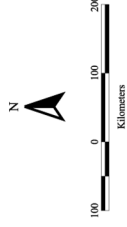


# Germany

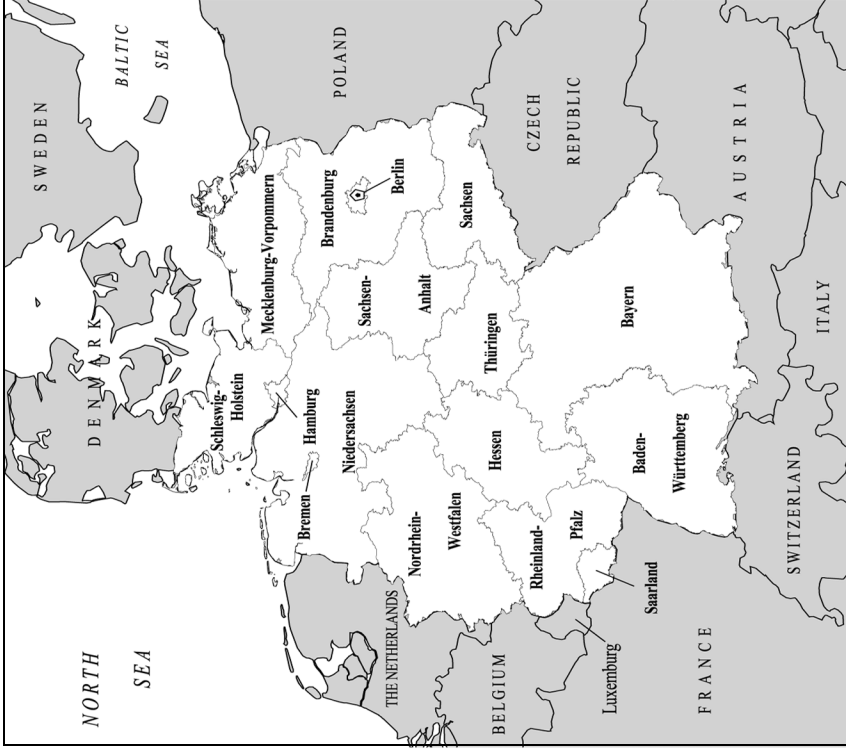
Capital: Berlin  
Population: 82.5 Million  
(September 2003)



Boundaries and place names are representative only and do not imply official endorsement.



Source: ESRI Ltd., CIA World Factbook,  
Times Atlas of the World



# Federal Republic of Germany

LARS P. FELD AND JÜRGEN VON HAGEN

Germany's fiscal federalism is in trouble. In 2003, the city state (*Land*) of Berlin sued the federal government at the Constitutional Court for financial bailout, arguing that Berlin was in extreme fiscal distress from which it could not escape by its own means. In 2005 and 2006 Saarland and Bremen, respectively, followed with similar claims, although they had obtained bailouts from the federal government from 1994 to 2004. As many Land governments have neglected constitutional rules concerning public borrowing for several years, it is only a matter of time before more states (*Länder*) ask for bailouts.

When the system was set up in 1949, the framers of the German Constitution, which is called the *Grundgesetz*, were not aware of the potentially perverse fiscal incentives the fiscal constitution might provide. The *Länder* lost their tax autonomy with the Weimar Constitution, and the attempts of some *Länder*, like Bavaria, to obtain higher tax autonomy after the Second World War were not successful.<sup>1</sup> A majority of the *Länder* favoured a comprehensive system of fiscal equalization in order to provide each Land with the financial means to meet its legal obligations and subsequent spending needs. Without the intervention of the Allies, the fiscal constitution would have allowed the *Länder* even less influence on tax laws in 1949. However, the Allies were not successful in their attempt to provide the *Länder* with greater tax autonomy. The involvement of the *Bundesrat* (second chamber of Parliament) in taxation results from the administrative responsibilities the states obtained for the most important (joint) taxes.

Germany's fiscal federalism evolved towards higher cooperation and centralization, culminating in the Great Financial Reform Act of 1969. Soon afterwards, critical assessments argued that this constitutional reform might have gone too far.<sup>2</sup> Further critical discussions emerged in the dawn of the two decisions of the Constitutional Court on the fiscal equalization

system in 1986 and 1992. Unification was still unimportant for this case as the decision of 1992 (partly) resulted from the bailout claims by Saarland and Bremen. Thus, the troubles of Germany's fiscal federalism started before unification, although it provided additional problems, as is indicated by the decision of the Constitutional Court on the fiscal equalization system in 1999.

This sequence of events led the political actors in the federal and state spheres to aim at a reform of Germany's federalism in 2001 and to the creation of the Commission for the Modernization of Federal Order in 2003. After one year of deliberations, the commission was, however, unable to agree on recommendations for reforming German federalism.<sup>3</sup> The commission was supposed to suggest a disentanglement of federal and Land responsibilities. Currently, 50.1 percent of all new federal laws require the approval of both chambers of the federal Parliament and, thus, of the Bundesrat, which represents the Länder.<sup>4</sup> Likewise, the Länder are strongly restricted by federal mandates in conducting their own tasks. Thus, neither the federal government nor the Länder have sufficient autonomy to pursue their own policy goals. As the assignment of competencies has constitutional prerogative over the fiscal constitution in Germany, disentanglement is particularly important for German fiscal federalism.

In view of this, the government elected in the fall of 2005 was a grand coalition of Christian Democrats and Social Democrats. They decided in November 2005 to re-enter this reform process with a revision of the compromise that had almost been achieved in 2004 between the Länder and the federal government. In the summer of 2006, the *Bundestag* (first chamber) and the Bundesrat accepted the Federalism Reform Act.<sup>5</sup> It contains a considerable reduction of federal laws that require the consent of the Bundesrat,<sup>6</sup> and it introduces a right for the Länder to deviate from federal law in the areas of administrative institutions and administrative procedures. Moreover, the legislative responsibilities of the federal government and the Länder are revised considerably. With respect to fiscal federalism, the reform is less ambitious. However, the compromise contains the prospect of a second reform step with considerably more changes for Germany's fiscal federalism.

Given these recent reform efforts, the question arises: What is wrong with Germany's fiscal federalism? In order to answer this question, we provide an overview of the components of German federalism and their main advantages and disadvantages. After giving a brief overview of the country, we describe the division of fiscal powers in Germany and relate it to macro-economic management. Thereafter, we discuss revenue-raising possibilities and intergovernmental fiscal transfers. The final section provides some ideas about the way forward.

## OVERVIEW OF THE COUNTRY

The Federal Republic of Germany is a representative democracy with a population of 82.4 million people in 2005 and an area of 357,050 square kilometres.<sup>7</sup> The official language is German. In 2005, 7.3 million people, or 8.8 percent of the population, were foreigners. Immigrants from Turkey make up the largest group, at 1.8 million, which is about as important as are the 1.7 million foreigners from the EU-15.<sup>8</sup> Although there are many people with no religious affiliation living in Germany, by far the largest part of the population is of Christian background. Roman Catholics, at 26.0 million members, and Protestants, at 25.6 million members, cover about one-third of the population each, but the large majority of them are not practising. They are followed by 1.2 million people of Orthodox faith, and 300,000 Free Church followers. About 3.2 million Muslims and 100,000 Jewish people live in Germany.

The Grundgesetz of 1949 legally established two orders of government: federal and state. The Grundgesetz guarantees the existence of the Länder and provides them with a strong constitutional position.<sup>9</sup> It is true that the Grundgesetz allows for changes in the territorial boundaries of states; therefore, some experts of constitutional law have argued that this renders Germany's federalism fictitious.<sup>10</sup> The article in the Grundgesetz regulates the merger of German states as a "new partitioning of the federation's territory." However, because the merger of states is the only area for which a mandatory and binding referendum in all the states involved is established by the Constitution, it must be conceded that the Grundgesetz puts strong emphasis on the sovereignty of those states' citizens and thus also of the Länder themselves. A merger is not accomplished if a majority of the citizens in one Land does not support it.<sup>11</sup>

Local governments do not enjoy the same constitutional status as do the Länder and thus do not form a sphere of their own. Their legal rights and duties are, instead, left to the constitutions of the states. Nevertheless, the Grundgesetz provides the local jurisdictions with strong constitutional rights by obliging the Länder to give the local jurisdictions the right to regulate local community affairs autonomously, including the right of financial autonomy for the local jurisdictions.<sup>12</sup> The Grundgesetz thus establishes Germany as a federation with strong state and local jurisdictions. The robust role of the states and the local jurisdictions is also indicated by a strong administrative decentralization in Germany, whereby locally and regionally elected and responsible representatives as well as local and regional administrations enjoy substantial autonomy. As federal law has constitutional prerogative over state law, and the states' constitutions impose their superiority over any local regulations, this subfederal autonomy is restricted in some ways.<sup>13</sup> These restrictions are important for fiscal federalism.

Table 1  
Basic political and geographic indicators

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|--|
| Official name: Bundesrepublik Deutschland (Federal Republic of Germany)  |
| Population (31.12.2005): 82,438,000  |
| Area (square kilometres): 357,050  |
| GDP per capita in US\$ (2005): 35,075.34   |
| Constitution: 1949, written  |
| Orders of government: Representative democracy   |
| Constitutional status of local government: Strong  |
| Official language: German  |
| Number and types of constituent units: Three levels of government – federal ( <i>bund</i> ), states ( <i>länder</i> ) and local ( <i>gemeinden</i> ) |
| Population, area, and per capita GDP in US\$ of the largest constituent unit:  |
| Northrhine-Westphalia (2005) – population: 18,058,105, area: 34,083.52 sq. km., per capita GDP US\$33,558.40   |
| Bremen (2005) – population: 663,000, area: 404.28 sq. km., per capita GDP US\$46,161   |

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Sources: Federal Statistical Office and Statistical Offices of the States

After the creation of Baden-Württemberg by a merger of the Länder Baden, Württemberg-Baden, and Württemberg-Hohenzollern in 1952 and the entry of the Saarland in 1956, Germany consisted of ten states plus West Berlin. In 1991, the five East German Länder of the former German Democratic Republic (GDR) became additional members of the Federal Republic of Germany, thus increasing the number of states to fifteen, while East Berlin was merged with West Berlin to form the sixteenth state. The largest Land is North-Rhine-Westphalia, with a population of 18,058,105, an area of 34,083 square kilometres, and a per capita GDP of \$33,558 in 2005. As Germany's per capita GDP is \$35,075, North-Rhine-Westphalia is just below average. The smallest Land is Bremen, with, in 2005, a population of 663,000, an area of 404 square kilometres, and a per capita GDP of \$46,161.<sup>14</sup> The number of jurisdictions declined considerably, however, first, in a merger wave in the early 1970s, which reduced the number of communities by 63 percent and, second, by unification, which reduced the number of East German communities by about 38 percent. With a larger population, Germany has fewer communities today than does France.

It should be noted that German federalism is historically quite different from the kinds of federalism observed in some older federations, such as Switzerland and the United States.<sup>15</sup> This is partly due to the fact that many existing states were newly created after the Second World War, notable exceptions being Bavaria, Saxony, and the city-states of Hamburg and Bremen. Stefan Oeter argues that another reason for the peculiarities of German federalism is found in the fact that Germany was created in the

nineteenth century under Prussian hegemony.<sup>16</sup> Since then, German federalism has been regarded by the public as a mechanism to ensure the influence of regional princes and executives. This is particularly reflected in the nature of the second chamber of Parliament, which resembles the old Bundesrat of the second German Empire (1871–1918). While the old Bundesrat was an assembly of the representatives of the states' (monarchic) executives, the current Bundesrat, according to the Grundgesetz, consists of members of the states' (elected) executives or their representatives.<sup>17</sup> Moreover, since 1871 the basic rationale for Germany's federalism has been the division of functions rather than the performance of actual tasks. The Bismarckian construction was to regulate a number of policy fields jointly but to leave their implementation to the Länder. Legislation and execution were thus divided – a path that has been followed until today. The Grundgesetz lays down the basic principle that the Länder shall execute federal law as their own task.<sup>18</sup>

German politics are organized as a parliamentary democracy with (mainly) proportional representation in the federal and state spheres. Direct elections of mayors in municipalities are the only deviation from that principle. On the one hand, the strong emphasis on parliamentary democracy means that elements of direct democracy are practically non-existent in German political decision making. Only the merger of states provides an exception. At the state and local arenas, a tendency exists for expanding direct democratic decision making, but it is still too weak to exert an important influence on state and local policy making.<sup>19</sup> On the other hand, and more important, the parliamentary system provides the political parties with strong political influence. If representatives want to pursue their political careers, they depend on their parties to put them in secure places on the party lists. Those party lists are more important with regard to winning a seat in Parliament than is success in the constituencies. This leaves Germany with strong parties that can discipline the representatives in the parliaments. The political parties are, however, also deeply rooted in German federalism. They recruit political talents from the local party organizations in the Länder, and those who succeed in the Land sphere have a good chance of obtaining a political post in the federal government.<sup>20</sup> Moreover, party lists are decided within the Land sphere, not within the federal sphere. These recruitment mechanisms do not work only via the Länder. A talented local politician can make it directly to the federal government. Moreover, this holds not only for legislators but also for executives. Success as a state executive serves as a recommendation for the federal government. Since the Second World War, the organization of German politics along these lines has provided for a stable system of (mostly) coalition governments. But it also helps to highlight the bias that leads the main parties and representatives in parliaments and governments to lean more heavily towards a cooperative than a competitive model of federalism.

With respect to Germany's civil law system, it should be noted that judicial oversight by the Constitutional Court restricts representatives in Parliament and the German government and is thus the strongest element of the German separation of powers. As a result, Germany's legal system is also heavily influenced by constitutional and administrative law. The separation of powers is, however, less pronounced between the Parliament and the government (i.e., executive). As the Bundesrat is often controlled by a majority of parties that are in opposition to parties that control the Bundestag, sufficient checks and balances exist outside the judiciary. The judiciary provides for a protection of minorities, but the Constitutional Court also plays an important role in guarding and developing the main constitutional principles of German federalism and, thus, shapes the current state of the country's fiscal federalism.

#### THE DIVISION OF FISCAL POWERS

The fiscal powers of each sphere of government follow the constitutionally assigned competencies. The latter have prerogative over the fiscal constitution, which, in Germany, is a subsidiary of the basic rules of federalism. According to the Grundgesetz, the Länder have legislative power as long as the Grundgesetz does not assign a legislative competency to the federal government.<sup>21</sup> Such an assignment takes place explicitly in the form of exclusive federal competency according to the Grundgesetz.<sup>22</sup> It also takes place implicitly for the area of concurrent legislation, according to which the Länder only have legislative power if the federal government does not use its legislative power.<sup>23</sup> Put differently and more bluntly, the federal government can acquire legislative competencies under the heading of concurrent legislation whenever it passes a law in a concurrent area. However, the federal government only has jurisdiction in this area if and to the extent that the maintenance of equal living conditions requires it.<sup>24</sup> The Federalism Reform Act will facilitate the use of concurrent legislation by excluding several areas from the requirements of the Grundgesetz.<sup>25</sup> The Länder will instead obtain the right to deviate from federal law in several areas (e.g., environmental law, university access, and university degrees).

The Grundgesetz enumerates the exclusive responsibilities of the federal government.<sup>26</sup> It comprises, among others, the responsibilities for external affairs and defence, citizenship, free movement of persons, immigration and emigration, establishment of a common German market, air traffic, railways, mail and telecommunications, and cooperation between the federal government and the Länder. The Grundgesetz regulates concurrent legislation and enables the federal government to extend its jurisdiction to a much larger catalogue of responsibilities, from the unity of law in different areas to waste disposal, including such fiscally

important areas as social welfare, health care, research policy, parts of environmental policy, and the payment and pensions of public employees.<sup>27</sup> In addition, the Grundgesetz establishes the federal right to pass so-called framing legislation, which establishes legislative guidelines in a certain area that must be filled out in detail by the Länder.<sup>28</sup> Prominent examples are the whole legal basis of public employment as well as university education. Framing legislation will be abolished by the Federalism Reform Act, which splits framing responsibilities between the Länder and the federal government. Fiscally most important in this respect, the Länder will have the exclusive responsibility for their civil servants, in particular their salaries and pensions.

Overall, the strong federal role as laid down in the Constitution and the strong emphasis on the equality of living conditions in Germany, together with a historically rooted skepticism about decentralized solutions, have led to Germany's cooperative model of (fiscal) federalism. The range of Land responsibilities is limited because the federal government has used concurrent legislation extensively and thus expanded its responsibilities across time. The federal government also has a strong influence on Land policies, and this is due not only to concurrent legislation but also to framing legislation. Only the latter will be changed by the Federalism Reform Act.

In addition, there are several areas of common financial responsibility. Four areas need to be distinguished. First, there are the common tasks of the federal government and the Länder according to the Grundgesetz (i.e., the construction of university buildings, including university hospitals; research promotion and educational planning; the improvement of regional economic structure for which the expenditure is split fifty-fifty between the states and the federal government; the improvement of agricultural structure, with federal spending at 60 percent; and the protection of the coastline, with federal spending at 70 percent).<sup>29</sup> The Federalism Reform Act abolishes the common tasks involved in the construction of university buildings and replaces the common task of educational planning with a reporting system whose purpose is to observe the performance of the education system within an international context.

Second, there are laws regulating monetary services such as social welfare and housing subsidies for the needy.<sup>30</sup> These laws may establish a financial obligation for the federal government (e.g., as in the case of housing subsidies), but they do not need to do so (e.g., as in the case of social welfare). In both cases, the federal government heavily influences or determines subfederal spending.

Third, there is financial aid that enables the federal government to subsidize state or local services when large investments are involved, macroeconomic stability is affected, or regional differences in economic performance need to be equalized.<sup>31</sup> The Federalism Reform Act



introduces the requirement of consent by the Länder in the Bundesrat for federal law in this area and abolishes financial aid for housing construction and local transport. Moreover, financial aid is restricted for certain periods and may only be provided in diminishing amounts across time. Finally, the federal government will be forbidden to shift responsibilities to the local governments.

Fourth, the Länder execute federal tasks for which the federal government does not pay the administrative costs.<sup>32</sup> For example, it pays the direct cost of freeway construction but not the administrative cost in the respective ministries and bureaucratic entities. Finally, it should also be noted that wage bargaining in the public sector is centralized, leaving the Länder with only restricted room for changes pertaining to the salaries and the pensions of their public employees.

The institutions that secure the strong influence of the federal government have come at the price of strong participation by the Länder in national policy making. Across time, an increasing share of federal legislation has required the consent of the Bundesrat. When the interests of the Länder (or their local jurisdictions) are affected by federal legislation, in particular when federal legislation touches the Land administrative competencies, a law requires permission from the Länder in the Bundesrat.<sup>33</sup> Thus, when they act jointly, the Länder have a strong position as a counterbalance in the federal sphere. This institutional environment has led to a "spaghetti bowl" of internal political relations.<sup>34</sup> The federal government cannot decide much without the Länder, while the Länder have only narrow discretion to follow their own policies. Still, the ability of the federal government to pursue autonomous policies in several regulatory areas, and with respect to several spending programs, is higher than is the states' ability to conduct their own expenditure programs. The states' autonomy is restricted to a small number of areas, such as education, culture, law and order, and regional planning – all of which are framed by federal mandates and regulations.<sup>35</sup> Local jurisdictions execute communal services, such as sewerage, sports and recreation, school building, housing, and local road construction.<sup>36</sup> It should be noted, however, that in most areas of government activity, a high degree of vertical integration of functions persists. For example, in health care each sphere of government has a certain amount of responsibility. Even in the areas in which they have autonomy, the Länder have deliberately decided to accept a high level of coordination between each other. In particular, for education policies, the states' executives meet regularly to establish common standards. Otherwise, the states execute the laws decided on by the federal government. German federalism has thus become a typical executive federalism. The Federalism Reform Act will change this assessment somewhat, but less for the fiscally important areas than for regulatory areas.

While the spending side of the different jurisdictional spheres already appears to be heavily restricted, the revenue side is even more so. As is outlined in more detail below, neither the federal government nor the *Länder* can make any large change of their tax revenue without the agreement of the other side. According to the *Grundgesetz*, the federal government has exclusive jurisdiction over tariffs, indirect taxes (as long as they are not a common responsibility of federal and state governments or within the exclusive power of local jurisdictions), capital transaction taxes, insurance taxes, and surcharges on income taxes.<sup>37</sup> Since the European Union (EU) obtained the power to change tariffs from the member states in the 1970s, the most important tax sources that the federal government can change without the consent of the *Länder* are the mineral oil tax, the tobacco tax, the insurance tax, and the surcharges on income taxes. The autonomy of the *Länder* is even weaker. While the *Grundgesetz* gives them the exclusive right to obtain the revenues from the wealth tax (which has not been levied since 1996), the inheritance and gifts tax, the car tax, transaction taxes that are not in the power of the federal government or in the common responsibility, the beer tax, and the lottery taxes, the legislation of bases and rates of these tax sources is passed by the federal Parliament as a result of concurrent legislation.<sup>38</sup> The Federalism Reform Act will only assign tax-rate autonomy for the real estate purchase tax to the *Länder*. The most important taxes as measured by their revenue – namely, the personal and corporate income taxes as well as the value-added tax – are joint taxes, the revenue from which is shared between the federal government, the *Länder*, and, to a lesser extent, the local jurisdictions. As a result, the states' own-source revenues are far from matching their responsibilities and subsequent spending, and the *Länder's* tax performance is weak, while tax-base and tax-rate uniformity is ensured across the *Länder*. The only notable exception to a total tax harmonization in Germany is the local business tax, for which the individual communities and cities can autonomously decide the rates. In addition, the local jurisdictions have autonomy over local property (real estate) taxes, which are of much less importance in Germany, however, than they are, for example, in the United States and Canada.

The relations between the federal and the state governments in Germany are complemented by a very complicated and quantitatively important system of fiscal equalization. After a distribution of the revenue from joint taxes according to an explicit formula, a system of horizontal fiscal equalization sets in that also follows an explicit formula and provides unconditional grants to the *Länder*. It is strongly egalitarian and lifts the fiscal capacity of all below-average *Länder* to about 90 percent of the national average. After that, the federal government makes vertical transfers that lift fiscal capacity to 97.5 percent of the national average. Vertical transfers

are, to a small degree, conditional. In fact, there are no credible restrictions on state borrowing by the federal government. Germany as a whole is restricted by the EU Stability and Growth Pact. In addition, the Grundgesetz restricts borrowing by the federal government to the Golden Rule amount of investment spending. Similar restrictions apply to Land borrowing but are not enforced by the federal government. In addition, there are several provisions to soften that borrowing restraint. Most notably, borrowing can exceed investment spending if the federal government declares a disturbance of macroeconomic equilibrium.<sup>39</sup>

Although local jurisdictions have a strong constitutional position, they are handmaidens of the Länder. The oversight competence of the Länder is executed in many ways. For example, the Länder control the restriction of local borrowing to their cash flow, although local jurisdictions have a wide range of borrowing possibilities. Moreover, the Länder regulate the provision of local services, although to different degrees, depending on the individual Land. For example, local jurisdictions in North-Rhine-Westphalia are less restricted by Land mandates than are those in Bavaria. Although the local jurisdictions have the power to set the tax rates of the local business tax, the local revenues from autonomous revenue sources do not match local responsibilities. Thus, a similar system of horizontal and vertical fiscal equalization exists and provides additional revenue to the local jurisdictions.

Table 2 summarizes de jure legislative responsibility and actual provision of services by the three different spheres of government. The EU is included in order to show which kinds of responsibilities have been fully adopted by that organization. The shared responsibilities in Germany's federalism that result from the distinction between legislation and execution become obvious (e.g., in health policies that are executed by all three spheres of government, with a predominant federal legislative responsibility). Other functions, like road construction, are split between all three spheres, with federal responsibility for federal roads. But these functions are executed by the Länder, with Land responsibility for Land roads and local responsibility for local roads. This area is even more complicated by the provision of subsidies that induce additional changes in decision-making power.

The shared responsibilities of the three spheres of government on the spending side are evident in Table 3 (calculated according to administrative tasks). Only a few functions are the exclusive responsibility of a particular government (e.g., defence, which is fully a federal responsibility), while local public services I and schools entail no federal responsibility. In the case of science and research, social security, and public enterprises, there is predominant but not exclusive federal responsibility. Similarly, in the case of schools, law and order, and universities, there is predominant but not exclusive Länder responsibility. There are also intermediate cases – for example

Table 2

Legislative responsibility and actual provision of services by different spheres of government

| <i>Legislative responsibility (de jure)</i> | <i>Public service</i>   | <i>Executive responsibility</i> |
|---|---|---------------------------------|
| Federal/land/local                          |   | Federal/land/local              |
| EU  | Monetary policy   | EU                              |
| EU  | Customs   | EU                              |
| Federal                                     | Defence   | Federal                         |
| Federal                                     | Foreign affairs   | Federal                         |
| Federal                                     | Citizenship   | Federal                         |
| Federal                                     | Customs   | Federal                         |
| Federal                                     | Rail and air transport  | Federal                         |
| Federal                                     | Post and telecommunication                                    | Federal                         |
| Federal                                     | Social security   | Federal/Land                    |
| Federal                                     | Health including health insurance and local health facilities | Federal/Land/Local              |
| Federal                                     | Social assistance (supplementary welfare)                     | Federal/Land/Local              |
| Federal                                     | Waste disposal  | Local                           |
| Federal/land joint task                     | Regional economic policy                                      | Land                            |
| Federal/land joint task                     | Coastline preservation  | Land                            |
| Federal/land joint task                     | Agricultural policy   | Land                            |
| Federal/land joint task                     | Publicly funded research                                      | Federal/Land                    |
| Federal/land                                | Environmental protection                                      | Land                            |
| Federal/land                                | Water supply  | Local                           |
| Federal/land                                | Sewerage  | Local                           |
| Land  | Law and order   | Land                            |
| Land  | Culture   | Land                            |
| Land  | Schools and education   | Land                            |
| Land  | Universities  | Land                            |
| Local                                       | Local roads   | Local                           |
| Local                                       | Sports and recreation   | Local                           |
| Local                                       | School construction   | Local                           |
| Local                                       | Public housing  | Local                           |

*Source:* Authors' collection on the basis of legal documents.

Table 3  
Direct expenditures by function and sphere of government

| <i>Function</i>                                  | <i>Federal (%)</i> | <i>Land (%)</i> | <i>Local (%)</i> | <i>All (%)</i> |
|--|--------------------|-----------------|------------------|----------------|
| Defence  | 100                | 0               | 0                | 100            |
| Debt servicing                                   | 77                 | 19              | 4                | 100            |
| General administration                           | 19                 | 29              | 52               | 100            |
| Law and order                                    | 11                 | 60              | 29               | 100            |
| Schools  | 0                  | 80              | 20               | 100            |
| Universities                                     | 10                 | 90              | 0                | 100            |
| Other education                                  | 20                 | 56              | 24               | 100            |
| Science and research                             | 72                 | 26              | 2                | 100            |
| Social security                                  | 65                 | 13              | 22               | 100            |
| Health, environment, sports,<br>and recreation   | 7                  | 40              | 53               | 100            |
| Housing, urban development,<br>regional planning | 16                 | 47              | 37               | 100            |
| Local public services I <sup>1</sup>             | 0                  | 4               | 96               | 100            |
| Subsidies  | 39                 | 51              | 10               | 100            |
| Traffic and communication                        | 44                 | 26              | 30               | 100            |
| Public enterprises                               | 63                 | 13              | 23               | 100            |
| <i>Total</i>                                     | 47                 | 37              | 17               | 100            |
| Local public services II <sup>2</sup>            | 11                 | 53              | 36               | 100            |

Source: Statistisches Bundesamt, Fachserie 14/Reihe 3.1, Finanzen und Steuern, 2002.

1. According to Federal Statistical Office definition, including street lights, sewerage, waste collection, and street cleaning.
2. According to the Forum of Federations definition, approximated as law and order, schools, other education, health environment, sports and recreation, housing, urban development and regional planning, and local public services I.

“other education,” health, environment, sports and recreation, housing, urban development, and regional planning, as well as subsidies – for which the largest spending share is that of the Länder. However, to a large extent, either the federal government or local jurisdictions exercise their own responsibilities for these policy areas. It should be noted that local jurisdictions bear the largest share of administrative expenses and are predominantly responsible for local public services I (e.g., sewerage, waste collection, street lights, and street cleaning). Overall, the federal government accounts for

almost half of total government spending in Germany. The Länder spend a bit more than one-third, and the local jurisdictions spend only 17 percent. Local public services II indicate the extent to which the federal and state governments play a fiscal role in local affairs. Still, these figures do not fully capture the extent to which the federal government is able to exercise its influence on state and local policies. The share of 11 percent is certainly an underestimation of its actual influence. Similarly, the local jurisdictions are more heavily restricted by federal and state mandates than even these figures might indicate.

In sum, the division of fiscal powers in Germany establishes a peculiar unitary federal state. With the possibilities of the federal government being able to attract responsibilities and the Länder being compensated by decision-making power in the federal sphere, this system differs from the subsidiarity principle as it is commonly understood; rather, German federalism is governed by strong cooperation between the spheres, leading to a high degree of policy interrelationships and a strong degree of executive federalism. The parallels between the current organization of federalism and the historical form of federalism of Bismarckian times are remarkable.<sup>40</sup>

#### FISCAL FEDERALISM AND MACROECONOMIC MANAGEMENT

According to the federal stability and economic growth law of 1967, the federal government and the Länder should consider the requirements of macroeconomic equilibrium in their economic and fiscal policy measures so that price stability, high employment, external balance, and adequate economic growth are obtained. Thus, the Länder have macroeconomic responsibilities. Because the European Central Bank conducts monetary policy, the role of the federal government and the Länder is restricted to the other instruments of economic policy, particularly fiscal policy. Moreover, with respect to fiscal policy, the EU Stability and Growth Pact (SGP) aims at a restriction on borrowing by the EU member states. Basically, unless it results from an unusual event outside its control or from a severe economic downturn (defined as an annual fall of real GDP of at least 2 percent), the annual budget deficit of an EU member state is not allowed to exceed 3 percent of GDP. Moreover, member states' public debt should not exceed 60 percent of GDP.

Up to now, the deficit and debt requirements of the SGP have not been divided between the federal and the state governments as a binding agreement. This holds, *a fortiori*, with respect to an assignment of deficit restrictions between the Länder. However, according to the law regarding the principles of public budgeting,<sup>41</sup> the federal government and the Länder have to fulfill this obligation under the SGP. The Joint

Planning Council on Financial Matters (*Finanzplanungsrat*) has agreed that 55 percent of the allowed public debts may be used by the Länder and municipalities and that 45 percent may be used by the federal government.<sup>42</sup> As this agreement cannot be enforced by the federal government, with the result that the Länder need to be convinced in concrete cases to stick to the rules of the pact, the SGP may impose strong restrictions (and thus high political costs) mainly on the federal government.<sup>43</sup> The Federalism Reform Act will change this. Any sanctions resulting from an application of the SGP will be divided between the federal government at 65 percent and the Länder at 35 percent. The distribution between the Länder is made according to the deficit distribution (at 65 percent) and population (at 35 percent).

The lack of Land autonomy on the revenue side and the strong restrictions on the spending side, which require the Länder to provide a minimum quality of public services, have led the Länder to rely on transfers (as part of the fiscal equalization system) and to use borrowing as the instrument of choice to finance any spending residuals. Indeed, the federal government appears to follow similar strategies, although it can count less on transfers from the Länder. In 2005, the ratio of public debt to GDP in Germany was 67.9 percent. Since 1990, the level of public debt of all German governments together tripled.<sup>44</sup> The federal government bears the largest part of public debt, with 61 percent, followed by the Länder, with 31 percent. In 2005, the share of interest payments in total public spending by the federal government amounted to 14.5 percent, while this share was 8.5 percent for the state and local spheres.<sup>45</sup>

In some Länder, the burden of debt has become so high that they have sued the federal government for a bailout. Already in 1992, the Constitutional Court acknowledged the existence of a situation of extreme fiscal stress for the Saarland and Bremen. The court ruling required the federal government and the other Länder to provide for a bailout, which was provided by the federal government, from 1994 to 2004, in the form of vertical conditional grants mandated to reduce the public debt of these two Länder.<sup>46</sup> Public debt of most Länder (except Bavaria, Baden-Württemberg, and Saxony) has increased tremendously over time. An infamous example is Berlin, which sued the federal government in 2003. Before the Constitutional Court rules on the extant bailout cases, more Länder might well sue for bailouts. The official federal bailout induces the financial markets to let the Länder benefit from the high standing of the Federal Republic of Germany in the financial markets. Although those Länder rated by Standard and Poor's or Moody's may have a slightly lower rating than does the federal republic, it is still far from the one they would have received without a federal bailout. Fitch actually awards all Länder the triple A rating of the federal government.<sup>47</sup>

Some researchers convincingly argue that this bailout provides for soft budget constraints on the *Länder*.<sup>48</sup> With a soft budget constraint, the marginal benefits exceed the marginal costs of additional spending by the *Länder*, with the result that they can externalize part of the cost to taxpayers in the other states.<sup>49</sup> As a result, the citizens of a *Land* can obtain the regionally concentrated benefits of state spending but pay only their share from federal taxation. This provides incentives for excessive spending and deficits.<sup>50</sup> Moreover, by providing a bailout, the federal government induces the *Länder's* expectations that further bailouts will follow.<sup>51</sup> The *Länder* adjust their spending and borrowing to these expectations, with the result that it will be difficult to deny bailouts in the future. The 1992 Constitutional Court ruling, in particular, has nourished such expectations. It is thus no surprise that Berlin has followed the former two bailout *Länder*, Saarland and Bremen, in suing the federal government. In the coming years, other *Länder* in fiscal trouble will likely follow, particularly when an aging society affects pension liabilities (most *Länder* have not built notable pension funds).

#### REVENUE-RAISING RESPONSIBILITIES

As mentioned before, a first reason for the existence of excessive borrowing by the *Länder* is the lack of autonomy on the revenue side of their budgets. While the German division of fiscal powers requires the *Länder* to provide public services at a certain quality and level, it leaves some room for them to pursue their own policies. However, the *Länder* do not have autonomy in setting tax rates or tax bases individually. Their most important revenue sources, the personal and corporate income taxes as well as the value-added tax, are joint taxes and can only be influenced by the *Länder* collectively via the Bundesrat.<sup>52</sup> The revenue from other tax sources belongs exclusively to the *Länder* (e.g., inheritance and gift taxes as well as car taxes). Legislation setting the bases and rates for these taxes, however, is passed in the federal sphere, again with the influence of the *Länder* coming only via the Bundesrat. Thus, taxes in Germany are largely harmonized. Only the local jurisdictions have autonomy to set the rates of the local business and real estate taxes. Tax competition between subfederal jurisdictions may occur only with respect to these two tax sources. This legal situation is reflected in Table 4, in which the revenue shares from the different tax sources are computed on the basis of actual revenue received.

By far the largest share (66 percent) of federal tax revenue thus comes from shared taxes. Of the exclusive federal taxes, only the mineral oil tax and the tobacco tax generate notable revenue. The insurance tax is already less important. Because the federal government does not rely heavily on fees or on grants from other spheres of government, its ability to raise



Table 4  
Tax assignment for various orders of government

|                            | <i>Determination of</i> |                    | <i>Shares in Revenue (%)</i>             |             |              |                   |
|----------------------------|-------------------------|--------------------|--|-------------|--------------|-------------------|
|                            | <i>Base</i>             | <i>Rate</i>        | <i>Tax collection and administration</i> |             |              | <i>All orders</i> |
|                            |                         |                    | <i>Federal</i>                           | <i>Land</i> | <i>Local</i> |                   |
| <i>Federal</i>             |                         |                    |  |             |              |                   |
| Mineral oil tax            | Federal                 | Federal            | 100                                      | 0           | 0            | 100               |
| Tobacco tax                | Federal                 | Federal            | 100                                      | 0           | 0            | 100               |
| Spirits tax                | Federal                 | Federal            | 100                                      | 0           | 0            | 100               |
| Sparkling wine tax         | Federal                 | Federal            | 100                                      | 0           | 0            | 100               |
| Intermediate good tax      | Federal                 | Federal            | 100                                      | 0           | 0            | 100               |
| Coffee tax                 | Federal                 | Federal            | 100                                      | 0           | 0            | 100               |
| Insurance tax              | Federal                 | Federal            | 100                                      | 0           | 0            | 100               |
| Electricity tax            | Federal                 | Federal            | 100                                      | 0           | 0            | 100               |
| Solidarity levy            | Federal                 | Federal            | 100                                      | 0           | 0            | 100               |
| <i>State or provincial</i> |                         |                    |  |             |              |                   |
| Property (wealth) tax      | Joint Federal/land      | Joint Federal/land | 0  | 100         | 0            | 100               |
| Inheritance tax            | Joint Federal/land      | Joint Federal/land | 0  | 100         | 0            | 100               |
| Real estate purchase tax   | Joint Federal/land      | Joint Federal/land | 0  | 100         | 0            | 100               |

Table 4  
Tax assignment for various orders of government (Continued)

|                         | Determination of   |                    | Shares in Revenue (%)             |         |       |            |
|-------------------------|--------------------|--------------------|-----------------------------------|---------|-------|------------|
|                         | Base               | Rate               | Tax collection and administration | Federal | Land  | All orders |
| Motor vehicle tax       | Joint Federal/land | Joint Federal/land | Land                              | 0       | 100   | 100        |
| Betting and lottery tax | Joint Federal/land | Joint Federal/land | Land                              | 0       | 100   | 100        |
| Fire protection tax     | Joint Federal/land | Joint Federal/land | Land                              | 0       | 100   | 100        |
| Beer tax                | Joint Federal/land | Joint Federal/land | Land                              | 0       | 100   | 100        |
| <i>Local</i>            |                    |                    |                                   |         |       |            |
| Business tax            | Joint Federal/land | Local              | Land/Local                        | 4.4     | 15.4  | 80.2       |
| Real estate taxes       | Joint Federal/land | Local              | Land/Local                        | 0       | 0     | 100        |
| <i>Shared taxes</i>     |                    |                    |                                   |         |       |            |
| Personal income tax     | Joint Federal/land | Joint Federal/land | Land                              | 42.50   | 42.50 | 15         |
| Interest rebate         | Joint Federal/land | Joint Federal/land | Land                              | 44      | 44    | 12         |
| Corporate income tax    | Joint Federal/land | Joint Federal/land | Land                              | 50      | 50    | 0          |
| VAT                     | Joint Federal/land | Joint Federal/land | Land                              | 49.50   | 48.40 | 2.10       |

Source: Own collection on the basis of legal documents

revenue largely depends on the Länder. In their case, 85.4 percent of their total tax revenue and 64.2 percent of their total revenue are collected from shared taxes. Given that the Länder cannot set the tax rates and bases of exclusively Land taxes and because they do not collect notable fee revenue, they depend on grants and borrowing. This is different from the local governments for which the revenue from the local business tax amounts to 77.9 percent of total tax revenue and 29.3 percent of total local revenue, while the revenue from real estate taxes is 17.4 percent of total tax revenue and 6.5 percent of total local revenue. The local jurisdictions actually use their tax autonomy. The tax-rate surcharges on the local business taxes vary between 200 (legal minimum tax surcharge) and 490 (Munich and Frankfurt), which implies tax rates between 10 percent and (roughly) 25 percent with a uniform tax measure of 5 percent.<sup>53</sup>

Only with respect to the local business tax does tax competition emerge in Germany. There is evidence that local jurisdictions engage in tax-mimicking behaviour, with the result that a reduction of tax rates in one jurisdiction triggers a reduction of tax rates in the other jurisdictions.<sup>54</sup> This evidence might indicate strategic tax setting by the jurisdictions competing with each other. Büttner reports empirical results showing that this kind of tax competition among Germany's local jurisdictions leads to tax-base effects and fiscal externalities. However, Barette et al. show that the rates of the local business tax increased between 1980 and 1990, thus somewhat contradicting the notion of tax competition and pointing, instead, to a race to the top of local business tax rates.<sup>55</sup>

#### INTERGOVERNMENTAL FISCAL TRANSFERS

The fiscal equalization system consists of four steps.<sup>56</sup> First, with the exception of revenue from the VAT, tax revenue from the different tax sources in Table 4 is assigned to the Länder. This is particularly important for the personal and corporate income taxes, the revenue of which is distributed according to the residence principle. VAT revenue is allocated per capita. Second, up to 25 percent of the revenue of the VAT is used to increase the fiscal position of the poorer states.

The third step is the horizontal fiscal equalization between the Länder. The Länder with a measure of fiscal capacity below the measure of equalization receive grants from those Länder with a measure of fiscal capacity above the measure of equalization. The measure of fiscal capacity is the sum of all tax revenue minus 12 percent of the more than proportional increase (compared with the average of the Länder) of a Land's tax revenue in the previous year plus 64 percent of local tax revenue in a particular Land. The measure of equalization is derived by calculating the average Land and local tax revenue of the Länder for the whole federation for a single Land using

the number of inhabitants. Fiscal capacity of the below-average Länder is thus lifted up to 90 percent of the national average. The redistribution takes place according to a progressive formulary schedule that raises the marginal subsidies to the recipients (and reduces revenue of the donors) from 44 percent to 75 percent. This means that, from an additional euro of tax revenue that a donor Land earns due to, for example, the location of new industry, it must give up seventy-five cents to the recipients. This schedule is associated with the typical adverse incentives on the efforts of the Länder to attract taxpayers.<sup>57</sup> Although the progressivity of the schedule was reduced in the latest reform (in effect since 2005), it is great enough that the incentive problems are still present. To what extent these adverse incentive effects occur empirically is, however, contested between scholars. There is, for example, no conclusive empirical evidence on the efficiency of donor and recipient Länder.

The fourth step in the fiscal equalization system is a vertical grants system. It is asymmetric because only some states receive funds from the federal government. General vertical grants are provided to all financially weak Länder in order to further lift fiscal capacity. Specific vertical grants are provided to the new Länder (to reduce specific burdens due to the separation of the two German states before unification and to deal with high structural unemployment) as well as to ten financially weak and small states to deal with more than proportional costs of political administration ("costs of smallness of a Land").<sup>58</sup> While the grants from the horizontal system are unconditional, the vertical grants introduce conditional grants, at least for some types. For example, the specific vertical grants to the new Länder for a reduction of specific burdens due to the separation of the two German states before unification must be spent for infrastructure and for an increase in local fiscal capacity. This final step in the system leads to an equalization of up to 97.5 percent of average fiscal capacity, thus yielding a strongly egalitarian system of fiscal equalization.

On average, however, the federal transfers to the Länder are not of overwhelming quantitative importance. Only 13.3 percent of total Land expenditures are covered by federal transfers, with a larger weight on capital transfers.<sup>59</sup> As Table 5 shows, the system closes the fiscal gaps between local jurisdictions in particular, but it also eases the cost of social security by mainly burdening the federal government. This look at the vertical fiscal gaps will not, however, suffice to detect the detrimental effects of the fiscal equalization system. One reason why economists strongly criticize this system concerns the negative incentive effects that a progressive redistribution schedule exerts on horizontal fiscal equalization. The implied marginal contribution rates to the fiscal equalization system varied between 60 percent and 100 percent until 2004 and, thereafter, have been reduced only somewhat.<sup>60</sup> However, the most important perverse incentive effect is that fiscal equalization leads to higher borrowing and spending by the Länder. In other words, the system puts a premium on fiscal imprudence.<sup>61</sup>

Table 5  
Vertical fiscal gaps

|   | <i>Total revenue collected<br/>(2002) Mill. \$Us</i> | <i>Total revenue available,<br/>including net transfers<br/>for that level of government<br/>(2002) Mill. \$Us</i> | <i>Expenditures<br/>(2002) Mill. \$Us</i> |
|---|--|--|---|
| National  | 346,338  | 234,867  | 265,733                                   |
| Subnational                                     |  |  |   |
| Land  | 227,979  | 215,967  | 243,571                                   |
| Local   | 96,430   | 138,257  | 141,723                                   |
| <i>Social security</i>                          | <i>354,669</i>                                       | <i>433,132</i>   | <i>440,155</i>                            |
| <i>Special purpose associations<sup>1</sup></i> | <i>1,872</i>   | <i>5,063</i>   | <i>4,989</i>                              |
| All levels                                      | 1,027,288  | 1,027,288  | 1,096,171                                 |

Source: Statistisches Bundesamt, Fachserie 14/Reihe 3.1

1. Finanzen und Steuern, 2002 (specific data provided to the authors).

The advantage of the fiscal equalization system is not only found in the fact that vertical fiscal imbalances are partly closed. Indeed, the East German Länder have relatively low tax-raising powers. The system also provides risk sharing for state budgets, although to what extent risk sharing occurs is contested.<sup>62</sup> There is evidence that fiscal equalization insures state budgets against revenue shocks but not against shocks to regional GDP. In contrast, other reports show a relatively large income-smoothing effect for fiscal equalization. Finally, some estimates indicate that the German fiscal equalization system reduced the cross-sectional variance of income in the West German Länder during the 1970s, 1980s, and 1990s by about 6.8 percent (for an insurance effect that is about the same as that in the United States). Thus, fiscal equalization in Germany appears to smooth income shocks among Länder significantly.

Grants are even more important for the German local governments than they are for the Länder. Including revenue sharing, the local jurisdictions obtain almost 50 percent of their total revenue as grants from other jurisdictions.<sup>63</sup> There are, however, no direct transfer payments from the federal to the local governments. While unconditional grants are larger than are conditional grants to the local governments, the latter are more important at the local than they are at the state level. The Länder run their own fiscal equalization systems, which encompass all local jurisdictions. The incentive effects of the local grants system in Germany have only recently been systematically analyzed. For 1,102 local jurisdictions in Baden-Württemberg, grants have a

significant, quantitatively important effect on local spending, but they have only a small effect on borrowing.<sup>64</sup> However, the soft budget constraint problem is more severe for medium-size and large cities than it is for small municipalities. Given that Land oversight of local borrowing is relatively strong, these results are not really surprising. It is more surprising that oversight appears to be less effective in the case of larger cities.

#### THE WAY FORWARD

German fiscal federalism is characterized by autonomy on the spending side of the budget, which is considerably shaped by mandates from the higher levels of government. The system is burdened by an asymmetry due to the fact that tax autonomy for all spheres of government is even more restricted than is spending autonomy. Neither the federal government nor the Länder can autonomously decide on the tax rates and bases of the most important tax sources. They are forced to decide jointly in the Bundesrat. Only the local jurisdictions have autonomy in setting the local business taxes and real estate tax rates. This institutional framework of cooperative federalism has led to a “spaghetti bowl” of political interrelationships and a strong executive, or administrative, federalism.<sup>65</sup> German fiscal federalism does not, therefore, correspond much with the ideas presented in Oates’s decentralization theorem or in his laboratory federalism.<sup>66</sup> The induced soft budget constraint problems associated with the fiscal troubles of some Länder are a logical consequence of the incentives provided by that system. A further bailout will exacerbate the disequilibrium currently governing German fiscal federalism.

There are several possible ways to cope with these problems. Denying a further bailout will lead to a higher variance in how financial markets assess the creditworthiness of the Länder and local jurisdictions. Even timid steps in this direction appear to be politically unfeasible. The only short-term solution will be to impose stronger restrictions on the autonomy of the Länder receiving bailouts. A further reduction in the fiscal autonomy of states will, however, contradict the introduction of tax autonomy as a long-term solution to the disequilibrium in German fiscal federalism. Despite the fact that even a considerable extent of fiscal competition works relatively well in other federations (e.g., Switzerland), a higher tax autonomy for the German Länder is extremely unpopular among Länder officials because they apparently fear pressure from tax competition.<sup>67</sup> The provision of tax autonomy is complicated by the fact that it requires a preceding disentanglement of competencies between the federal government and the Länder. This is because the fiscal constitution is subordinate to the assignment of competencies. However, a disentanglement of competencies will only succeed if it is followed by a reform of fiscal federalism. The recent Federalism Reform Act is a first step in the right direction, but it must trigger the second step – a reform of the fiscal constitution.

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