

Fiscal Federalism in Germany

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FISCAL FEDERALISM IN GERMANY

A. FEDERALISM IN GERMANY: THE CONSTITUTIONAL AND POLITICAL CONTEXT

The Federal Republic of Germany established in 1949 has firm historical roots in the earlier experience of the German Empire (1871-1918), the Weimar Republic (1919-34), the failure of the totalitarian centralization of the Third Reich (1934-45), and the immediate postwar influence of the allied occupying powers. In 1949, the eleven Länder of West Germany became the Federal Republic of Germany. Thirty-one years later, the reunification of Germany in 1990 provided for the accession of five new Länder from what had previously been the Democratic Republic of Germany. The federation, therefore, now consists of sixteen Länder with a total population of over 80 million. The population of the German federation is linguistically homogeneous, although there remains considerable economic disparity and difference in political cultures between the former West and East Germanies.

A notable characteristic of the German federation, by comparison with the Canadian and United States federations, is the extensive constitutional and political interlocking of the federal and state governments. The federal government has a very broad range of exclusive, concurrent (with federal law prevailing) and framework legislative jurisdiction. But the Länder in turn have a mandatory constitutional responsibility for applying and administering most of these federal laws. While the legislative powers of the federal government are much more extensive than in Canada or the United States, another significant feature of the German federation is that the Länder are more directly involved in decision-making at the federal level than the states or provinces in virtually any other federation. This is achieved through the constitutional requirement that the second chamber, the Bundesrat, is composed of Land first ministers and senior ministers serving as ex officio delegates of their Land governments. The Bundesrat possesses an absolute veto on all federal legislation affecting the Länder. In practice about 60 percent of federal legislation falls in this category and therefore the voice of the Länder through the Bundesrat is highly influential in federal policy-making. Thus, the Bundesrat is a key

institution in the interlocking federal-state relationship and the extensive joint decision-making that occurs within the German federation including those on financial interrelationships.

Both the Federal and Land institutions are organized on the principle of parliamentary responsible cabinets, with the Chancellor at the federal level and a Minister President in each Land as the heads of government accountable to their legislatures. In addition there is a formal head of state with largely ceremonial powers, the President of the Federal Republic, who is elected by an electoral college consisting of the Bundestag and an equal number of members elected by the legislatures of the Länder.

Fiscal federalism in the German federation is of particular interest because of the way they relate to the closely interlocked legislative and administrative powers of the two orders of government, and because of the unique way in which the Länder participate in federal decision-making through their representation in the Bundesrat. This makes the Bundesrat a key institution in the highly integrated legislature, administrative and financial interdependence of the two orders of government.

1. CONSTITUTIONAL STATUS OF VARIOUS ORDERS OF GOVERNMENT

The Federal Republic of Germany consists of a federal (Bund) government, 16 Land (state) governments, and numerous municipal (or local) governments. All of the federal and Land governments are organised on the basis of the parliamentary system. There is a formal, indirectly elected head of state, the President of the Federal Republic.

The Federal and Land Legislatures

The fusion of legislative and executive branches of government within the federal and Land legislatures effectively transfers legislative power to the executive branch of government. However, unlike in the majoritarian Westminster model of parliamentarism, German governments are at both levels frequently composed of a coalition of two or more political parties. Therefore, government positions represent a compromise arrived at through a process of inter-party bargaining within the governing coalition.

One of the most distinctive features of the German system of government is the Bundesrat, the Upper House of the federal legislature. The membership consists of *ex*

officio delegates of the Land governments each Land delegation voting as a block under direction from its government. Thus, the governments of the Länder are directly involved in the federal decision-making process. The Bundesrat holds an absolute veto on all legislation affecting the Länder; in practice about sixty percent of all federal legislation falls into this category because the Länder are responsible for administering all federal legislation in areas of concurrent jurisdiction. The Bundesrat has a suspensive veto on all other federal legislation. The institutional position of the Bundesrat produces what is commonly referred to as an ‘interlocking’ relationship between the Federal and Land orders of government.

The Bundestag, the Lower House of the federal parliament, is elected via a mixed electoral system. The voter casts two ballots, one for a constituency member, and one for a political party. Constituency members are elected on a first past the post basis, while the party list members are elected on a proportional basis. The result is that the party membership of the Bundestag very closely matches the party vote distribution. A party must, however, receive at least five percent of the vote or win at least three constituency seats in order to be represented in the Bundestag; this rule discourages a splintering of the vote.

Following an election where, as is often the case, no party emerges with a majority, there is a period of inter-party bargaining as parties negotiate the terms of agreements to form a governing coalition. The leader of the party with the most seats becomes the Chancellor, or in the Länder Minister President; cabinet posts are allocated among the parties to the coalition as negotiated in the coalition agreements. While there is frequently ongoing inter-party tension within the governing coalition, parties have honoured their coalition agreements and thus stable governments have been the norm.

Land legislatures are unicameral, with the exception of bicameral Bavaria. The relationship between the executive and the legislature (Landtag) is the same as it is in the federal Bundestag. In the three historic free cities (Berlin, Bremen, and Hamburg) the Landtag is also the city council, and the mayor is head of the government.¹

The Courts

The Federal Constitutional Court is established under the constitution, and has comprehensive jurisdiction over all questions of federal constitutional law. It is not, however, a court of general appeals as are the Supreme Courts of Canada and the United States, but rather only determines constitutional questions. It is assigned the following functions: the judicial review of legislation, the adjudication of disputes between Land and Bund political institutions, the protection of individual civil rights as constitutionally guaranteed, and the protection of the constitutional and democratic order against groups and individuals seeking to usurp it.² Half the members of the Constitutional Court are appointed by the Bundesrat on behalf of the Länder and half by the Bundestag. In both cases two-thirds majorities are required.

With the exception of seven national courts of appeal, all regular tribunals are Land courts, established and administered by Land statutes.³ However, they apply a unified national legal code.

Constitutional Status of the Federal and Land Governments

The Basic Law explicitly states that all state authority emanates from the people, and that the organs of government are simply the means via which the people exercise their authority.(Article 20(2) As well, the federal nature of the German state is guaranteed by the Basic Law: the so-called ‘eternity clause’ of the Basic Law prohibits amendments which would abolish the Länder.(Article 79(3)

Two fundamental features of the distribution of powers are worthy of note. First, the Basic Law allocates legislative jurisdiction on the basis of an exclusive list of federal powers and a list of concurrent powers, with the residual power remaining with the Länder.⁴ Exclusive federal legislative power is granted in areas which include foreign affairs and defence, citizenship and immigration, rail and air transport, criminal policing, and foreign trade.(Article 73) An extensive list of areas of concurrent legislative jurisdiction includes such areas as civil and criminal law, the regulation of nuclear energy, labour relations, environmental protection, and road transport.(Article 74)

There are also two additional special categories of concurrent powers in the Basic Law. First, the federal government may under its ‘framework’ powers restrict the

exercise of Länder legislative authority, to a limited extent, in certain fields.(Article 75) In these fields, the federal government has the right to enact framework legislation aimed at providing a degree of uniformity of action across the federation; within these parameters, the Länder have the right to enact customized, detailed laws. Framework legislative fields include areas such as higher education, nature conservation, and regional planning. Second, there is a constitutional provision for the federal and Land governments to carry out ‘joint tasks’ together. These areas include university construction, regional policy, agricultural structural policy and coastal preservation, education planning, and research policy.

A second notable feature of the German division of powers relates to the distribution of administrative authority. In the Anglo-American federations, the general principle is constitutionally mandated legislative-administrative coincidence.⁵ That is, the order of government that has legislative jurisdiction over a policy area also has administrative responsibility for that area. In the German federation, by contrast, the Land governments are largely responsible for the administration of legislation, whether that legislation originates at the federal or Land level. Thus it is possible to have a relatively high degree of legislative centralization, while retaining a high degree of administrative decentralization. Constitutional protection of the administrative role of the Länder serves as a bulwark against thorough-going centralization of the federation.

Local Governments

Local government autonomy is constitutionally guaranteed.⁶ The local government bodies which carry out many of the administrative tasks attributed to the Länder thus have their status protected, even to the degree of raising legal questions concerning that status before the Federal Constitutional Court. However, the organization and supervision of local governments falls within the legislative sphere of the Länder.

2. CONSTITUTIONAL ALLOCATION OF REVENUE AND EXPENDITURE RESPONSIBILITIES AND PROVISIONS RELATED TO INTERGOVERNMENTAL TRANSFERS

The German constitution is quite specific in regard to issues of fiscal federalism. Separate articles of the Basic Law assign competency for legislation, for administration, for revenue-raising, and for expenditure among orders of government.⁷ In general, legislative power lies at the federal level, administrative responsibility primarily at the Land level, and revenue-raising and expenditure powers are shared. As regards the federal legislative power, however, the role of the Bundesrat in federal decision-making must be borne in mind.

Constitutional Allocation of Revenue

As assignment of tax revenue is determined by the constitution, only minor adjustments in these assignments can be made by legislation, while major adjustments require constitutional amendments.

While the Basic Law distinguishes between the right of each layer of government to legislate on specific taxes, and the right to appropriate the proceeds of taxes, in practice the two are tied together. The exclusive federal power to legislate on taxes is restricted to customs duties and fiscal monopolies.(Article 105 (1))The power to legislate on all taxes the revenue from which is shared is concurrent; in practice, this means that the Länder can use the federal Bundesrat as their vehicle for shaping federal tax legislation.⁸

The major feature of German revenue-raising arrangements is constitutionally-mandated sharing of tax revenues. All of the most important revenue sources are shared. Together, the wage and assessed income taxes, the corporation income tax, and the general sales, or value added tax (VAT), make up about three-quarters of total tax revenue, and the proceeds of all are shared.⁹

Personal Income Taxes

The constitution mandates that the proceeds of the personal income tax are shared among the Bund, Land, and local orders of government.(Article 106(3)) The federal and Land orders of government each receive 42.5 percent of the proceeds, with the remaining 15 percent accruing to local governments.

Corporate Income Taxes

Corporate income tax is constitutionally mandated to be shared equally between the Federal and Land governments.(Article 106(3))

Sales Taxes

The proceeds of the VAT are constitutionally mandated to be shared between the Bund and Land orders of government, but the respective shares are determined by federal legislation. The ratio is reviewed every two years, and adjusted if necessary in light of changing financial needs; this provides an important element of flexibility in fiscal arrangements. At present, the allocation ratio is 56:44, for the Federation and Länder respectively.

Constitutional Allocation of Expenditure Responsibilities

The relatively centralized system of revenue-raising is counterbalanced by a relatively decentralised system of expenditure. Land administration of both Federal and Land legislation means that the vertical division of legislative competences is not reflected in the distribution of administration and hence of expenditures among orders of government.¹⁰ Thus, expenditures for areas as varied as social policy and investment in infrastructure are made by all orders of government.

Constitutional Provisions Related to Intergovernmental Transfers

Intergovernmental transfers in Germany flow both from the Federal government to the Länder, and among the Länder. These transfers fall into two broad categories: specific grants, and equalization transfers.

Specific grants flow from the Federal government to the Länder for projects under the 'joint tasks' category, for reimbursement of Länder for federally mandated expenditures, and for specific projects related to the creation of uniformity of living conditions. These payments are made in accordance with Articles 91a and 104a. These are dealt with in details in section C below.

Equalization transfers consist of two elements.¹¹ First, there is an interstate revenue pool into which richer Länder pay and from which poorer Länder draw according to specified criteria and a set formula. The criteria are set, under Article 104a, as the necessity to avert disturbance of overall economic equilibrium, to equalize economic capacity, or to promote economic growth. Second, there are federal supplementary payments made to the poorer Länder based on a fixed percentage of the VAT(Article 106(3),(4); Article 107).

3. CONSTITUTIONAL OR OTHER SPENDING POWER PROVISIONS

The constitutional allocation of expenditure responsibilities to the federal government is explicit, but limited. The Federal government is permitted to spend in certain areas of Länder jurisdiction.¹² The Federal government may participate in the areas of the ‘joint tasks’ provided that this participation is relevant to the community as a whole and that such participation is necessary to improve living condition.(Article 91a(1)) As well, where the Länder are obliged to expend funds to meet the requirements of a federal law, the Federal government is obliged to provide compensation.(Article 104a(2))

There are, however, legal limits on the power of the federal government to spend in areas of Land jurisdiction.¹³ First, specific projects to be undertaken under the ‘joint tasks’ provision must be defined in detail in federal law. Such legislation must gain the consent of a majority of votes in the Bundesrat. Second, any transfer payments authorized under Article 104a also require the Bundesrat’s consent.

4. POLITICS AND LEGAL DYNAMICS- INCLUDING THE ROLE OF LAW AND ROLE OF POLITICS IN THE DECISION-MAKING PROCESSES

The German federal constitutional system attempts to achieve a balance between diversity and unity by utilising a federal structure, but with the societal goal of uniform living conditions across the federation.

The achievement of a common standard of living throughout the country has been a stated goal in the Federal Republic of Germany since federation.¹⁴ Indeed, the achievement of ‘uniformity of living conditions’ was a principle entrenched in the Basic Law until 1994. It was considered a guiding tenet of the West German state that, although

it was organised federally, all institutions should be oriented toward uniformity.¹⁵ The primary impetus behind this philosophy was the belief that the general population, regardless of their territorial position, had essentially undifferentiated demands and expectations in regard to social conditions. Uniformity became a powerful norm permeating all relationships between, and actions of, both orders of government. This contrasts sharply with the traditional greater emphasis in the United States upon state autonomy and individual initiative as higher values.

Adjustments in the balance between the achievement of uniform living conditions and the maintenance of a federal system are accomplished by means of constitutional amendment, intergovernmental relations, and judicial review. Amendment of the German constitution requires only special majorities in the two houses of the federal parliament; it must be noted, however, that because the Bundesrat is composed of *ex officio* delegates of the Land governments, this process in effect entails agreement of a special majority of the Land governments. This process has proved relatively flexible, allowing 46 amendments during the first 50 years of the federation. These amendments have included the strengthening of the Bund's legislative and financial roles in the period 1967-9, and the reunification of Germany in 1990.

In the aftermath of reunification in 1990 there was a felt need to further adjust the constitutional basis of the federation. The western Länder believed that the addition of the economically-dependent eastern Länder and the ongoing process of European Union (EU) integration put them in danger of losing ground to the federal government.¹⁶ The Constitutional Reform Act of 1994 was the answer to these concerns. Among the changes were the strengthening of the Bundesrat's role in German policy-making in relation to the EU, the placing of a greater onus on the federal government to justify its use of its concurrent and framework legislative powers, additions to the administrative powers of the Länder, and expansion of the areas over which the Bundesrat has veto powers.¹⁷ While the effects of these changes are complex, it appears that the position of the Länder, especially in regard to their institutional privileges as represented by the Bundesrat, was further enhanced.¹⁸

While Germany has been relatively successful in using incremental constitutional amendment as a means of adjustment in the federation, however, the particular

characteristics of the German distribution of powers necessitate intensive and ongoing coordination among orders of government. Thus, an extensive system of intergovernmental relations is a prominent feature of the German political decision-making processes.

Intergovernmental relations occur in the context of a tension between parliamentary government and federalism. During periods when there are differing party majorities in the Bundestag and Bundesrat, the second chamber sometimes acts as an alternative opposition. Parallels are sometimes drawn with the U.S. pattern of ‘divided government’. This can complicate the processes of intergovernmental relations.

Role of Law in the Decision-Making Process

The two processes noted in the previous section have played a large role in the resolution of issues affecting both the overall federal system and the fiscal arrangements within that system. These include the processes of incremental constitutional amendment, and the non-constitutional processes of adjusting of responsibilities according to the principle of concurrency and the intricate bargaining processes of intergovernmental relations. The courts have also played a role in the evolution of German federalism.

Political life in Germany takes place to a high degree within, or with significant reference to, a legal framework. There is a tendency to attempt to frame actions within legal norms, to justify political actions with reference to constitutional or legal bases, and to seek to achieve binding conflict resolution via legal means. The decisions of the Federal Constitutional Court should be understood in this context.

The Federal Constitutional Court has provided a general support for federalism via the promulgation of the principle of federal comity.¹⁹ This principle, advanced in one of the Court’s earliest decisions, was held to create, for the Federal government in its relations with the Länder, and for the Länder in relations with each other and with the Federal government, a constitutional duty to cooperate sincerely in reaching common understandings. The principle covers not only the substance but also the style of conduct, and extends beyond the legal to the political sphere.²⁰ The effect is to oblige political actors to conduct political negotiations in a way which does not violate or weaken the federal nature of the German system of governance.

Given the wide area of concurrency in the division of powers, the Court has been important as a protector of Land jurisdiction; i.e., had the Court adopted a broad interpretation of federal power, the competences of the Länder would have been seriously compromised. The Court has chosen, however, to stress the importance of Articles 70 and 83 of the Constitution, which provide the residual power to the Länder and provide for Länder administration of federal law, respectively.²¹ While the Court has sometimes been generous to the Federal government in cases concerning economic matters, even in this area the interpretation has been sufficiently narrow to protect Land privileges.

In general, the pattern of decision-making by the Court seems to indicate a desire to maintain a balance in the federal system, but with a tendency to protect the position of the Länder.

Reference Procedures

The Federal Constitutional Court has a broad power to consider referred cases.²² The so-called ‘abstract review of norms’ allows the Court to determine if a norm of federal or Land law is in conformity with the Basic Law, and whether Land law is in conformity with federal law. References can be directly initiated by the federal government, a Land government, or by request of one third of the members of the Bundestag, without reference to a concrete case(Article 93).

It is not necessary for the issue in question to directly affect the party requesting the adjudication. Thus, it is relatively easy for governments to seek a judicial opinion on legislative provisions to which they object, even if the issue is not strictly a federal one. While this ease of access can be abused by governments or political parties for partisan purposes, this has not been seen as a major problem in the German system.

Appointments to the Courts

The federal principle in Germany extends to the selection of judges for the Federal Constitutional Court. One-half of the sixteen judges are selected by the Bundestag, and the other half by the Bundesrat. In each case, there is a requirement for a two-thirds majority vote to confirm a selection.

In practice, a special judicial selection committee of the Bundestag, composed of elite members of the political parties in proportion to their strength in the chamber, makes the Bundestag's selections. The Bundesrat's judiciary committee makes nominations to a plenary session of the Bundesrat. As Land delegations to the Bundesrat must vote on instructions, the Land governments retain a direct influence on the selections.

A procedure similar to that for the Federal Constitutional Court is used to select judges for all other federal courts.

Role of Politics in the Decision-Making Process

As noted, the peculiarities of the distribution of powers in the German system necessitates extensive intergovernmental coordination. This system of intergovernmental relations may be conceived of as having three levels.²³ The first is the level of the 'whole state' (*Gesamstaat*). This level comprises institutions in which both the Federal government (Bund) and the Länder are represented on terms of equal status. Decisions at this level must be made unanimously, via a process of accommodation and compromise; thus, discussions may end with only an agreement to disagree. The function of this level is to provide consultation and cooperation in all fields, but in particular in overlapping fields of competence.

The top institution in this category is the Conference of the Heads of Government of the Federation and the Länder. Meetings of this group occur about every four months. Agreements reached among Heads of Government may require the further approval of Federal or Land legislatures.

The second level of intergovernmental relations are those of the 'federal state' (*Bundesstaat*). This level comprises the constitutionally organised structure of interrelationships between the Federal and Land institutions. Decisions at this level are subject to simple or special majority decision-making rules. The subject matter of decisions made at this level must fall within the federal legislative field or, as in the case of 'joint tasks', be subject to federal procedures. The function of this level is to provide coordination and preparation for voting on legislation.

The Bundesrat is the key institution at this level. Its plenary sessions occur every third week, but committee work leading to these sessions is ongoing. An entire network of

bodies supports the work of the Bundesrat, ranging from permanent advisory councils, to missions of the Länder staffed by Land civil servants. The latter provide a conduit for information flow between orders of government.

While decision-making via majority voting is the constitutionally-mandated rule in the Bundesrat, there has developed an institutional culture which puts a premium on consensus. There is extreme reluctance on the part of the Länder to pass legislation over the serious objections of even a single Land.²⁴ There is thus a norm of negotiation to find a unanimously acceptable compromise, even if this means that agreement can only be achieved on the basis of the lowest common denominator. While such a norm may have questionable policy consequences, it conforms to the general culture of federal comity.

The 'third level' of intergovernmental relations consists of cooperation among the Länder, excluding the federal government. This level consists of institutions in which the Länder are represented on terms of equal status. Decisions must be unanimous, and may require the approval of the federal or Land legislatures. Matters discussed may fall within either or both of Federal and Land areas of legislative jurisdiction. The function of this level is to provide coordination not only in the preparation of legislation but also on processes of administration.

The highest ranking institution at this level is the Conference of Minister-Presidents of the Länder. The Conference convenes formally once per year, but informally almost monthly. Parallel meetings among ministers and officials with the same area of functional responsibility (i.e., health, justice, etc.) are ongoing.

Even this brief account should make it clear that intergovernmental relations are a prominent feature of the German system of governance. Political decision-making routinely entails complex processes of intergovernmental bargaining and compromise.

The Differences Among the Länder

Large differences in area and population existed among the Länder even before unification; in 1988 the city-state of Bremen, area 400 km² and population 650,000, had the same constitutional status as Bavaria, area 70,500 km², and North Rhine-Westphalia, population 16.8 million. The ability of such disparate economic units to bear symmetrical constitutional responsibilities, especially in the context of the goal of uniform living

conditions, was often questioned. In the 1980s, increasing disparities in economic development among the Länder put financial pressure on the poorer Länder, and placed greater strain on inter-Länder bargaining over financial equalization.²⁵ In the post-reunification period, the difficulties were made even more salient: economic disparities deepened, and were compounded by cultural differences among the former western and eastern Länder.

While initial transitional financial arrangements were made in the wake of reunification, and subsequent long-term adjustments made in the financial equalization system, differences in size, population, and level of economic development continue to generate disagreements among the Länder. The result has been a growing unease with the equalization system. The recipients believe the system is inadequate to their needs, as it aims mainly to equalize revenues from shared taxes, but does not take into adequate account the higher per capita expenditure requirements of the poorer Länder. Meanwhile, the contributors believe the system subsidises economic and financial mis-management among the poorer Länder, and penalises the Länder that are better economic managers.

Superimposed on these issues are concerns on the part of the richer Länder that the Federal government will exploit the weak position of the poorer Länder to gather more power to itself. They fear the Bund will use the 'golden leash' of supplementary funding to convince the poorer Länder to cede responsibilities to the Federal government. The result has been calls for the further reform of German federalism

5. TRANSPARENCY AND ACCOUNTABILITY

Revenue and Expenditure Responsibilities of Governments

Despite the extensive constitutional specification of legislative, administrative, revenue-raising, and expenditure responsibilities, the German system of fiscal federalism exhibits a degree of complexity which is inimical to accountability and transparency.

The Länder are responsible for the most important administrative functions in German federalism, including the implementation of federal law. While there are provisions for the federation to provide financing of activities mandated by its legislation, and such legislation must pass through the Länder-controlled Bundesrat, it remains the

case that Länder are consistently left with uncompensated administrative costs. For example, the Länder are responsible for the costs when they execute federal law as a matter of their own concern, (Article 83) and it is their responsibility to cover the administrative costs incurred by local governments in implementing legislation.(Article 104a(5))²⁶ Only in situations in which the Länder are acting as agents of the Federal Government, as in some capital construction, are the costs covered by the federation, and even then ongoing administrative costs are a Länder responsibility. In addition, for some categories of co-financed projects, the Bundesrat has a veto only if one-quarter or more of the costs, excluding administrative costs, are to be met by the Länder(Article 104a(3)). Overall, the net result is that accountability is decreased, as the Länder ‘foot the bill’ for some federally mandated initiatives.

Beyond the accountability problems involved in the shifting of administrative costs from one order of government to the other, transparency is decreased by the complexity of the entire fiscal federal system. The interdependent network of shared taxes, equalization transfers, expenditure responsibilities, and even decision-making institutions renders it practically impossible for voters to identify which government is taxing or spending for particular purposes. Thus, in Germany the principles of subsidiarity, economic efficiency, and revenue equalization have largely trumped accountability.

B. A SUMMARY OF FEDERAL AND STATE BUDGETARY RELATIONS IN GERMANY

This section contains a description of the stylized facts and the relative magnitudes of federal and state (including local government) responsibilities and how they have evolved over time. This includes the shares of federal and state governments in public spending and revenue allocation as well as the importance of transfers between and among levels of government. Of particular significance is the impact of German unification on federal-state and state-state fiscal relations. Not only did the integration of the former east German states into the Federation seriously strain the extant system of intergovernmental fiscal relations, it also resulted in dramatic shifts in flows, especially federal-state flows through the allocation of the Unification Fund.

The German system of budgetary relations is dominated by the uniformity-of-living conditions principle noted in Section A of this report. This is articulated in Articles 72 and 106 of the Basic Law. Article 72 [Concurrent legislation of the Federation] reads:

- (1) On matters within the concurrent legislative power, the Länder shall have the right to legislate so long as and to the extent that the Federation has not exercised its legislative power by enacting a law.
- (2) The Federation shall have the right to legislate on these matters if and to the extent that the establishment of equal living conditions throughout the federal territory or the maintenance of legal and economic unity renders federal legislation necessary in the national interest.

Article 106 [Apportionment of tax revenue] lists federal taxes, state taxes, and common (joint) taxes. As noted in Section A, most of the major tax sources are placed in the third category involving a constitutionally-mandated sharing of specific tax revenues. Of particular relevance here, Article 106(3) specifies that shares in the VAT shall be determined based on the following principles:

1. The Federation and the Länder shall have an equal claim to funds from current revenue to cover their necessary expenditures. The extent of such expenditures shall be determined with due regard to multi-year financial planning.
2. The financial requirements of the Federation and the [Länder] shall be coordinated in such a way as to establish a fair balance, to avoid excessive burdens on taxpayers, and ensure uniformity of living standards throughout the federal territory.

In many ways, German federalism emulates the unitary state. Intergovernmental fiscal relations are largely ruled by the so-called financial constitution, comprising Articles 104-115 of the Basic Law. Revenue apportionment is roughly commensurate with expenditure responsibility. In this regard, the balancing role of shares in VAT is particularly important.

Equal per capita distribution of VAT implies a fully equalized revenue source—so-called first-tier equalization. However, state-state equalization of income tax revenues—so called second-tier equalization—places an important function of the federal government in the context of federal systems such as Canada instead in the hands of the German states. Moreover, this operates as a net scheme.

Federal and State Shares of Total Public Spending and Government Revenues

Table B.1 provides data indicating the shares of federal and state governments in total public sector spending. These data include federal supplementary grants; that is, transfers in the form of supplementary grants to states are included as a component of federal spending. The provision in 1969 for negotiated changes in federal and state shares of VAT in light of shifts in relative expenditure responsibilities obviated the need for supplementary grants to poorer states which had previously accommodated vertical fiscal imbalance. Following unification in 1990, however, allocation of the federally controlled German Unity Fund again increased the federal share in spending. As the former east German states have been integrated into state-state equalization, the federal share has again fallen. By the same token, the states' share in spending has risen.

Table B.2 provides data indicating the shares of federal and state governments in total public sector revenues. These data include federal supplementary grants. Again, transfers to states dropped with the 1969 arrangements on VAT allocation, increasing the states' share of revenues. Transfers to states increased in 1990 with the introduction of the German Unity Fund, financed in part through a federal income surtax²⁷ but also through a reallocation of VAT revenues in favour of the states, which increased the states' share.

Transfer Payments from the Federal to State Governments

Table B.3 shows transfers from the federal government as a percentage of revenues by state. The message is clear: the states rely on the federal government for only a small percentage of their revenues; for the former east German states, however, these transfers are of considerable significance. Indeed, the data also show a marked increase in the significance of the federal government since reunification and the dramatic impact of federal supplementary grants on some states revenues.

Table B.1: Federal and State Governments Shares (Percentages) of Total Expenditures Including Transfers (Federal Supplementary Grants)							
Year	Federal	State					
1950	40.9	59.1					
1955	40.5	59.5					
1962	41.8	58.2					
1963	41.6	58.4					
1964	40.8	59.2					
1965	41.2	58.8					
1966	40.9	59.1					
1967	43.2	56.8					
1968	41.8	58.2					
1969	41.6	58.4					
1970	39.8	60.2					
1971	38.7	61.3					
1972	39.1	60.9					
1973	38.0	62.0					
1974	36.7	63.3					
1975	38.9	61.1					
1976	38.8	61.2					
1977	38.8	61.2					
1978	39.0	61.0					
1979	38.5	61.5					
1980	37.6	62.4					
1981	38.5	61.5					
1982	39.1	60.9					
1983	39.2	60.8					
1984	39.1	60.9					
1985	38.6	61.4					
1986	37.8	62.2					
1987	37.8	62.2					
1988	37.6	62.4					
1989	37.7	62.3					
1990	37.5	62.5					
1991	41.6	58.4					
1992	36.0	64.0					
1993	36.4	63.6					
1994	36.8	63.2					
1995	36.7	63.3					
1996	36.8	63.2					
1997	36.6	63.4					
Note: State governments are considered to be the sum of Länder (state) governments, local (gemeinden) governments and special-purpose associations (Zweckverbände).							
Source: Author's calculations using data from Statistisches Bundesamt (Federal Statistical Office), Fachserie 14, R 3.1, 1997							

Table B.2: Federal and State Governments Shares (Percentages) of Total Revenues after the Distribution of Shared Taxes and Including Transfers (Federal Supplement)

Year	Federal	State							
1950	40.2	59.8							
1955	45.3	54.7							
1962	41.8	58.2							
1963	41.5	58.5							
1964	41.9	58.1							
1965	42.7	57.3							
1966	42.0	58.0							
1967	41.4	58.6							
1968	40.8	59.2							
1969	41.7	58.3							
1970	41.5	58.5							
1971	40.7	59.3							
1972	39.0	61.0							
1973	38.3	61.7							
1974	36.7	63.3							
1975	36.1	63.9							
1976	36.4	63.6							
1977	36.4	63.6							
1978	36.6	63.4							
1979	36.8	63.2							
1980	36.4	63.6							
1981	36.7	63.3							
1982	37.2	62.8							
1983	37.4	62.6							
1984	37.3	62.7							
1985	37.4	62.6							
1986	36.7	63.3							
1987	36.2	63.8							
1988	35.2	64.8							
1989	36.8	63.2							
1990	36.8	63.2							
1991	39.3	60.7							
1992	35.3	64.7							
1993	34.5	65.5							
1994	35.8	64.2							
1995	35.9	64.1							
1996	34.4	65.6							
1997	34.6	65.4							

Note: State governments are considered to be the sum of Länder (state) governments, local (gemeinden) governments and special-purpose associations (Zweckverbände).

Source: Author's calculations using data from Statistisches Bundesamt (Federal Statistical Office), Fachserie 14, R 3.1, 1997.

Table B.3(a)								
Share of Federal Transfer Payments in State Total Revenues (Percentages)								
Year	Baden- Württemberg	Bayern	Brandenburg	Hessen	Mecklenburg- Vorpommern	Niedersachsen	Nordrhein- Westfalen	Rheinland- Pfalz
1975	0	0.54		0		1.42	0	1.52
1980	0	0.61		0		1.58	0	1.79
1985	0	0.56		0		1.45	0	1.72
1990	0	0		0		2.78	0.00	2.50
1992	0	0		0		2.70	0.01	2.77
1993	0	0		0		2.90	0.01	3.16
1994	0	0		0		3.09	0	3.42
1995	0	0	11.81	0	12.10	2.07	0	3.69
1996	0	0	11.55	0	11.75	2.19	0	3.43
Year	Saarland	Sachsen	Sachsen- Anhalt	Schleswig- Holstein	Thuringen	Berlin	Bremen	Hamburg
1975	1.57			1.58		0	0	0
1980	1.78			1.77		0	0	0
1985	2.94			1.86		0	0	0
1990	5.33			2.97		0	4.10	0
1992	6.00			2.86		0	9.42	0
1993	6.17			3.01		0	9.97	0
1994	20.81			2.43		0	22.90	0
1995	21.95	10.76	11.87	1.81	12.00	9.85	24.12	0
1996	21.40	10.61	11.76	1.83	12.03	10.60	24.24	0
Source: Author's calculations using data from Statistisches Jahrbuch 1998, tables 20.1.3 and 20.1.4.								

Table B.3(b) shows state-state transfers as a percentage of revenues by state. What is notable from the table is the relatively small percentages of revenues involved in explicit state-state transfers.

Vertical Fiscal Imbalances

The vertical fiscal imbalance (VFI) indicates an imbalance between federal (state) revenues and expenditure responsibilities. A large VFI indicates that the states rely heavily on the Federation for transfers to finance their expenditures. Since 1969, VFI has been only a transient issue in German federalism. Previously, special allocations had bridged the gap on an equalizing basis. As mentioned, the need for this system was obviated by the provision for periodic negotiation between the Federation and the states

of shares in value added tax (VAT) revenues, based on shifts in expenditure-revenue positions of the two tiers of government.

Table B.3(b)								
Share of Horizontal Equalization Payments in State Total Revenues (Percentages)								
Year	Baden- Württemberg	Bayern	Brandenburg	Hessen	Mecklenburg- Vorpommern	Niedersachsen	Nordrhein- Westfalen	Rheinland- Pfalz
1975	-2.26	1.13		-1.17		3.43	-0.88	2.71
1980	-3.29	0.82		-1.14		2.36	-0.11	1.57
1985	-2.65	0.05		-2.23		2.15	0.11	2.00
1990	-3.61	-0.05		-3.52		4.13	-0.06	2.18
1992	-1.92	0.06		-3.83		2.37	0.00	2.54
1993	-1.24	-0.01		-4.25		1.79	0.02	2.91
1994	-0.50	-0.69		-3.61		1.68	0.12	2.44
1995	-3.39	-2.51	3.91	-4.31	4.72	0.79	-2.50	0.11
1996	-3.02	-2.88	4.58	-6.12	5.10	0.94	-2.24	0.83
Year	Saarland	Sachsen	Sachsen- Anhalt	Schleswig- Holstein	Thuringen	Berlin	Bremen	Hamburg
1975	5.97			3.14		0	1.71	-7.22
1980	6.47			2.80		0	4.49	-3.06
1985	6.63			4.16		0	7.07	-3.20
1990	5.34			3.49		0	10.25	-0.05
1992	5.52			2.02		0	6.93	0.00
1993	5.36			0.90		0	8.91	0.68
1994	4.63			0.34		0	6.21	0.36
1995	1.94	4.24	4.64	-0.65	4.65	11.16	6.37	-0.64
1996	2.51	4.64	5.08	0.07	5.16	12.29	7.26	-2.74

Source: Author's calculations using data from Statistisches Jahrbuch 1998, tables 20.1.3 and 20.1.4.

Table B.4(a) depicts the VFI for the federal and state governments. It is evident from the table that VFI became a more significant issue following unification. Generally, the data reflect the level of deficit financing, especially from the mid-1970s to mid 1980s. The Federal government, especially, was forced into deficit finance with the establishment of the German Unification Fund. Recall that this was to be financed partly through an income tax surtax and partly through debt, while the states' share of financing

was partly offset by a transfer of shares in VAT revenues. Table B.4(b) depicts VFI by state. VFI is shown to be a significant problem for the former east German states.

Table B.4(a)								
Vertical Imbalances Between Federal and State Governments (Percentages)								
[(Total Expenditures - Total Revenues)/ Total Expenditures]*100								
Year	Federal	State						
1950	7.74	4.81						
1955	-16.11	4.45						
1962	1.34	1.34						
1963	4.24	3.87						
1964	1.53	6.08						
1965	2.92	8.98						
1966	3.11	7.20						
1967	11.81	4.93						
1968	6.46	2.68						
1969	-1.44	-1.24						
1970	-0.47	6.52						
1971	1.16	9.26						
1972	5.21	4.76						
1973	2.26	3.46						
1974	7.75	7.62						
1975	21.86	11.74						
1976	17.14	8.29						
1977	13.01	3.52						
1978	13.86	4.76						
1979	12.63	6.14						
1980	12.70	7.90						
1981	16.16	9.73						
1982	15.28	8.32						
1983	12.84	5.91						
1984	11.28	4.35						
1985	8.78	4.01						
1986	8.83	4.48						
1987	10.29	4.31						
1988	12.94	3.46						
1989	6.85	3.35						
1990	7.67	4.63						
1991	13.10	4.37						
1992	9.12	6.33						
1993	14.48	7.03						
1994	10.57	6.86						
1995	10.31	7.13						
1996	15.90	6.62						
1997	13.17	5.37						
Note: State governments are considered to be the sum of Länder (state) governments, local (gemeinden) governments and special-purpose associations (Zweckverbände).								
Source: Author's calculations using data from Statistisches Bundesamt (Federal Statistical Office), Fachserie 14, R 3.1, 1997.								

Table B.4(b)								
Vertical Imbalances of State Governments (Percentages)								
[(Total Expenditures - Total Revenues)/ Total Expenditures]*100								
Year	Baden- Wurtemberg	Bayern	Brandenburg	Hessen	Mecklenburg- Vorpommern	Niedersachsen	Nordrhein- Westfalen	Rheinlan Pfalz
1975	12.08	10.17		15.17		14.27	15.15	13.16
1980	8.81	4.34		7.59		8.86	13.31	8.26
1985	1.32	0.29		2.43		3.71	9.01	5.08
1990	2.97	3.53		6.63		5.95	5.63	5.88
1992	4.75	3.46	20.71	4.61	12.30	6.28	4.20	5.76
1993	3.64	2.05	21.02	5.16	15.09	8.04	6.28	7.08
1994	1.67	1.43	19.68	4.95	16.63	8.38	6.83	7.33
1995	5.99	2.63	12.30	7.23	12.68	9.55	6.92	7.66
1996	4.20	5.69	10.98	4.53	13.06	5.53	5.76	7.49
1997	2.77	5.28	7.75	5.66	9.34	5.82	7.87	8.74
Year	Saarland	Sachsen	Sachsen- Anhalt	Schleswig- Holstein	Thuringen	Berlin	Bremen	Hambur
1975	17.83			14.42		7.68	23.65	11.51
1980	13.86			6.97		4.71	20.30	6.41
1985	19.25			6.45		1.10	14.59	5.17
1990	10.43			6.25		5.47	10.91	6.87
1992	10.05	14.84	18.96	5.84	16.99	7.49	8.46	9.71
1993	12.45	11.87	18.23	6.24	16.54	13.72	15.96	12.06
1994	-4.00	12.04	17.86	6.17	17.20	18.63	-7.72	12.89
1995	-1.84	7.63	13.74	7.82	10.86	22.73	-0.73	7.94
1996	-3.64	7.04	10.90	7.86	12.61	22.98	0.38	13.46
1997	-4.40	5.00	12.89	6.57	9.79	9.00	-1.18	7.33

Source: Author's calculations using data from Statistisches Jahrbuch 1998, table 20.1.3.

Horizontal Fiscal Imbalances

Different states have different fiscal capacities for delivering public services to their residents—that is, there are horizontal fiscal imbalances (HFIs). These can arise from both the expenditure and revenue sides of the budget. With respect to expenditures, the need for public services of different types can differ across states because of different demographic make-ups of the state populations. As well, costs of provision can differ. On the revenue side, different states have different tax capacities—that is, per capita tax bases will differ across states. This is the case in respect of both common taxes (distributed to states on an origin basis) and state taxes (including local taxes). Because of

the uniformity-of-living-conditions principle as well as centralized tax legislation, these measures should be quite comparable across states.

HFI of State Expenditures

Table B.5 shows per capita state government expenditures as a proportion of the national average. Other than the city states, values range between 87% and 117% of the national average. For the city states, however the values are markedly different, in the neighbourhood of 40%-50% greater. These differences are substantial and indicate differences in need and cost across states.

HFI of Common Taxes

Table B.6(a) shows per capita revenues from common taxes by state as a percentage of the German average. The disparities are wide; although they appear to have lessened in recent years, this appears to be more a consequence of the high degree of HFI associated with the former east German states following unification.

HFI of State Taxes

Table B.6(b) shows per capita revenues from state taxes as a percentage of the German average. Most noticeable here is that the former east German states exhibit a lesser degree of HFI in respect of state taxes than is the case with common taxes.

HFI of Local Taxes

Table B.6(c) shows per capita revenues from local taxes by state as a percentage of the German average. Once again, the former east German states exhibit huge disparity in terms of HFI, tending to pull down the average.

HFI of State Revenues After Distribution of Common Taxes

Table B.7(a) shows per capita state revenues after distribution of common taxes as a percentage of the German average. These data are before state-state equalization. They reflect both the disparity in fiscal capacities in respect of common taxes and the implicit equalization associated with VAT distribution as well as the explicit component

associated with supplementary equalization financed out of the VAT. Evidently, VAT distribution has dramatic impacts on states' relative fiscal capacities.

HFI of Local Taxes After Distribution of Common Taxes

Table B.7(b) shows per capita local revenues after distribution of common taxes as a percentage of the German average. They, too, reflect both the disparity in fiscal capacities in respect of common taxes. Evidently, personal income tax distribution has an impact on local governments' relative fiscal capacities, although less dramatically so than VAT distribution has on states' relative fiscal capacities.

HFI of State Revenues After Distribution of Common Taxes and Transfers

Table B.7(c) shows per capita revenues from all sources after distribution of common taxes and transfers as a percentage of the German average. There remains a marked degree of disparity between city states and others. Nonetheless, only one state exhibits a fiscal capacity below 90 percent of the national average. Other than with regard to the city states, the German system exhibits a remarkable degree of uniformity in fiscal capacities across states.

Table B.5								
State Governments Per Capita Expenditures as a Percentage of German Average								
Year	Baden- Wuerttemberg	Bayern	Brandenburg	Hessen	Mecklenburg- Vorpommern	Niedersachsen	Nordrhein- Westfalen	Rheinlan Pfalz
1975	101.37	93.72		104.93		94.28	94.37	95.21
1980	106.49	92.64		99.55		94.82	95.37	92.35
1985	100.74	94.25		101.47		93.54	94.13	91.62
1990	101.03	96.49		107.08		94.03	93.66	88.97
1992	99.34	97.24	107.04	104.12	103.63	94.09	92.02	87.09
1993	97.16	94.65	110.82	104.15	109.44	93.00	92.49	86.01
1994	93.40	94.93	112.65	102.38	114.09	93.17	91.65	84.70
1995	95.65	97.22	111.34	100.77	114.75	91.43	93.21	84.08
1996	94.79	98.96	112.57	103.87	119.81	89.80	93.33	86.88
1997	94.32	98.49	113.00	101.77	116.60	89.29	94.17	86.84
Year	Saarland	Sachsen	Sachsen- Anhalt	Schleswig- Holstein	Thuringen	Berlin	Bremen	Hambur
1975	93.05			96.38		183.10	136.77	138.26
1980	94.59			93.51		186.70	140.36	130.00
1985	107.89			93.53		201.65	140.29	142.60
1990	99.39			97.97		177.33	143.65	136.28
1992	96.94	100.24	104.03	97.16	103.86	149.84	143.35	139.17
1993	96.58	101.90	109.19	95.70	108.47	154.28	145.17	130.83
1994	95.51	105.76	111.07	96.14	111.38	155.36	143.00	132.04
1995	93.96	110.86	114.43	96.87	109.75	158.10	144.27	129.63
1996	94.92	112.84	113.10	95.67	112.93	148.65	145.34	134.80
1997	95.73	104.51	117.86	95.90	112.59	152.36	147.97	136.60

Source: Author's calculations using data from Statistisches Jahrbuch 1998, table 20.1.3.

Table B.6(a)								
Revenues Per Capita from Common Taxes as a Percentage of the German Average								
Year	Baden- Württemberg	Bayern	Brandenburg	Hessen	Mecklenburg- Vorpommern	Niedersachsen	Nordrhein- Westfalen	Rheinlan- Pfalz
1975	103.47	79.88		103.41		64.53	103.81	71.21
1980	103.21	83.94		100.52		68.42	101.72	70.19
1985	101.75	88.50		105.58		61.87	101.59	68.70
1990	124.58	105.12		129.90		73.08	142.45	84.80
1993	110.65	102.50	26.74	127.62	21.51	77.28	110.29	129.40
1995	105.39	100.05	36.78	122.45	29.14	73.23	111.18	119.17
1997								
Year	Saarland	Sachsen	Sachsen- Anhalt	Schleswig- Holstein	Thuringen	Berlin	Bremen	Hambur-
1975	75.29			64.74		52.43	136.50	219.93
1980	72.85			63.50		48.67	131.73	236.79
1985	70.07			58.90		56.80	135.91	242.05
1990	90.06			80.27		31.41	139.99	242.49
1993	79.91	24.50	23.85	80.70	21.01	73.64	136.29	230.77
1995	80.50	32.46	30.77	80.23	28.96	85.32	125.40	235.65
1997								
Note: Data for Berlin are for West Berlin only up to 1990, and for unified Berlin after 1990.								
Source: Author's calculation using data from Statistisches Jahrbuch, Various Editions.								

Table B.6(b)								
Revenues Per Capita from State (Lander) Taxes as a Percentage of the German Average								
Year	Baden- Wurttemberg	Bayern	Brandenburg	Hessen	Mecklenburg- Vorpommern	Niedersachsen	Nordrhein- Westfalen	Rheinland Pfalz
1975	98.57	95.76		95.36		74.14	93.31	77.72
1980	95.99	93.78		96.74		78.85	95.35	79.48
1985	101.13	103.24		100.63		78.89	87.29	76.70
1990	128.88	124.15		125.95		93.36	117.59	85.34
1993	109.90	112.04	50.02	114.78	48.03	89.56	99.42	81.75
1995	107.70	110.48	59.14	105.55	51.55	84.97	101.24	76.77
1997								
Year	Saarland	Sachsen	Sachsen- Anhalt	Schleswig- Holstein	Thuringen	Berlin	Bremen	Hamburg
1975	82.04			70.03		106.33	114.68	156.85
1980	78.81			71.60		105.92	104.17	153.46
1985	76.43			78.25		112.88	95.72	131.11
1990	88.15			94.93		73.58	112.84	169.71
1993	75.18	56.87	44.90	92.29	48.55	82.82	103.08	133.44
1995	75.66	64.05	50.16	90.10	52.04	91.53	96.85	136.25
1997								
Note: Data for Berlin are for West Berlin only up to 1990, and for unified Berlin after 1990.								
Source: Author's calculation using data from Statistisches Jahrbuch, Various Editions.								

Table B.6(c)								
Revenues Per Capita from Local Taxes as a Percentage of the German Average								
Year	Baden Württemberg	Bayern	Brandenburg	Hessen	Mecklenburg- Vorpommern	Niedersachsen	Nordrhein- Westfalen	Rheinlan Pfalz
1975	97.04	85.10		104.41		74.70	96.33	80.90
1980	103.36	92.20		100.79		84.16	90.95	87.34
1985	99.93	92.34		105.59		74.67	94.93	87.29
1990	122.68	111.34		139.03		90.74	125.91	103.45
1993	109.46	104.14	21.88	123.62	19.78	93.86	113.69	94.01
1995	104.25	100.49	32.29	120.17	29.01	88.00	113.62	91.76
1997								
Year	Saarland	Sachsen	Sachsen- Anhalt	Schleswig- Holstein	Thuringen	Berlin	Bremen	Hambur
1975	62.22			70.44		99.75	139.38	172.90
1980	70.92			71.48		59.87	131.30	160.62
1985	62.23			60.40		69.62	131.09	185.33
1990	85.73			78.69		49.61	148.47	195.20
1993	77.32	25.39	20.96	83.47	19.26	90.87	141.96	185.96
1995	73.80	37.14	28.95	82.54	28.12	89.95	152.27	197.54
1997								

Note: Data for Berlin are for West Berlin only up to 1990, and for unified Berlin after 1990.

Source: Author's calculation using data from Statistisches Jahrbuch, Various Editions

Table B.7(a)								
State (Lander) Per Capita Tax Revenues After the Distribution of Shared Taxes as a Percentage of the German Average								
Year	Baden- Wurttemberg	Bayern	Brandenburg	Hessen	Mecklenburg- Vorpommern	Niedersachsen	Nordrhein- Westfalen	Rheinland- Pfalz
1975	99.72	86.89		97.40		82.85	95.85	82.40
1980	102.02	89.09		97.70		84.39	94.89	85.18
1985	101.45	93.44		102.07		82.28	91.98	84.28
1990	127.27	116.20		127.20		102.89	118.49	104.48
1993	106.44	103.86	52.13	114.85	50.88	92.34	101.23	89.80
1995	83.10	82.25	112.46	82.59	115.12	84.92	84.05	85.49
1997								
Year	Saarland	Sachsen	Sachsen- Anhalt	Schleswig- Holstein	Thuringen	Berlin	Bremen	Hamburg
1975	82.70			83.28		73.20	110.45	147.96
1980	82.00			83.69		72.56	105.44	132.13
1985	81.45			82.65		81.05	99.02	135.21
1990	102.42			103.25		52.20	115.14	155.24
1993	90.07	52.03	51.31	97.07	49.75	86.71	105.43	129.58
1995	126.67	111.60	113.73	88.15	113.39	130.73	184.91	111.05
1997								
Note: Data for Berlin are for West Berlin only up to 1990, and for unified Berlin after 1990.								
Source: Author's calculation using data from Statistisches Jahrbuch, Various Editions.								

Table B.7(b)								
Local Per Capita Tax Revenues After the Distribution of Shared Taxes								
as a Percentage of the German Average								
Year	Baden- Wurtemberg	Bayern	Brandenburg	Hessen	Mecklenburg- Vorpommern	Niedersachsen	Nordrhein- Westfalen	Rheinland- Pfalz
1975	95.96	85.90		103.61		78.98	96.75	80.39
1980	102.55	92.15		99.81		84.19	92.76	86.66
1985	100.17	92.06		104.08		77.05	95.51	85.31
1990	123.97	113.23		135.61		93.63	124.63	104.37
1993	108.61	105.40	27.21	122.08	26.58	94.37	110.44	93.28
1995	102.73	100.11	46.61	116.69	39.74	89.75	108.80	89.96
1997								
Year	Saarland	Sachsen	Sachsen- Anhalt	Schleswig- Holstein	Thuringen	Berlin	Bremen	Hamburg
1975	64.91			77.74		83.28	131.25	164.97
1980	70.73			78.29		54.67	124.13	149.94
1985	66.20			69.10		65.83	121.97	170.07
1990	85.66			91.75		41.48	139.05	184.86
1993	78.64	29.97	31.48	92.42	24.60	87.22	125.32	167.00
1995	78.34	45.76	38.84	91.55	38.67	92.20	130.06	167.93
1997								

Source: Author's calculation using data from Statistisches Jahrbuch, Various Editions.

Table B.7(c)								
State Governments Per Capita Revenues, including Shared Tax Revenues and Transfers, as a Percentage of German GDP								
Year	Baden-Württemberg	Bayern	Brandenburg	Hessen	Mecklenburg-Vorpommern	Niedersachsen	Nordrhein-Westfalen	Rheinland-Pfalz
1975	102.91	97.22		102.78		93.33	92.46	95.47
1980	106.82	97.48		101.19		95.06	90.94	93.18
1985	104.19	98.50		103.76		94.40	89.77	91.15
1990	103.48	98.27		105.55		93.36	93.30	88.40
1992	102.14	101.32	91.61	107.20	98.10	95.19	95.15	88.59
1993	101.96	100.97	95.33	107.57	101.21	93.14	94.40	87.04
1994	99.86	101.75	98.39	105.82	103.42	92.82	92.86	85.34
1995	98.03	103.20	106.45	101.92	109.24	90.15	94.58	84.63
1996	98.38	101.12	108.57	107.44	112.85	91.92	95.28	87.08
1997	98.16	99.85	111.57	102.77	113.15	90.01	92.87	84.83
Year	Saarland	Sachsen	Sachsen-Anhalt	Schleswig-Holstein	Thuringen	Berlin	Bremen	Hamburg
1975	88.28			95.24		195.18	120.58	141.26
1980	89.62			95.68		195.68	123.05	133.82
1985	91.31			91.70		209.01	125.58	141.73
1990	93.98			96.96		176.96	135.10	133.98
1992	94.11	92.14	91.00	98.74	93.06	149.61	141.63	135.62
1993	92.08	97.81	97.24	97.72	98.60	144.98	132.86	125.30
1994	108.01	101.16	99.20	98.09	100.27	137.47	167.49	125.08
1995	104.31	111.63	107.61	97.35	106.65	133.18	158.43	130.09
1996	106.58	113.64	109.18	95.50	106.93	124.03	156.86	126.38
1997	106.97	106.27	109.89	95.91	108.71	148.41	160.26	135.49

Source: Author's calculations using data from Statistisches Jahrbuch 1998, table 20.1.3.

C. SYSTEM OF INTERGOVERNMENTAL TRANSFERS

The German system of intergovernmental transfers involves both federal-state transfers and state-state transfers. Federal-state transfers include both conditional grants and unconditional grants. Of these, some are focused on vertical imbalances, especially directed at constitutionally mandated areas of joint responsibility. Others are focused on horizontal imbalance, especially directed at the former east German states, but generally on states with below average fiscal capacities after VAT distribution and after interstate equalization.

Interstate transfers are constitutionally mandated and are both implicit and explicit. 75% of the states' share of VAT is distributed on an equal per capita basis, resulting in implicit transfers from those states with above average VAT yields to those with below average VAT yields. In addition, explicit interstate equalization is an important component of the allocation of income, corporate, and local taxation.

Nature of Programs Focused on Vertical Imbalances

Specific-Purpose Grants

Conditional grants from the Federation to the states are made in areas of so-called joint tasks and in the form of grants-in-aid. Joint responsibilities are listed under Chapter VIIIa of the Basic Law. Article 91a is prefaced as follows:

(1) In the following areas the Federation shall participate in the discharge of responsibilities of the Länder provided that such responsibilities are important to society as a whole and that federal participation is necessary for the improvement of living conditions (joint tasks).

The items listed are:

1. extension and construction of institutions of higher education including university clinics;
2. improvement of regional economic structures;
3. improvement of the agrarian structure and of coastal preservation.

Such joint tasks are constitutionally mandated, involving joint planning and decision-making, as well as sharing of responsibility and financing. Grants-in-aid are directed at correcting for regional disparities, stabilization motives, and promoting economic growth.

Article 91a continues:

- (2) Joint responsibilities shall be defined in detail by a federal law requiring the consent of the Bundesrat. This law shall include general principles governing the performance of such tasks.
- (3) The law ... shall provide for the procedure and institutions required for joint overall planning. The inclusion of a project in the overall plan shall require the consent of the Land in whose territory it is to be carried out.

Finally, Article 91a has language that specifies cost-sharing in areas of joint responsibility:

- (4) In cases to which subparagraphs 1 and 2 of paragraph (1) of this Article apply, the Federation shall finance one half of the expenditure in each Land. In cases to which subparagraph 3 of paragraph (1) of this Article applies the Federation shall finance at least one half of the expenditure; and the proportion shall be the same for all Länder. Details shall be regulated by the law. The provision of funds shall be subject to appropriation in the budgets of the Federation and the Länder.
- (5) Upon request the Federal Government and the Bundesrat shall be informed about the execution of joint responsibilities.

Article 91b relates to co-operation between the Federal government and the states in education and research:

Pursuant to agreements the Federation and the Länder may cooperate in educational planning and in the promotion of research institutions and projects of supraregional importance. The apportionment of costs shall be regulated by the relevant agreement.

Other Specific-Purpose Grants

Article 106a [Federal grants for local mass transit] reads as follows:

Beginning January 1 1996 the Länder shall be entitled to an allocation from federal tax revenues for purposes of local mass transit. Details shall be regulated by a federal law requiring the consent of the Bundesrat. Allocations made pursuant to the first sentence of this Article shall not be taken into account in determining the financial capacity of a Land under paragraph (2) of Article 107.

Nature of Programs Focused on Horizontal Imbalances

Article 107 of the Basic Law [Financial equalization] is directed at horizontal imbalances across states. It reads as follows:

- (1) Revenue from Land taxes and the Land share of revenue from income and corporation taxes shall accrue to the individual Länder to the extent that such taxes are collected by revenue authorities within their respective territories (local revenue). Details respecting the delineation as well as the manner and scope of the allotment of local revenue from corporation and wage taxes shall be regulated by a federal law requiring the consent of the Bundesrat. This law may also provide for the delimitation and allotment of local revenue from other taxes. The Land share of revenue from the turnover tax shall accrue to the Länder on a per capita basis; a federal law requiring the consent of the Bundesrat may provide for the grant of supplementary shares not exceeding one quarter of a Land share to Länder whose per capita revenue from Land taxes and from income and corporation taxes is below the average of all the Länder combined.

- (2) Such a law shall ensure a reasonable equalization of the disparate financial capacities of the Länder, with due regard for the financial capacities and needs of municipalities (associations of municipalities). It shall specify the conditions governing the claims of Länder entitled to equalization payments and the liabilities of Länder required to make them, as well as the criteria for determining the amounts of such payments. It may also provide for federal grants to be made by the Federation to financially weak Länder from its own funds to assist them in making their general financial needs (supplementary grants).

Article 107 therefore prescribes two forms of federal legislation (requiring consent of the Bundesrat): The first is legislation governing state-state equalizing transfers of local revenue (revenue from Land tax and the states' share of revenue from the income tax and corporation tax); the second is legislation governing supplemental equalization payments, financed out of a 25% share of the VAT, to be made to states whose per capita revenue from income and corporation tax is below the national average.

Equalization and the VAT

As mentioned, 75% of the states' share of VAT revenues is distributed on an equal per capita basis across states. This, then, incorporates a significant element of implicit horizontal equalization, transferring revenues from those states with above average VAT capacity to those with below average VAT capacity. In fact, this implicit transfer is referred to as first-tier equalization in the German system. One implication is that the greater is the states' share of VAT, the greater will be the level of first-tier equalization, and, hence, the less will be the need for explicit (second-tier) equalization.

The remaining 25% of the states' share of VAT is used to fund a supplementary equalization scheme, directed at poorer states. Based on adjusted fiscal capacity for state taxes (defined below), states with fiscal capacities after equalization below the national average are eligible for a VAT grant. The grant pool is, of course, restricted to 25% of VAT revenues. Hence, if aggregate entitlements exceed the size of the pool, all entitlements are pro-rated accordingly (on an equal proportionate basis). If aggregate entitlements fall short of the size of the pool, the surplus is distributed to all states on an equal per capita basis.

Interstate Equalization

State-state equalization operates as a net scheme—payments to receiving states are just covered by contributions from paying states. For each state, equalization entitlements are calculated in steps with graduated rates according to the difference between its adjusted fiscal capacity and its individual equalization standard. It is important to note that state-state equalization is, in fact, a second-tier equalization process. That is, states' fiscal capacities include revenues from the VAT which are already “equalized”.

Adjusted fiscal capacity (AFC_i) is essentially aggregate state and local revenues (including shared taxes) with an adjustment for extraordinary expenditures for harbours. Aggregate state and local revenues include (a) state revenues as specified under Article 106(2), (b) state revenues from joint taxes as specified under Article 106(3), distributed on a residence basis, (c) state share of VAT, and (d) local taxes.

The equalization standard for each state (ES_i) is calculated as the average per capita fiscal capacity for all states, scaled up (or down) to reflect the higher (lower) revenue needs associated with larger (smaller) population densities, times population. For cities, weights used to scale average per capita fiscal capacity start with a value of 1.00 for cities with a population of 5,000 and move up by steps to a value of 1.35 for cities with populations in excess of 500,000. Population density is also taken into account in determining the overall weight for each state.

State taxes are weighted by a factor of 1.35 in city states to account for agglomeration diseconomies. Elsewhere the weighting factor is 1. For local taxes, weights rise progressively, based on population size.

Table C-1: Weighting of Population

Number of inhabitants of a municipality	Weight
The first 5,000	1.00
The next 15,000	1.10
The next 80,000	1.15
The next 400,000	1.20
The next 500,000	1.25
All others above 500,000	1.30

Source: Extracted from Spahn (1997), 143.

Furthermore, states with more than 500,000 inhabitants receive additional points on their weighting factor according to population density. Those with between 1,500 and 2,000 inhabitants per square kilometre receive an additional 2 percentage points; those with between 2,000 and 3,000 inhabitants per square kilometre receive an additional 4 percentage points; and those with more than 3,000 inhabitants per square kilometre receive an additional 6 percentage points.

Those states with an adjusted fiscal capacity between 92% and 100% of their equalization standard are equalized to 37.5% of the difference. Thus, for such states, in symbols, equalization entitlements are calculated as:

$$E_i = 0.375(ES_i - AFC_i).$$

States for which AFC_i is less than 92% of their equalization standard are equalized at a marginal rate of 92% of the difference. Thus, for such states, in symbols, equalization entitlements (E_i) are calculated as:

$$E_i = (0.92ES_i - AFC_i) + 0.375(ES_i - 0.92ES_i)$$

States with adjusted fiscal capacities above their equalization standard are required to contribute to the equalization pool. If the difference is less than 1% (that is, if AFC exceeds ES by not more than 1%) they contribute 15% of the difference.²⁸ Thus, the contribution to the equalization pot is calculated as:

$$E_i = 0.15(AFC_i - ES_i).$$

States for which AFC exceeds ES by between 1% - 10% contribute 66% of the difference.²⁹ For such states, then, equalization entitlement is calculated as:

$$E_i = 0.15(1.01ES_i - ES_i) + 0.66(AFC_i - 1.01ES_i).$$

For differences in excess of 110% they contribute 80% of the difference, or:³⁰

$$E_i = 0.15(1.01ES_i - ES_i) + 0.66(1.1ES_i - 1.01ES_i) + 0.8((AFC_i - 1.1ES_i).$$

Since wealthier states—those with relatively high fiscal capacities—tend to be those with relatively high population densities, the scaling process tends to lessen the level of equalization flows at the second tier.

Where aggregate equalization payments exceed (fall short of) aggregate equalization contributions, state entitlements are pro-rated accordingly.

The German Unity Fund

Incorporation of the former east German states into the Federation's fiscal equalization scheme would have completely distorted the historic outcomes. All but Bremen among the recipient states would have become contributing states and, as well, would have lost their federal supplementary allocations.³¹ The 1990 Unification Treaty temporarily suspended the parts of the Basic Law relating to financial equalization (Article 107), providing a period to review the equalization question, as they would otherwise have applied to the new states through the beginning of 1995.

The German Unity Fund, co-financed by the Federation and the western states, was established as an interim program directed at raising fiscal capacities in the former east German states to levels comparable with those which would have prevailed had the temporary suspension not been implemented. Of the DM115 billion in this fund, DM20 billion was to be directly contributed by the federal government in respect of financial savings arising from unification. The balance was to be financed through debt, the responsibility for which was to be shared equally by the Federation and the Länder (including local governments). In 1992 an additional DM31 billion was added to the fund, financed partly through a one-point increase in the VAT rate (DM23 billion) and partly by the Federation (DM8 billion).

The Federation introduced an income tax surcharge in 1991/92 (7.5% on all income tax payments) to assist in paying for the Fund. In addition, they raised the mineral oil tax and the insurance tax.

States were partially compensated for the additional burdens they assumed by a reapportioning of the VAT—from 63/37% to 56/44%.

Former federal supplementary grants were to be replaced by two types of unconditional grants. Type A grants, payable to both east and west German states, are designed to raise per capita revenues (after horizontal equalization) to 90% of the national average. Type B grants are primarily directed at east German states in respect of infrastructure development.³²

The fund was distributed among the new states based on population. In turn, states were obliged to pass on 40% of their grant to their local governments. Participation in financial equalization (Article 107) was extended to the east German states in 1995. Changes, reflected in the discussion above, were made with respect to the terms of payment for contributing states.

In each state, state-local equalization schemes exist, based on the gap between need and fiscal capacity.

Table C-2: Fiscal Equalization Among States, 1995

	Relative Fiscal Capacity Per Capita (Average = 100)				Rank after equalization
	Public revenue per capita				
	Without VAT	After VAT distribution	After interstate equalization	After federal grants	
Hamburg	157.5	133.9	102.3	93.4	15
Hesse	118.7	109.7	103.5	94.6	10
Baden-Wu	115.7	107.1	103.0	94.2	12
N.Rhine-Wes.	114.2	105.4	102.4	93.7	14
Bavaria	113.8	105.1	102.5	93.7	13
Bremen	111.7	103.0	96.4	141.4	1
Schleswig-Hols.	106.8	100.0	101.3	95.9	9
Lr. Saxony	96.2	94.2	97.8	92.9	16
Rhineland-Pala.	95.7	92.6	96.8	94.3	11
Berlin	93.3	93.4	95.0	111.0	8
Sarland	83.5	89.1	95.0	129.2	2
Brandenburg	56.4	84.4	95.0	118.6	6
Saxony	50.3	83.1	95.0	117.4	7
Mecklenburg-W.Pom	47.0	82.3	95.0	119.8	3
Saxony-Anhalt	44.5	82.7	95.0	118.8	5
Thuringia	43.7	82.6	95.0	118.9	4

Source: Extracted from Spahn and Föttinger (1995).

D. SYSTEMS OF TAX HARMONIZATION AND TAX COLLECTION

In section A-2 and A-3 above the constitutional allocation of revenue and expenditure responsibilities are set out. Since unlike Canada and the United States the German constitution sets out detailed provisions for tax harmonization and collection, this section D sets out these constitutional provisions in further detail.

Article 106 [Apportionment of tax revenues] separates taxes into federal taxes, state taxes, common taxes, and municipal taxes. Section (1) of the article specifies federal taxes and reads as follows:

- (1) The yield of fiscal monopolies and the revenue from the following taxes shall accrue to the Federation:
 1. customs duties;
 2. taxes on consumption in so far as they do not accrue to the Länder pursuant to paragraph (2) or jointly to the Federation and the Länder in accordance with paragraph (3) or to the municipalities in accordance with paragraph (6) of this Article;
 3. the highway freight tax;
 4. the taxes on capital transactions, insurance and bills of exchange;
 5. nonrecurring levies on property and equalization of burdens levies;
 6. income and corporation surtaxes;
 7. levies within the framework of the European Communities.

Federal taxes account for roughly 17% of all revenues in Germany. The most significant among them are excise taxes—mineral oils tax, tobacco taxes, and alcohol taxes (excluding beer). There is provision for a federal surtax on both personal and corporate income taxes (the German Unity Fund).

Section (2) of article 106 specifies state taxes and reads as follows:

- (2) Revenue from the following taxes shall accrue to the [states]:
 1. the property tax;
 2. the inheritance tax;
 3. the motor vehicle tax
 4. such taxes on transactions as do not accrue to the Federation pursuant to paragraph (1) or jointly to the Federation and the Lander pursuant to paragraph (3) of this Article;
 5. the beer tax;
 6. the tax on gambling establishments.

Exclusive state taxes account for 5% of all revenues in Germany. The most significant among these are the motor vehicle tax and the property (net worth tax).

Exclusive municipal (local) taxes account for 7% of all revenues in Germany. Principal among these are local business tax (trade tax), the property tax and utilities charges. Municipal revenues are, however, significantly tied up in revenue sharing arrangements specified in subsequent sections of the Article.

Joint taxes (or common taxes or shared taxes), as noted previously in Section A, are the income tax, the corporation tax and the value added tax (VAT). Joint taxes account for the bulk of revenues in Germany—71% of the total. Their distribution is specified in section (3) of Article 106. The income tax is shared between all three levels of government—that portion of the income tax which is not distributed to municipalities is to be shared equally between the federal and state governments. The corporation tax is shared equally between the federal and state governments. The distribution of the VAT is to be determined through negotiation and federal legislation subject to the consent of the Bundesrat, and subject to specified principle, particularly the uniformity-of-living-conditions principle mentioned previously.

Section (3) reads as follows:

- (3) Revenue from income taxes, corporation taxes and turnover taxes shall accrue jointly to the Federation and the Länder (joint taxes) to the extent that the revenue from the income tax and the turnover tax is not allocated to municipalities pursuant to paragraph (5) and 5(a) of this Article. The Federation and Länder shall share equally the revenue from income taxes and corporation taxes. The respective shares of the Federation and the Länder in the revenue from turnover tax [VAT] shall be determined by a federal law requiring the consent of the Bundesrat. Such determination shall be based on the following principles:
1. The Federation and the Länder shall have an equal claim against current revenues to cover their necessary expenditure. The extent of such expenditures shall be determined with due regard to multi-year financial planning.
 2. The financial requirements of the Federation and of the Länder shall be coordinated in such a way as to establish a fair balance, avoid excessive burdens on taxpayers, and ensure uniformity of living standards throughout the federal territory.

At present, 15% of income tax revenues is apportioned to the municipalities, leaving federal and state shares of 42.5% each.

Section (4) of Article 106 spells out the apportionment of the VAT. Vertical adjustments through shares of the VAT is the feature of the otherwise rigid German

revenue sharing arrangements which provides the relief valve, ensuring that any vertical fiscal gap is consistent with constitutional principles. Section (4) reads as follows:

- (4) The respective shares of the Federation and the Länder in the revenue from the turnover tax shall be reapportioned anew whenever the ratio of revenues to expenditures of the Federation becomes substantially different from that of the Länder. If a federal law imposes additional expenditure on or withdraws revenue from the Länder the additional burden may be compensated for by federal grants pursuant to a federal law requiring the consent of the Bundesrat provided that additional burden is limited to a short period of time. The law shall establish the principles for calculating such grants and distributing them among the Länder.

Section (5) specifies that municipalities are to receive a share of income tax revenues, to be determined by federal legislation requiring the consent of the Bundesrat. Section (6) specifies (a) exclusive municipal taxes as well as revenue sharing arrangements concerning the business (trade) tax. Specifically, both the state and federal governments are accorded shares in business tax revenues, to be specified in federal legislation requiring the consent of the Bundesrat. At present, 80% remains with local governments, 15% is rendered to state governments, and 5 % is rendered to the federal government. (Note: This tax was to be replaced with revenue sharing from VAT.) The federal government shares a portion of its revenues from the mineral oil tax with the states in aid of regional public transport programs.

Sections (5) and (6) read as follows:

- (5) A share of the revenue from the income tax shall accrue to the municipalities, to be passed on by the Länder to their municipalities on the basis of the income taxes paid by their inhabitants. Details shall be regulated by a federal law requiring the consent of the Bundesrat. This law may provide that municipalities may establish supplementary or reduced rates with respect to their share of the tax.
- (6) Revenue from taxes on real property and trades shall accrue to the municipalities; revenue from local taxes on consumption and expenditures shall accrue to the municipalities or, as may be provided for by Länder legislation, to associations of municipalities. Municipalities shall be authorized to establish the rates at which taxes on real property and trades are levied within the framework of existing laws. If there are no municipalities in a Land, revenue from taxes on real property and trades as well as from local taxes on consumption and expenditures shall accrue to the Land. The Federation and the Länder may participate by virtue of an apportionment, in the revenue from tax on trades. Details regarding such apportionment shall be the subject of a federal law requiring the consent of the Bundesrat. In

accordance with Land legislation, taxes on real property and trades tax as well as the municipalities' share of revenue from the income tax and the turnover tax may be taken as a basis for calculating the amount of apportionment.

Section (7) of Article 106 provides explicitly for revenue sharing between states and their municipalities of revenues from joint taxes. Otherwise, revenue sharing arrangements are at the discretion of individual states.

Section (7) reads as follows:

- (7) An overall percentage, of the Land share of total revenue from joint taxes to be determined by Land legislation, shall accrue to the municipalities or associations of municipalities. In all other respects Land legislation shall determine whether and to what extent revenue from Land taxes shall accrue to municipalities (associations of municipalities).

Finally, section (8) provides for compensation to municipalities where federal requirements place a financial burden on municipalities.

Section (8) reads as follows:

- (8) If in individual Länder or municipalities (associations of municipalities) the Federation requires special facilities to be established that directly result in an increase of expenditure or in reductions of revenue (special burden) to these Länder or municipalities (associations of municipalities) the Federation shall grant the necessary compensation if and in so far as the Länder cannot reasonably be expected to bear that burden. In granting such compensation due account shall be taken of indemnities paid by third parties and financial benefits accruing to these Länder or municipalities (associations of municipalities) as a result of the establishment of such facilities.

Article 108 of the Basic Law specifies the allocation of responsibilities for collecting, handling and spending taxes. States have the principal responsibility for tax administration. That is, while the federal government administers federal taxes, the states are responsible not only for administering state taxes, but also the common (i.e. shared) taxes.

There is provision to ensure uniformity in tax collection and auditing.

Article 109 requires that each level of government, while autonomous fiscal units, should take into account impacts of their budgetary policies on the other levels. This is achieved by requiring federal legislation be passed through the Bundesrat (representing

the Länder) that, in effect, approves the budgets of all three tiers. State budgetary policies must, for example, be consistent with the broader goal of macroeconomic stability.

E. ANALYSIS

1. ECONOMIC ASPECTS

1. Impacts on Economic Efficiency

The German system of federal-state fiscal relations is constitutionally anchored in the uniformity-of-living-conditions principle. Article 30 [Division of authority between the Federation and the Länder] confirms the paramountcy of states in the provision of government services. Equally, Articles 72 and 106(3)2 confirm the role of the federal government in ensuring fiscal equity (if that is what may be interpreted by uniformity-of-living-conditions). Constitutional provisions that promote horizontal equalization—both implicitly and explicitly—provide the “glue” that binds the system together. The end result is a high degree of uniformity in terms of public infrastructure and government services. In this respect the emphasis upon uniformity of living standards is much higher than in Canada or the United States.

The German system is decentralized on the expenditure side—that is, the states are primarily responsible for delivery of key social services. Equally, the system is highly centralized on the revenue side; the bulk of revenues are collected as common taxes with proscribed allocation between the orders of government and subject to federal legislation albeit usually requiring the consent of the Bundesrat representing the states. The allocation of the VAT between orders of government provides the relief-valve for any emerging vertical fiscal imbalance in the federation. Otherwise, the bulk of federal transfers to states are directed at alleviating the horizontal fiscal imbalance arising out of German unification.

Nonetheless, German states are, at the margin, accountable for the revenues used to finance the provision of public services. And this, combined with decentralized provision of public services, albeit with provision for joint decision-making with regard to general principles (Article 91a(2)), conforms to general notions of economic efficiency. Moreover, the significant degree of harmonization in the tax system and the general commitment to equalization principles mutes the standard criticisms of decentralized fiscal systems. Thus, for example, the commitments to the equalization principle on the revenue side and uniformity-of-living-conditions on the expenditure side ensure a degree

of uniformity in net fiscal benefits (NFBs) across states, alleviating pressures for inefficient migration. Centralized tax systems preclude the possibility of tax competition among states.

It needs to be said, however, that the German system brings with it some potentially serious flaws. Equalization, for example, has caused the burden to fall disproportionately on a small sub-set of states. As might be expected, this has led to political tension. Moreover, in the post-unification era, pressure on the western states from proposed inclusion in the interstate equalization scheme has threatened support for pursuing the goal of fiscal equity. In turn, this has resulted in an increased federal role in promoting fiscal equity. Yet, this increased federal role has all but reversed the order of states in terms of fiscal capacity.

The German commitment to equalization and uniformity-of-living-conditions may result in a disincentive for states to pursue expansion of their own-revenue sources. Relatively rich states may not pursue economic development potential in view of the equalization implications.

Moreover, the willingness of the federal government to bail out near-bankrupt states through federal supplementary grants might seriously compromise the principle of accountability in state budgeting.

2. Impacts on Equity

Equity in federal systems is a central concern. Equity achieved through the provision of public services is consistent with the uniformity-of-living-conditions principle. Uniform public services conform with the equity objectives of equality of opportunity and economic security, for example. Moreover, the notions of both vertical and fiscal equity are well served by the German arrangements.

It is the emphasis upon the uniformity of living conditions principle, the revenue-sharing arrangements and the self-financing nature of the state-to-state equalization that truly distinguishes the German fiscal arrangements from those in Canada and the United States.

Equity and Public Services

Important public services such as education, health and social services are provided through the public sector essentially because their provision serves equity objectives. Otherwise, their provision could be left to the private sector. Decentralization to the states, as in the case of Germany, may be efficiency enhancing in that it permits better reflection of residents' preferences; equally, the federal government may have an interest in ensuring that some notion of national standards is satisfied. In the German case, maintaining some degree of vertical fiscal imbalance has been important in this process. Equally, the roles of both the federal and state governments in ensuring fiscal equity have been clearly enunciated in the Basic Law, resulting in a significant degree of horizontal fiscal equity.

2. POLITICAL ASPECTS

1. Impact on Stability

The process of intergovernmental relations and fiscal arrangements has been both a stabilizing influence and a source of conflict in Germany.

Areas of Consensus

Equivalence of Living Conditions: As noted in section A.4, the achievement of a common standard of living across the federation has been a goal of the Federal Republic of Germany since its establishment. Uniformity became a powerful norm permeating the German system of governance.

Post-unification, the Constitutional Reform Act of 1994 substituted the term 'equivalence of living conditions' for 'uniformity of living conditions'.³³ It does not appear, however, that the modified constitutional wording is reflective of a serious diminution of the norm of uniformity.³⁴ Indeed, the enduring importance of the drive to create a common standard of living across the federation cannot be over-estimated. It remains a leading value of the system, and thus affects not only relations among governments, but also sets standards for the equal distribution of wealth throughout the country.

Areas of Dispute

Territorial Reform:

As we have noted, the ability of the Länder to bear symmetrical constitutional responsibilities has been questioned. Given their disparate territorial areas, population sizes, and, since re-unification, levels of economic development, it has been argued that territorial reform is necessary if the country is to achieve its goal of equivalence of living conditions. Any territorial reform of Land boundaries has had important motivations and major implications related to the financial position resulting from territorial modifications.

There are six specific arguments advanced for the necessity of territorial reform.³⁵ It has been argued, first, that under the present boundaries, not all Länder can fulfill their constitutional functions within the Federal Republic of Germany, and, second, nor can all fulfill the functions expected of them in relation to the European Union. Third, it has been argued that reorganization is necessary for the orderly economic development of urban areas which cut across Land boundaries. Fourth, it has been argued that the increased number of Länder post-unification presents a more difficult environment for intergovernmental coordination. Fifth, it has been argued that the economic disparities among the Länder leave the Länder open to 'divide and rule' tactics on the part of the Bund, and, sixth, that these disparities place the onus for the realization of the goal of equivalence of living conditions on the Bund, thereby subverting the federal nature of the German state.

Despite the strength of these arguments, however, the prospects for territorial reorganization are not bright. While such reorganization has been a matter of debate for the entire life of the Federal Republic of Germany, only the 1951 amalgamation of three small south-western Länder, into the new Land of Baden-Württemberg, has been successfully implemented.³⁶ Two expert commissions, in 1955 and 1973, recommended territorial reorganization, but the governments involved proved both unwilling and unable to carry through with reforms. In 1990, the extreme political time pressures associated with the re-unification process meant that another opportunity for reorganization was lost; the eastern Länder were simply admitted to the FRG on the basis of the Land boundaries that had existed in East Germany prior to 1952. Finally, an attempted 1996

merger of Berlin with Brandenburg failed when the voters of the latter rejected it in a referendum.

Reform of the Fiscal Transfer System: As noted, while transitional financial arrangements were made in the wake of unification, and subsequent long-term adjustments made in the financial equalization system, differences in size, population, and level of economic development among the Länder continue to generate disagreements among them and between them and the federal government. One issue is the level of equalization payments.

The second stage of the equalization process, the award of supplementary federal allocations, now ensures income equalization at a level of 99.5 percent of the Länder average.³⁷ However, as expenditure needs are not taken into account, the recipient Länder remain unsatisfied. The poorest Länder therefore continue to press the Bund for selective financial support. Meanwhile, the payee Länder feel that they are penalised for their effective economic and financial management; they believe they are being forced to subsidise Länder that have not made the hard choices necessary to improve their own positions. While cuts to the target level of equalization have been suggested, territorial reorganization may be the only long-term solution. In the absence of such reorganization, payee Länder may resort to constitutional litigation in an attempt to decrease their financial obligations to the poorer Länder.

A second issue is that of ‘unfunded mandates’. As we have noted above, the Länder, as administrators of federal policy, often end up footing the bill for costs incurred as a result of federal legislation. Proposals to remedy this situation have focused on the need for constitutional revisions which would provide that the order of government which legislates costs should be legally required to cover those costs, rather than shifting them to another order of government.³⁸ Such revision may be possible, given the history of constitutional amendment in Germany, but it will assuredly not be easy.

A third financial issue relates to the ‘joint tasks’. The Länder have regarded this as the area most open to abuse by the Bund. Both the difficulties, noted above, of the use of the ‘golden leash’ by the Bund, and of decision-making on the basis of the lowest common denominator, seem to occur most frequently in relation to the joint tasks. While further adjustment of the VAT allocation ratio, in favour of the Länder, may decrease somewhat

the financial influence of the Bund, it is unlikely that this would be sufficient to remedy the difficulty entirely. The disparities in size and population of the Länder pose a structural difficulty which tinkering cannot cure; i.e., the smaller and poorer Länder will never be able to afford to provide the same levels of services in regard to the joint-task policy areas without special assistance from the Bund. Unfortunately, the long-term resolution of these difficulties depends upon territorial reorganization.

Ability to Adapt to Changes

Despite the areas of dispute noted in the previous section, the fact remains that the Federal Republic of Germany has proven itself remarkably adaptable over its first fifty years. Adjustments in the federal balance have been accomplished via constitutional amendment, intergovernmental relations, and judicial review. All three processes have proved relatively flexible. Partial revisions of the constitution have been common, with the major amendments having included the strengthening of the Bund's legislative and financial roles in the late 1960s, the reunification of Germany in 1990, and the post-unification reforms of 1994.

Intergovernmental relations in Germany have also proven a relatively successful method of adjustment in the federation. The German pattern of intergovernmental relations follows the 'executive federalism' model common to parliamentary federations. However, in Germany the intensive network of relationships, at the *Gesamstaat*, *Bundesstaat*, and 'third' levels, provide for systematic coordination among orders of government. This tightly interlocked relationship appears to offer a less conflictual model of executive federalism than is found in some other parliamentary federations.

This system of interlocked relationships has been criticized, however, for being an impediment to adaptation. An institutional culture which puts a premium on consensus can mean the indefinite postponement of difficult policy choices. This is the so-called 'joint-decision trap', identified by Fritz Scharpf, in which both policy decisions and changes to the rules via which such decisions are made are blocked by an institutional culture which prescribes unanimous agreement for virtually all major decisions. Finding the most effective balance between cooperation among orders of government and maintenance of each order's ability to act autonomously and flexibly in response to

policy challenges has become a major issue within the German federation, although it is a problem not unknown to other federations.

Judicial review has been an important method of adaptation to changing circumstances, in part due to German societal norms which prescribe that political life take place with significant reference to a legal framework. The Federal Constitutional Court's balanced approach to jurisdictional disputes has meant that both orders of government have been able to use the Court to seek adjustments in the federation.

While the fiscal transfer system was showing some strain in the 1980s, overall it may be observed that prior to reunification it had proven a flexible instrument in the West German context. With special transitional provisions and adjustments in the allocation of VAT revenues, the system has survived re-unification. However, the enduring disparities in economic development between the former West- and East-German Länder, and the consequent high levels of transfers, are severely straining the inter-Länder solidarity on which the system depends. Whether the wider system of intergovernmental relations will be sufficiently flexible to effect the necessary changes which would preserve the principles of the present system while adapting its details to the new economic realities is an open question.

2. Transparency and Accountability Considerations

As noted in section A.5, the highly integrated German system of fiscal federalism exhibits a degree of complexity which is inimical to transparency and accountability.

Transparency is decreased by the complexity of the system of fiscal federalism. The interdependent network of shared taxes, equalization transfers, expenditure responsibilities, and even decision-making institutions makes it difficult for citizens to identify which government is taxing or spending for particular purposes. Given the interlocking of German institutions, however, it is difficult to see how this situation could be remedied. Nevertheless, the issue of improving transparency and accountability has been receiving increased attention within Germany in recent years.

If accountability requires clear mechanisms for making executive action answerable to legislative control and supervision, then the German system cannot be said to exhibit high levels of accountability. The German system of legislative and administrative non-

coincidence is a structural impediment to clarity in lines of accountability. As well, the evolution of the Federal Republic of Germany has reinforced the interlocked features of the federation. While this has aided governments in the efficient coordination of their activities, it has also further blurred the lines of democratic accountability.

3. Political Culture

Post-unification, German society remains relatively homogeneous, if less so than before, and the process of intergovernmental relations and fiscal arrangements reflects and reinforces this characteristic.

The quest to create a common standard of living across the federation, ‘equivalence of living conditions’ in post-1994 constitutional parlance, is emblematic of both the fact and the norm of homogeneity. It is in the context of the drive to create what has been termed “the unitary federal state”³⁹ that the operation of a number of the features of the German federal system are best understood. The division of legislative/administrative responsibilities, the wide area of concurrent legislative jurisdiction, and the constitutional provision for federal framework legislation, together provide a constitutional environment facilitative of uniformity. Federal framework legislation, for example, can provide a basic legislative standard across the country, while Land governments are allowed a certain latitude for customization of implementation via their administrative control.⁴⁰

The extensive system of financial equalization between richer and poorer Länder has also had its philosophical roots in the achievement of uniform living standards across the Federal Republic of Germany. It is true that the degree of equalization which should be pursued is now a matter of dispute among Länder. However, the principle of equalization payments as a means to achieve the goal of common living standards remains a matter of consensus. Indeed, even the proposals for territorial reform and changes to the fiscal transfer system are aimed not at undermining the goal of uniformity, but at facilitating its achievement. Thus, the highly integrated and interdependent characteristics of fiscal federalism in Germany largely grow out of and reflect its prevailing political culture.

Notes

- ¹ Daniel Elazar, *Federal Systems of the World: A Handbook of Federal, Confederal and Autonomy Arrangements* (Harlow, Essex, UK: Longman, 1991), 105
- ² David P. Conradt, *The German Policy* (5th ed.; New York: Longman, 1993), 183
- ³ Conradt, 181
- ⁴ Ronald L. Watts, *Comparing Federal Systems* (2nd ed.; Montreal and Kingston: McGill-Queen's University Press, 1999), 37-39.
- ⁵ Ronald L. Watts, "German Federalism in Comparative Perspective," in Charlie Jeffery, ed., *Recasting German Federalism: The Legacies of Unification* (London: Pinter, 1999), 272
- ⁶ Uwe Leonardy, "The Institutional Structures of German Federalism," in Charlie Jeffery, ed., *Recasting German Federalism: The Legacies of Unification*, (London: Pinter, 1999), 12.
- ⁷ Paul Bernd Spahn and Wolfgang Föttinger, "Germany," in Teresa Ter-Minassian, ed., *Fiscal Federalism in Theory and Practice* (Washington: International Monetary Fund, 1997), 239.
- ⁸ Leonardy, "Institutional Structures", 15.
- ⁹ Spahn and Föttinger, 229.
- ¹⁰ Ibid., 228
- ¹¹ Ronald L. Watts, *The Spending Power in Federal Systems: A Comparative Study* (Kingston: Institute of Intergovernmental Relations, 1999), 27.
- ¹² Ibid., 25
- ¹³ Ibid.
- ¹⁴ Uwe Leonardy, "German Federalism Towards 2000: To be Reformed or Deformed?," in Charlie Jeffery, ed., *Recasting German Federalism: The Legacies of Unification*, (London: Pinter, 1999), 297.
- ¹⁵ Hartmut Klatt, "Forty Years of German Federalism: Past Trends and New Developments," *Publius* 19 (1986), 186-87.
- ¹⁶ Hans-Peter Schneider, "German Unification and the Federal System: The Challenge of Reform," in Charlie Jeffery, ed., *Recasting German Federalism: The Legacies of Unification*, (London: Pinter, 1999), 69-70.
- ¹⁷ Werner J. Patzelt, "The Very Federal House: The German Bundesrat," in Samuel C. Patterson and Anthony Mughan, eds., *Senates: Bicameralism in the Contemporary World* (Columbus Ohio, USA: Ohio State University Press, 1999), 75-79.
- ¹⁸ Ibid., 78.
- ¹⁹ Philip Blair and Peter Cullen, "Federalism, Legalism and Political Reality: The Record of the Federal Constitutional Court," in Charlie Jeffery, ed., *Recasting German Federalism: The Legacies of Unification*. (London: Pinter, 1999), 132-33.
- ²⁰ Leonardy, "Institutional Structures", 20.
- ²¹ Blair and Cullen, 123.
- ²² Ibid., 120.
- ²³ Leonardy, "Institutional Structures", 20.
- ²⁴ Fritz W. Scharpf, "the Joint-Decision Trap: Lessons from German Federalism and European Integration," *Public Administration* 66 (1988), 246.
- ²⁵ Roland Sturm, "Party Competition and the Federal System: The Lembruch Hypothesis Revisited," in Charlie Jeffery, ed., *Recasting German Federalism: The Legacies of Unification*, (London: Pinter, 1999), 201.
- ²⁶ Uwe Leonardy, "German Federalism Towards 2000: To be Reformed or Deformed?," in Charlie Jeffery, ed., *Recasting German Federalism: The Legacies of Unification*, (London: Pinter, 1999), 295.
- ²⁷ The German Unity Fund is discussed in detail in section C, p. 38.
- ²⁸ Prior to 1995, states with AFC less than 2% of ES were referred to as being in the "dead zone"—that is, they were not required to contribute to the equalization pot.
- ²⁹ Prior to 1995, states with AFC between 102% and 110% of ES were required to contribute 70% of the difference to the equalization pot.
- ³⁰ Prior to 1995, such states contributed 100% of the difference to the equalization pot.

³¹ It was estimated that incorporating the former east German states into the fiscal equalization scheme would have increased flows from DM5 billion per year to a staggering DM25 billion per year (see Spahn, Paul Bernd, "Intergovernmental Transfers in Switzerland and Germany" in Ehtisham Ahmad ed., *Financing Decentralized Expenditures: An International Comparison of Grants* (Brookfield: Edward Elgar, 1997), 103.

³² Also, Type C grants are available to compensate western states for undue hardship from integrating the eastern states into horizontal equalization, grants-in-aid to eastern states to promote investment and economic growth, and additional grants to fiscally strapped states.

³³ Uwe Leonardy, "German Federalism Towards 2000: To be Reformed or Deformed?," in Charlie Jeffery, ed., *Recasting German Federalism: The Legacies of Unification*, (London: Pinter, 1999), 297.

³⁴ Ibid.

³⁵ Ibid., 291.

³⁶ Ibid., 287.

³⁷ Mackenstein, Hans, and Charlie Jeffery, "Financial Equalization in the 1990s: On the Road Back to Karlsruhe?," in Charlie Jeffery, ed., *Recasting German Federalism: The Legacies of Unification*, (London: Pinter, 1999), 169.

³⁸ Leonardy, "German Federalism Towards 2000," 296.

³⁹ Hartmut Klatt, "Centralizing Trends in West German Federalism, 1949-89," in Charlie Jeffery, ed., *Recasting German Federalism: The Legacies of Unification*, (London: Pinter, 1999), 42.

⁴⁰ Ibid.

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