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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,

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 beca

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 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

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

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-

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

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.

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.

Intergovernmental transfers in Germany flow both from the Federal government to

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).

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.

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 'te(t) 0.2 (he) 0.B (c'hol) 0.2 (of0 0B2.4oJ gde)

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.

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.

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.

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.

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

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

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 fede

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.

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,

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(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.

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

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.

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

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.

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.

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.

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.

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.

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.

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

Table B.6(a)
Revenues Per Capita from Common Taxes as a Percentage of the German Average

Year	Baden- Wurttemberg	Bayern	Brandenburg	Hessen	Mecklenburg- Vorpommern	Niedersachsen	Nordrhein- Westfalen	Rheinland- 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	Hamburg
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								

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							

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
1997	172.90							

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- Wurtemberg	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-	Bayern	Brandenburg	Hessen	Mecklenburg-
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Table B.7(c)

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)

- (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.

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.

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.

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.

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

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

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

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.

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

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.

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

Areas of Consensus

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.

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
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.

- ¹ Daniel Elazar,
(Harlow, Essex, UK: Longman, 1991), 105
- ² David P. Conradt, (5th ed.; New York: Longman, 1993), 183
- ³ Conradt, 181
- ⁴ Ronald L. Watts, (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.,
, (London: Pinter, 1999), 272
- ⁶ Uwe Leonardy, "The Institutional Structures of German Federalism", in Charlie Jeffery, ed.,
, (London: Pinter, 1999), 12.
- ⁷ Paul Bernd Spahn and Wolfgang Föttinger, "Germany," in Teresa Ter-Minassian, ed.,
(Washington: International Monetary Fund, 1997), 239.
- ⁸ Leonardy, "Institutional Structures", 15.
- ⁹ Spahn and Föttinger, 229.
- ¹⁰ Ibid., 228
- ¹¹ Ronald L. Watts,

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

