28 856	26 570	26 178	26 098	26 611	27 337	36.6	–9.4
Investment in fixed assets	33 140	28 426	26 468	25 091	24 402	24 744	24 576	24 189	–14.2	–14.9
Allocations for investment to	2 200	2 729	2 849	2 779	2 647	2 653	2 584	2 663	24.0	–2.4
States	257	339	343	339	338	323	325	278	32.1	–18.0
Other areas	1 943	2 390	2 506	2 440	2 309	2 330	2 258	2 385	23.0	–0.2
Loans to other areas	939	860	725	609	471	652	441	419	–8.4	–51.3
Acquisition of shareholders	1 089	1 009	945	865	1 062	1 124	1 076	1 942	–7.3	92.4
Other expenses	1 345	1 617	1 603	1 029	1 035	1 253	4 658	1 147	20.2	–29.0
Adjusted expenditure	142 311	151 208	147 762	143 091	141 881	144 093	145 125	147 909	6.3	–2.2
Taxes and similar items	43 685	43 903	44 118	44 840	48 602	51 031	51 913	49 065	0.5	11.8
of which:	17 551	15 538	17 143	18 521	18 544	19 486	19 344	17 144	–11.5	10.3
Net trade tax	20 533	21 420	19 374	18 449	19 604	20 447	21 256	20 416	4.3	–4.7
Share of wage tax/assessed income tax	–	–	–	–	2 326	2 639	2 687	2 676	–	–
Share of turnover tax	6 188	7 015	7 219	7 424	7 610	7 887	7 668	8 162	13.4	16.3
Revenue from economic operations	35 588	39 935	39 900	38 140	38 293	39 026	40 745	40 459	12.2	1.3
Current allocations from	34 475	38 954	39 256	37 665	37 800	38 561	40 268	40 046	13.0	2.8
States	1 113	981	644	475	492	465	477	413	–11.9	–57.9
The Federal Government	17 267	19 585	18 891	18 052	17 521	17 058	16 936	16 540	13.4	–15.5
Charges	11 216	9 600	10 015	9 491	8 931	8 592	8 439	8 135	–14.4	–15.3
Allocations for investment from	10 195	8 967	9 438	8 997	8 505	8 183	8 092	7 818	–12.1	–12.8
States	1 021	633	577	494	426	409	347	317	–37.9	–50.0
The Federal Government	4 627	6 602	6 962	6 789	8 313	7 879	6 878	6 927	42.7	4.9
Sale of assets	334	591	624	588	624	849	559	527	76.9	–10.7
Loan repayments from other areas	14 664	16 836	16 659	14 725	14 418	14 077	13 910	14 139	14.8	–16.0
Other revenues										
Adjusted revenues	133 569	144 067	144 389	140 050	144 312	146 398	147 049	143 954	7.9	–0.1
Balance	–8 742	–7 141	–3 373	–3 041	2 431	2 305	1 923	–3 955	–18.3	–44.6

Sources: Federal Statistical Office; DIW Berlin calculations.

Social payments expanded strongly until the mid-1990s but have been falling since then. When care insurance was introduced it took over assistance payments for ambulatory and hospitalised care, so easing the burden on local finances. The decline in the number of asylum seekers and the cutbacks in payments to them have also kept the trend down.

For many years during the last decade local authority tax revenue grew only very slightly. That was particularly the case with revenue from income tax, which has remained below the rise in the assessment bases owing to the loss of revenue due to the tax reform packages and as a result of massive tax concessions to rebuild East Germany. But revenue from trade tax was also lower in 1996 than in 1992. During the most recent upswing local tax revenues rose markedly; there was also additional revenue from turnover tax. But last year the local authorities had to take a big shortfall. The big losses in income tax were due to the tax reform, while several factors played a part in trade tax. Some of the losses reflected the generally weak trend in the economy, some were the result of the tax reform. But they were also due to the fact that affiliated companies were able to offset their profit and losses mutually to a greater extent than before by forming integrated relations for tax purposes. The local authorities are expecting to face big drops in company taxation this year as well.

The allocations by the federal states to their local authorities have almost stagnated since the mid-1990s, and the conclusion is compelling that the states have consolidated their financial position at the expense of the local authorities, that is, they have evaded part of their financial responsibility for the local authorities, for the tax revenue to the states has increased.

All in all, the position of the local authorities in 'cooperative federalism' contrasts with the principle of subsidiarity based on allocation and with the institutional guarantee of self-administration under Art. 28, § 2 of the Basic Law. The gradual undermining of the local finance system is a particular cause for concern. Taken on average, the local authorities are chronically underfunded, although they have undergone a tough consolidation regime. That in turn involved a dramatic decline in their investment. One major reason is their financial dependence on the federal states – in East Germany even more than in West Germany – and particularly in times when funds are scarce the states are inclined to consolidate their position at the expense of the local authorities. Another reason is the lack of interconnection. Again and again the federal government and the states have transferred tasks to local level without at the same time providing the necessary funds. Allowing the local authorities a share of income tax is also not without its problems, as tax policy decisions generally have to be taken for macroeconomic reasons, that is, without local references. Above all, trade tax in its present form is less and less suited to providing a fertile source of funds for the local authorities. Ultimately the financial and investment crisis can only be solved through fundamental reform of local finance. And this will have to give the local authorities greater financial independence; that is, their share in tax revenue will have to be increased.

Reform of local government finance

The range of options for reforming local government finance is considerable. One possibility that could be realised at short term would be to give the local authorities a greater share than hitherto in turnover tax. Here it would be of advantage that turnover tax reacts less strongly to cyclical fluctuations than income and trade tax; moreover, the rates of tax are not lowered, as is repeatedly the case with income tax. Admittedly, this solution would require the federal government and the states to agree on a 'fair' distribution of the load, for a higher share for the local authorities would have to be funded by them. Naturally, a higher local share only makes sense if the local authorities do not have to reckon with cutbacks in the financial compensation allocations. Another possibility would be to reduce the allocations the local authorities make out of trade tax. This might meet with less resistance from the federal government and the states, but it would have the disadvantage that trade tax is very vulnerable to cyclical movements and so the effect in easing the financial situation for the local authorities would fluctuate strongly. The East German local authorities would probably be in a better position if the share of turnover tax were increased than if the trade tax allocation were reduced, as turnover tax is spread much more evenly across the regions – namely, corresponding to the number of inhabitants – than trade tax, which depends on business activity.

But in regard to the allocations, both proposals could only be interim solutions. Over the long term fundamental changes to the system of local government finance must be the aim.

Reform of trade tax long overdue

The role of trade tax as a local business tax with equivalence reference has been progressively reduced. Wage bill tax, for example, has been abolished (in 1980) and the addition of interest on borrowed funds to earnings on trading and of borrowed funds to trading capital has been limited to 50% (1983). The free allowances for sole proprietors and partnerships have been increased (in 1978, 1980 and 1993) and grading of the tax assessment figure introduced for trade earnings tax (1991). Trading capital tax was abolished in 1998. Some branches have in any case always been exempt from this tax (the independent professions, agriculture and private renting of housing).

This progressive undermining has concentrated tax revenue on big companies with high earnings (cf. table 2). According to the 1995 trade tax statistics (more

Table 2
Liability for Trade Tax, Trade Earnings and Tax Assessment Thresholds 1995

Trade earnings (DM) from ... to less than ...	Taxpayers			Tax assessment threshold according to trade earnings		
	Number	%	% cumulative	DM million	%	% cumulative
Trading firms and the tax assessment threshold						
Showing a loss	52 984	5.6	5.6	0.0	0.0	0.0
No trade earnings	18 940	2.0	7.6	0.0	0.0	0.0
0 to 7 600	42 851	4.5	12.1	6.4	0.1	0.1
7 600 to 24 100	51 451	5.4	17.5	32.8	0.3	0.4
24 100 to 48 100	44 700	4.7	22.2	57.9	0.6	1.0
48 100 to 96 100	398 778	41.9	64.1	195.0	2.1	3.1
96 100 to 144 100	144 153	15.2	79.3	268.2	2.9	6.0
144 100 to 250 000	101 088	10.6	89.9	531.9	5.7	11.6
250 000 to 500 000	51 370	5.4	95.3	703.0	7.5	19.1
500 000 to 1 million	22 084	2.3	97.6	699.5	7.4	26.5
1 million to 5 million	17 893	1.9	99.5	1 776.6	18.9	45.4
5 million to 10 million	2 363	0.2	99.8	813.3	8.7	54.1
10 million to 20 million	1 207	0.1	99.9	839.6	8.9	63.0
20 million to 50 million	727	0.1	100.0	1 084.8	11.5	74.6
50 million to 100 million	207	0.0	100.0	715.5	7.6	82.2
100 million and more	136	0.0	100.0	1 676.5	17.8	100.0
Total	950 932	100.0	x	9 400.9	100.0	x
Gini coefficient	90.3%					
Memo item:						
Trading firms below tax assessment threshold	1 186 467	124.8	x	x	x	x
All trading firms	2 137 399	224.8	x	x	x	x

Sources: Federal Statistical Office, Trade Tax 1995; DIW Berlin calculations.

recent data are not yet available) 1.1 million of the 2.1 million trading firms never reached the tax threshold. Among those that did, the taxation was concentrated on very few firms, with just under 5% accounting for more than 80% of the tax revenue. Fewer and fewer taxpayers were affected by the increases in the rate, and this was at the price of a correspondingly higher burden on the firms paying tax. This development undermines the principles of fiscal equivalence, or balance of interests, and it creates problematic incentives for local government economic policy. For tax reasons the local authorities are primarily interested in attracting big firms to their locality. But generally the high share of profits in the assessment basis makes them strongly dependent on cyclical trends.

Principally, there are three possible models for reforming local government corporate taxation: business value added taxation, the share of turnover tax and a local income and earnings tax.[7]

Business value added taxation – the classic

A kind of 'revitalisation' of trade tax to bring this more into line with a business value added taxation has been under discussion for a long time.[8] The aim is to spread the load more evenly between all the companies and economic sectors by

– extending taxation as far as possible to all production units, that is, including the independent professions, agriculture and forestry, housing, commercial enterprises run by legal entities under public law, and possibly even administrative offices incorporated under public law;
– reducing free allowances;

[7] Cf. Michael Broen: 'Ersatzvorschläge für die Gewerbesteuer: Darstellung und Vergleich einiger häufig genannter Ansätze', in: Wirtschaftsdienst 2001, p. 713 ff., SVR, Jahresgutachten 2001/2002, Item 374.

[8] Wissenschaftlicher Beirat beim Bundesministerium der Finanzen (Academic Advisory Council to the Federal Ministry of Finance): Gutachten zur Reform der Gemeindesteuern, Schriftenreihe des Bundesministeriums der Finanzen, vol. 31, Bonn 1992, p. 52 ff.; SVR, Jahresgutachten 1983/84, Items 399 ff.; SVR, Jahresgutachten 1995/96, Item 342. The Academic Advisory Council has now distanced itself from the idea of a business value added taxation, and is in favour of a municipal income and profits tax, cf. SVR, Jahresgutachten 2001/2002, Item 383. DIW Berlin was also in favour of revitalisation at the time, cf. 'Zur Finanzlage der Gemeinden', Dieter Teichmann and Dieter Vesper, in: Wochenbericht des DIW, no. 37/1985.

– widening the assessment bases towards the entire (net) value added, calculated from profits (minus earnings from shareholders), interest expenditure (minus interest earnings), expenditure on rent and leasing (minus earnings from rent and leasing) and the wage bill.

In return, the tax rate could be enormously reduced. The negative allocation incentives in trade tax would be almost completely removed and the dependence on only a few large companies clearly reduced. The dependence of tax revenue on profits, and so on cyclical trends, would also be considerably reduced. In regard to the system of local government financial compensation the tax revenue should be much more evenly distributed between the local authorities, so that the financial compensation could be limited more to its subsidiary function. Above all, a business value added taxation would correspond to the principle of fiscal equivalence. In conjunction with the local authorities' right to fix the rates of tax a larger number of firms paying tax and a wider assessment basis would draw the bond between the local authorities and their local businesses, which has loosened, tighter again.

However, the idea of a business value added taxation has so far met with little response in discussion on tax policy. The business associations are against it because it would give too much weight to the element of business taxation that is independent of earnings, and criticism is directed at the reintroduction of the wage bill tax because it lays a greater burden on the factor labour. However, that criticism is directed at the macroeconomic requirements for taxation, which should be taken into account in federal and state taxes and in social insurance contributions, but not in local taxation.[9] A compromise could be to reduce the weight of the wage bill in the assessment basis.

A share of turnover tax only as a supplementary measure

There has been growing support in recent years for the proposal of successively reducing trade tax and making good the loss of revenue to the local authorities by giving them a share in the revenue from turnover tax.[10] The same method was used to abolish trade capital tax.[11] Turnover tax guarantees a relatively steady trend in revenue. The distribution key envisaged is related to economic activity; it will provide funding more in line with need and also take account in principle of the local authorities' interest in attracting businesses. In the view of the local authorities, however, a share of turnover tax is ultimately an allocation; their fiscal autonomy would be greatly restricted, as they would have no right to fix the rate. Entirely abolishing trade tax is now unconstitutional. Since 1998 the fiscal autonomy of the local authorities has been guaranteed in the Basic Law as independent taxation based on the local economy and incorporating the right to fix the rates of tax (Art. 28, § 2, Sentence 3 GG). A share of turnover tax should therefore – as hitherto – only be considered as a supplementary financing instrument.

The right for local authorities to fix rates of income tax is meaningful

To strengthen the local authorities' fiscal autonomy they could be given the independent right to set rates of income tax.[12] The idea takes up a proposal from two business associations (BDI and VCI) to replace trade tax and the 15% local share of income tax with the right for local authorities to fix rates of income *and* corporation tax.[13]

Besides removing the element in local taxation that is related to business activity, this concept has the serious disadvantage that companies' earnings fluctuate strongly. Hence, the local authorities should not be given the right to charge a local supplement on corporation tax. Local income tax should not be under discussion as a replacement for trade tax; rather, it should be seen as strengthening the local taxes that are related to the residential population.

[9] Cf. SVR, Jahresgutachten 1989/90, Item 344.

[10] The business associations have been putting forward proposals of this nature for a long time. Cf. Wolfgang Ritter, 'Abbau der Gewerbesteuer. Ein Beitrag zur überfälligen Reform der Gemeindefinanzen und der Unternehmensbesteuerung', in: Betriebs-Berater 1983, p. 389 ff. Lothar Schemmel und Wolfgang Krehwinkel, 'Abbau und Ersatz der Gewerbesteuer', Schriften des Karl-Bräuer-Instituts, no. 57, Wiesbaden 1984; Bundesverband der Deutschen Industrie (BDI), 'Zukunftsorientierte Steuerpolitik – Reform der Unternehmensbesteuerung', Cologne 1985, p. 14 ff.

[11] Since 1998 the local authorities have received 2.2% of the revenue from turnover tax.

[12] The possibility of giving the local authorities the right to fix the rates for the local share of income tax was expressly envisaged in the 1969 financial reform, see Art. 106, § 5, Sentence 2 Basic Law. So far the legislature has not made use of this clause.

[13] Cf. Michael Broer, 2001, loc. cit, p. 715; Matthias Sander, 'Ersatz der Gewerbesteuer durch eine Gemeindeeinkommensteuer', in: Wirtschaftsdienst, no. 8/2001, p. 452 ff.

More active taxation of the residential population

The right for local authorities to add a supplement to income tax certainly makes sense as part of local taxation of the residential population.[14] It would strengthen the fiscal autonomy of the local authorities and be more in keeping with fiscal equivalence – people would then see each month on their wage statement how much tax they are paying locally. However, the differences in revenue from one local authority to another would increase considerably; the cities particularly fear disadvantages in tax competition for wealthy residents. In fact, there are already, with the present system of allowing the local authorities a share in income tax, considerable differences in financial strength between 'poor' inner city areas and 'rich' communities in the fringe. These differences could, however, be dealt with through intergovernmental compensation transfers.

Finally, property tax is urgently in need of reform. In West Germany the old uniform values of 1964 are still used, and in East Germany, the uniform values of 1935. In principle, property tax is a 'good' local tax, as it falls equally on the local businesses and the local population. Not least, the quality of local services is reflected in property prices.[15]

However, reform of property tax would require regular updating of the valuations of about 30 million properties. The administrative labour this would involve has so far prevented the establishment of new uniform valuations. Experience in other countries shows that this is certainly feasible if the matter is tackled pragmatically. A simplified 'fixed asset procedure' would be conceivable, in which the land values would be fixed according to the orientation values set by the local assessment committees; for the buildings on the land typical building valuations could be set, using technical building features that could easily be assessed (living/usable space, gross floor space on each storey or updated normal building costs, differentiated according to type of building).[16] Alternatively, the tax could be a pure land value tax, as is the practice in Denmark.

What now?

The core of local government finance reform must be to strengthen the financial position of the local authorities by increasing their tax revenue. Higher revenues are essential to improve their ability to invest. For this a volume of euro 5 billion a year should be the aim, which is roughly the equivalent of the decline in local authority investment since the mid-1990s. The business value added taxation could contribute euro 3 billion to this; another euro 2 billion could come from reform of the property tax. The allocation out of the trade tax should be abolished, at the expense of the federal government and the states (cf. table 3).

At the same time, tax revenues to the local authorities should be made less vulnerable to cyclical fluctuations, to enable the local authorities to fulfil their local tasks more steadily. If they had more income they would have more scope to perform voluntary self-administration tasks. The roughly equal division of local taxation between businesses and the residents should be retained; it has proved its worth, all in all. But the local authorities should be given the right to fix the rates of tax for the residential population as well; the option which the Basic Law allows for income tax should be utilised. It is also urgently necessary to put property tax on a more up to date basis and obtain more revenue from it; a simplified 'fixed asset valuation' procedure would be appropriate here.

A local business tax should be kept in mind to retain the relation to local businesses, which in turn profit from

Table 3

The Fiscal Effects of a Business Value Added Taxation in 2001

In million euro

Revenue from trade tax	
Gross trade tax	24 533
Trade tax allocation[1]	5 509
Trade tax allocation[1]	19 024
Proposed business value added taxation[2]	22 000
Reduction in revenue from value added/trade tax[3]	–2 530
Increase in revenue from income and corporation tax, solidarity surcharge[4]	1 540
Of which: local authorities' share (of income tax)	160
Total fiscal effects	–990
Local authorities	3 140
Federal Government and states	–4 130

1 Including city states. — 2 For local authorities: abolition of trade tax allocation assumed. — 3 Gross trade tax minus revenue from proposed business value added taxation. — 4 Federal Government, states and local authorities together.
Sources: Federal Statistical Office; DIW Berlin calculations.

14 Bundesverband der Deutschen Industrie (BDI) and Verband der Chemischen Industrie (VCI) (ed.): 'Verfassungskonforme Reform der Gewerbesteuer – Konzept einer kommunalen Einkommen- und Gewinnsteuer', Cologne 2001, *http://www.bdi-online.de*.

15 Karl-Heinrich Hansmeyer and Horst Zimmermann: 'Möglichkeiten der Einführung eines Hebesatzrechtes beim gemeindlichen Einkommensteueranteil', in: Archiv für Kommunalwissenschaften 1993, p. 221 ff.

16 SVR: Jahresgutachten 2001/2002, Item 376; Stefan Homburg: 'Reform der Gewerbesteuer', in: Archiv für Kommunalwissenschaften, no. 39/200, p. 44.

the supply of local infrastructure. Ultimately this can only be a tax oriented to value added. That would also show that the success of a company, which will be taxed, is the result of a combination of the various production factors. Widening the basis of taxation would enable the rates of tax to be greatly reduced – the local business tax would then no longer be a 'tax on big companies'; it would be a tax that affected every company, but at lower rates.

If the local authorities' right to fix rates of tax were not limited to the local business tax but also extended to income tax, the local authorities would have greater scope for their tax policy. They could then, depending on the preferences of their taxpayers, decide whether to draw more on the business or residential sources of revenue. If this reform caused too great a differential between local authority areas – richer local authority areas could obtain further advantages by reducing their rates – the effect could be cushioned through local financial compensation mechanisms.

Stefan Bach and Dieter Vesper