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Financing
the federal system

Introduction

According to the official English translation of Article 20, para. 1, of the Basic Law, the Federal Republic of Germany is a “democratic and social federal state.” A better translation might be “a democratic and federal social welfare state.” “Social” in German usually means socially fair, or just, and generally equal. Therefore, this concept provides a constitutional basis for the German welfare state. A European-type welfare state is under strong unitary pressures, because government programs for old age pensions, disability, medical insurance, nursing home care, unemployment insurance, child support, and other social services must be offered on a national basis in order to avoid regional differences and meet nation-wide expectations of fairness and equality. Even such programs as public assistance (Sozialhilfe), which is implemented and financed by local governments, is regulated by federal law so that there are hardly any differences among the localities. The Basic Law still speaks of preserving or securing “uniformity of living conditions” in Article 106, para. 3. This goal was modified somewhat in the 1994 constitutional reform process to read “equivalency of living conditions” in Article 72, para. 2 (Article 106 was not changed, because it was anticipated that it would be replaced by a new section on financial arrangements). In any case these “conditions” are not only those provided by the welfare state but also include a variety of services such as education, cultural activities, youth services, police protection, hospitals, sports facilities, etc. They also include the infrastructure that goes with such services, such as schools, roads, bus, and rail services. Total expenditures for all of these and other public services and facilities amounted to 50.8 percent of GDP in 1995 and 50.6 percent in 1996, but declined to 48 percent in 1998 (United States = 31.6 percent
The Länder and German federalism

in 1997). Taxes for all levels were 22 percent and various social insurance charges 18.5 percent for a total of 40.5 percent of GNP (however, individual social insurance charges in 1998 were 41.8 percent of wages and salaries, which is significantly higher than in the United States).\(^1\) It is clear that pressures are strong for a national welfare and tax system that can raise efficiently and effectively the revenues needed to support the many state functions in Germany.

On the other hand, the Basic Law provides for a federal system that, along with the concept of the “social” state, is guaranteed in Article 79, para. 3. How to secure and preserve a highly developed social welfare state with a variety of public services available to all citizens and simultaneously maintain a functioning federal system with autonomous Länder is a question Germans have had to wrestle with since the Basic Law went into effect in 1949. To put it somewhat crassly, “power is where the money is.” If the federal government has control over revenues, it is going to be difficult to sustain a meaningful federal system. As we will see below, the federal government does not “control” the tax system, but the federation does. What this means is that the government and its majority in the Bundestag can pass tax legislation that also binds the Länder, but the Bundesrat, which represents the Land governments, must approve such legislation as long as the tax revenues accrue at least partially to the Land or local governments. The result is that the Länder – that is, the Land governments that make up the Bundestag majority – have about as much power collectively as the federal government and its majority in the Bundestag in passing finance legislation, but the individual Länder, especially if they are in the minority, have little influence. The Land parliaments, which are not represented in the Bundesrat, have even less to say.

**Historical development**\(^2\)**

In the Bismarck Reich of 1871, the Constitution gave the federation the right to collect customs duties and revenues derived from postal and telegraph services as well as various excise taxes on salt, tobacco, and sugar. The states (they were not called Länder until the Weimar Republic) were given the general power to pass tax legislation, and the Reich was dependent on the states for contributions based on population. These contributions were approved annually by the Bundesrat, which then as now is composed of unelected delegates from the states. They were not adequate to meet the needs of the federation, which had to borrow heavily as a result.
The Weimar Republic that emerged after the First World War brought about fundamental changes in the tax system. The constitution gave the federation general authority for tax legislation, and the Länder had little power to shape federal tax policy. The only limitation on the federation was that it had to preserve the capacity of the Länder to survive, which was a nebulous restriction at best. The new constitution provided the basis for a uniform Reich administration of finances and for the finance and tax reform introduced by Finance Minister Matthias Erzberger shortly after 1918. The separate taxes of the previous Reich were replaced by a system of joint taxes. The most important taxes, the income tax, corporation tax, and turnover (sales) tax, were assumed by the federation, which then transferred a certain percentage of each to the Länder. Since the revenues the Länder received from the income and corporation taxes depended on the local yield, considerable differences in tax resources emerged among the Länder. These were made up to some extent by transfers among the Länder and federal grants.

If the Weimar Republic became more like a decentralized unitary state than a federal state, the Third Reich of Adolf Hitler was a centralized state with no pretense of regional autonomy. In January 1934, a year after Hitler took power, a law was passed according to which the Länder ceased to exist as meaningful federal units, and the local administrative units that came into being were financed by grants from the central government.

During the occupation in West Germany after 1945, politically active German finance experts debated the future of their country’s tax policy. They divided basically into two camps: one oriented strongly by principle toward a federal solution that favored the Länder more or less along the lines of the Bismarck Reich, and one that was more unitary in orientation for pragmatic and largely economic reasons. Those who focused on economic and social policies, especially the Social Democrats, tended to support the more unitary solution, but federalists and centralists could not always be identified with any particular party.

In the years immediately following the 1945, significant differences emerged among the newly created Länder in their fiscal capacities, with those receiving the largest numbers of refugees from the East suffering the most. Controversy developed among the Länder over some kind of fiscal equalization measure which demonstrated their desire to arrive at a resolution of the issue; however, this was hardly possible without some kind of central authority. The “poor” and “rich” Länder were divided among themselves, sometimes in spite of common political party ties. As we shall see, the Basic Law and its provisions for tax legislative authority at the federal level brought about a dramatic change of the situation.
The issue of taxes in the drafting of the Basic Law

In June 1948 the Western Allies encouraged the Germans in their three zones to draft a democratic and federal Constitution and to call for a constitutional convention by 1 September 1948. Though many Germans were reluctant to take a step that was sure to exacerbate tensions between the Western Allies and the Soviets and therefore place unification at risk, a group of constitutional experts was invited to participate in a conference in August at Herrenchiemsee, a palace on a lake island in Bavaria. The Bavarians introduced a draft constitution that was basically confederal in nature and which gave the Länder taxation powers modeled after the Bismarck Reich. Other participants looked more at the Weimar Constitution as a more unitary model for a federal state. After the opening debates about confederation versus federation, this issue was turned over to committee for further deliberation.

Given these two very different positions on the nature of the future political system, it is not surprising that the participants of the Herrenchiemsee Conference were provided with some dramatically different models of financing. They were also ambivalent about which alternatives to follow, because of the uncertainty over the future financial needs of the federal, Land, and local governments. The result was a set of rather disappointing recommendations for the Parliamentary Council, which was to draft the official document.

The Parliamentary Council met on 1 September 1948 as the first parliamentary-like body to include representatives of all three Western zones. The political parties generally sent their leading members, some of whom were also constitutional experts. Although the majority of votes was controlled by the middle-class parties – CDU/CSU, FDP, and DP – the SPD was confident of victory in the coming elections and decided to concentrate on broad legislative powers for the Bundestag rather than attempting to have certain economic and social provisions included in the new Constitution. The middle-class parties, in turn, focused on a federal system that could serve as a barrier to future socialist economic policy that might be introduced by a social democratic government.

When the finance committee of the Parliamentary Council met, the discussions were dominated by an expert, Hermann Höpker-Aschoff from the FDP, rather than the representatives of the large parties. The committee did not follow the American example of fiscal autonomy for the states, because this allowed for differences in tax systems, revenues, and thus public services that the Germans thought they could not afford. Dr. Höpker-Aschoff explained that
Our poverty and the high level of our tax rates will not permit us the luxury of an entirely unregulated scramble for tax sources between two competitors. In the United States it may be possible for the federation to levy and collect its own income tax and the states to levy and collect their income taxes—the same with inheritance taxes and so on. For us, it would be entirely unworkable.4

The goal was to create a system of finances in which neither the federal nor the Land level would be dependent on the other, as was the case, respectively, in the Bismarck Reich and the Weimar Republic. The solution presented was to have certain taxes set aside for each level but to have the two levels share the most important taxes. Statutory law would then provide for a distribution of the shared or joint taxes in such a way that the needs of the poorer Länder would be addressed. It was also agreed that the Länder via the Bundesrat would have the right to veto the tax legislation proposed by the federal government. Only the administration of the finances remained unsettled. Unfortunately for the finance committee, however, the Allies—in particular, General Lucius Clay—indicated they would not accept these provisions, because they were not sufficiently federal.5

The Allies insisted that the Constitution provide for a dual tax system in which the federation and Länder each had legislative authority over only those taxes it needed to meet its responsibilities.6 The Allies also rejected the proposed system of fiscal equalization payments by the richer to the poorer Länder, which not even the Germans in the Economic Council in the Bizonia had approved at that time. They saw a system of grants-in-aid on the American model as a better solution that would not make the Länder so dependent on the federation for their taxes. The Land governments, on the other hand, took the opposite position that their autonomy would be threatened by a system of federal grants but protected by the proposal to require approval of finance legislation in the Bundesrat.

While Konrad Adenauer and the CDU seemed willing to compromise with the Allies, the SPD leader, Kurt Schumacher, and his party were adamant in insisting on tax legislation authority for the federation. The SPD believed that a strong welfare state in West Germany would be attractive to East Germany and discourage communist elements in their efforts to undermine the West German republic. Only a financially strong federation could meet this challenge. Too great a focus on federal principles would make it more difficult to offer the necessary social services equally and nation-wide.

It is not a little ironic that just as the Allies notified the Parliamentary Council toward the end of April that they would accept a broad federal legislative authority in tax matters and a joint administration of finances,
the SPD was also indicating its willingness to compromise with the Allies on various issues. Agreement on the constitutional draft between the Allies and Germans was therefore reached without much difficulty. Turnover (sales) taxes were given to the federation, and the income and corporation taxes were given to the Länder; however, the right of the federation to tap into these taxes made them in effect joint taxes, in spite of the fact that the Allies had rejected the proposal for federal–Land joint taxes. Concurrent powers were broadened so that the SPD no longer feared the federation would not have sufficient authority to pass the kind of economic and social legislation it desired. Though not provided for directly, the constitutional draft also made it possible to create a system of fiscal equalization among the Länder. The constitution, called Basic Law because of its alleged temporary nature until unification, went into effect on 23 May 1949.

The finance reforms of 1955 and 1969

Once the Basic Law went into effect, much, but not all, of the German system of finance had been determined. The proportions of the income and corporation taxes that were to go to the federation and Länder had to be set each budget year, and each year the federal government and the Länder struggled over these in the Bunderrat. That this was more a federalism issue and not just a partisan struggle could be seen in the fact that the CDU/CSU-dominated federal government, which had a majority in both chambers, could not count on all of the CDU-governed Länder to support it. Connected to the question of the proportions of the income and corporation taxes that each level would receive was the issue of fiscal equalization and the transfer of funds to the poorer Länder. The first law passed by the Bundestag and Bunderrat regulating the proportions each level was to receive gave the federation 27 percent for the fiscal year 1951; between 1951 and 1954 the federal share was raised to 38 percent. The demands of the federal government for a still larger share led to considerable tension between the federal government and the Länder and demonstrated clearly that the finance provisions in the Basic Law were unsatisfactory, especially for the poorer Länder.

A second continuing controversy raged between the poorer and richer Länder over the issue of fiscal equalization payments among them. The poorest Länder, Schleswig-Holstein, Lower Saxony, and Bavaria, in that order, were especially burdened by large proportions of refugees; these
same Land were more rural than industrial and simply did not have the
tax resources enjoyed by the more industrialized territorial Land and
city-states; and some Land, for example, those in the French zone, had
higher occupation costs. The richer city-states of Hamburg and Bremen
had suffered severe bomb damage and were reluctant to share their relative
wealth with their neighbors because of their own burdens; the richer
territorial states, especially North-Rhine Westphalia, insisted on the
importance of maintaining Land autonomy in a federal system. Based in
part on a study commission’s recommendations, a modest fiscal equal-
ization law was passed in February 1951. It was promptly challenged
before the Federal Constitutional Court by two of the richer Land, but
the law was upheld. Nevertheless, the poorer Land remained frustrated
in their efforts to persuade their richer counterparts to approve a law that
would provide meaningful transfers of funds.

In the meantime the federation and the Land had become commit-
ted by a change in the Basic Law to pass a finance reform act by the end of
1955. Two bills were involved: one was in effect an amendment to the
Basic Law specifying which major taxes were to belong to which level and
distributing the proportions of the income and corporation taxes
between the federation and the Land; the other concerned the transfer
payments among the Land designed to achieve more fiscal equality. The
conflict over the provisions of this legislation between the federal govern-
ment and, to a considerable extent, the poorer Land, on the one hand
and the richer Land, on the other hand was severe, and it revealed funda-
mental differences between these two groups about the federal order.
For the majority of Land, especially for the richer Land, their ability to
manage their own affairs and their essential autonomy were at stake,
while for the poorer Land their ability to provide essential services and
meet the constitutional requirement of uniform living conditions
required assistance from the federal and other Land governments. In the
meantime the federal government continued to demand a greater share of
total revenues in order to meet its needs, which now included a newly
established military force.

Finally, in December 1955, a compromise was reached and approved by
both chambers. The turnover (sales) tax was retained as a federal tax, and
the income and corporation taxes remained with the Land with federal
shares set at first at 33.3 and then at 35 percent after 1958. The new pro-
visions for transfers among the Land and federal supplementary grants
were to bring the fiscal resources of the poorer Land to within 87.5 per-
cent of the Land average. As in the period of the late 1940s and early
1950s noted above, the conflict over the finance reforms in 1955 was not partisan, although party loyalty had some relevance. Unfortunately, the Finance Reform of 1955 did not bring about the stability that everyone had hoped to achieve. The federation became more intrusive in its dealings with the Länder, gaining ever more authority via federal grants to the Länder, a process that was occurring also in the United States. At the same time the Länder were required to administer—and to finance—more and more federal legislation. In theory the Bundesrat could have been more of a barrier against these federal activities, but partisan considerations combined with the fact that most of the Länder thought it politically unwise to reject federal help usually made it difficult to oppose the government. Criticism grew that Land tasks were being financed by the federation and federal policies by the Länder, that federal grants were undermining Land autonomy, and that there was too much imbalance in the development of federal and Land budgets.

On the other hand, the law on fiscal equalization among the Länder which was debated and changed in 1959, brought considerable relief to the Länder. The amounts by which the resources of the poorer Länder were to be raised were increased to 90 percent of the average of all the Länder in 1958 and 91 percent after the beginning of 1959. Länder with above-average fiscal capacity were to transfer 75 percent of the amount between 100 and 110 percent to the pool for the poorer Länder. In general these changes were to the advantage of the poorer Länder and came largely at the expense of North-Rhine Westphalia and Hamburg.

In March 1964 the government of Chancellor Ludwig Erhard and the Land prime ministers agreed to form a commission to recommend a comprehensive finance reform. This became known as the Troeger Commission, named after its chairman, a former minister of finance in Hesse. Both the SPD and CDU/CSU were represented, which was necessary because any constitutional amendment to reorganize the system of finances would require a two-thirds majority in the Bundestag and Bundesrat. The Commission issued its final report in March 1966. The concept of “cooperative federalism,” borrowed from the American term that suggested cooperation rather than competition or conflict between the federal and subnational levels, was a theme that ran throughout the comprehensive recommendations of the report. This implied a reduction of Land autonomy in favor of joint tasks. Later this positive view toward cooperation was given particular expression in Article 104a, para. 4, which authorizes federal grants in very broad language, and in the “joint tasks” of Article 91a and 91b, which called for the federation to
participate in the financing and planning of three areas that had been
Land responsibilities.12

In the meantime the Erhard government was severely weakened by
eroding economic conditions and strains between the two partners in the
government coalition, the CDU/CSU and the FDP. When this coalition
fell apart, a Grand Coalition of CDU/CSU and SPD was formed in
December 1966. One of its announced goals was a finance reform that the
previous government under Chancellor Erhard had begun but not com-
pleted. Dissatisfaction with the Finance Reform of 1955 remained high:
severe conflict remained over fiscal equalization; there had been an
increase in “mixed financing” that was in a constitutional “gray zone”; and
federal grants for various projects were a tempting “golden harness”
(Goldener Zügel) that led to distortions in Land priorities, which meant
that tasks not aided by federal government were neglected.13 But the Län-
der demonstrated again that they were unable to come to an agreement
among themselves without the intervention of the federal government.14

The new government introduced a bill in March 1967 based closely on
the Troeger Commission report. It asserted in its draft legislation that the
people no longer accepted significant differences in services and burdens
as the price of a general autonomy for the Länder in policy making.15 But
federation–Land differences arose immediately and threatened to under-
mine the reform even though the Grand Coalition government had an
overwhelming majority in both legislative chambers. The underlying
problem in efforts to achieve any kind of finance reform was that the fed-
eral government and the rich and poor Länder, respectively, always agreed
that someone else should pay. For the poor Länder, dependence either on
their richer counterparts or on the federation was unsatisfactory.16 For the
rich Länder, their autonomy was at stake. The federation always claimed
to need more funds.

But there was agreement that the uncontrolled growth (Wildwuchs) of
commonly financed programs should be straightened out by placing
them into separate areas. For example, the federation should restrict itself
to programs, including joint tasks, that involved responsibilities that
crossed Land borders and were expensive. In such programs there should
be joint financing and planning. However, controversy emerged regarding
the number of joint tasks that should be included in the reform pack-
age. In the end three were accepted, and it was agreed that as a rule the
federation would provide 50 percent of the funding.17 The localities
should share in the joint taxes, partly from the Value-Added Tax (VAT)
and partly from the personal income tax. In the case of the income tax,
the federal government wanted to give localities the right to set different rates. But it did not push for a general local government finance reform at that time.  

An important debate occurred over the taxes that were to become joint taxes – that is, the income, corporation, and turnover (sales) taxes. In 1968 the VAT was introduced as a new European Community-wide turnover tax. Conflict arose immediately over the distribution of its revenues, over joint taxes, need-based distributions, and Land autonomy.  

In March 1968 the federal government introduced a draft of a finance reform bill that went to the Bundesrat in April. It proposed several changes in the previous system of finance, including the addition of Article 91a and 91b and Article 104a to the Basic Law. Joint taxes were to consist of the VAT as well as the income and the corporation tax. The business tax for the local governments was in effect – though not officially – a joint tax, because 40 percent of the revenues were to be shared with the Land and federal levels. The localities would participate in income tax revenues, but they would not set tax rates. After considerable controversy, especially between rich and poor Länder, final agreement was reached and a considerable number of important changes in the system of finance, usually referred to as the Finance Reform of 1969, went into effect on 1 January 1970.  

Fiscal equalization measures in 1970 brought about a range in the adjusted fiscal capacity of the Länder from 95.6 percent to 104.7 percent of the average. Article 104a and the joint tasks put an end to the uncontrolled growth of federal grants. The federation now sat in committees with all the Länder, and bilateral agreements ceased. Federal grants were now based on Bundesrat approval. In federal–Land planning committees for joint tasks, each Land was given one vote and the federation was given votes equal to the total number of Länder; decisions were made with a three-fourths majority. The “supply-side dictatorship” (Angebotsdiktatur) created by federal grants basically disappeared. The federation no longer had the option of offering a single Land funds or of withdrawing an offer.  

The expert whose book on German finance from 1948 to 1990 has been the source for this historical review concluded, among other things, that the constitutional finance reform of 1969 which strengthened the trend toward a broader unitary system under the slogan of “cooperative federalism” did not lead to a strengthening of the federation vis-à-vis the Länder in general. On the contrary, as a result of the increase in central decision-making at the federal level with a strengthened participation of the Bundesrat, or, in other words, through more “joint and intertwined decision-making” (Politikverflechtung), the Länder as a whole gained additional influence in federal policy-making. One should not overlook the
fact, however, that the individual *Land* more likely lost an autonomous room for maneuver.22

The Finance Reform of 1969 did not, of course, resolve all of the conflicts between the rich and poor *Länder* and between these and the federation. Significant changes in the fiscal capacity of *Länder* took place in the 1970s. As a result of the oil crises in the early and late 1970s, Lower Saxony benefited strongly from its oil production. To the great annoyance of the *Länder* that had to transfer equalization funds to Lower Saxony, these oil revenues were not counted in fiscal equalization. Owing to the steel and shipbuilding crises, North-Rhine Westphalia, Bremen, and Hamburg became much less affluent, and the Saarland became even poorer. On the other hand, Bavaria rose to about average in fiscal capacity. It was alleged with some reason that the CDU/CSU–FDP coalition government favored the CDU/CSU *Länder* in financial matters. Several SPD *Länder* took the fiscal equalization law to the Federal Constitutional Court, which ruled much of it unconstitutional in 1986 and set the criteria for a new law. One of these criteria concerned changing the basis of the calculations for transfers from the richer to the poorer *Länder* to fiscal capacity rather than tax capacity. Thus, Lower Saxony could not exclude its oil revenues after 1986.23

No sooner was the reform implemented in response to the 1986 decision of the Federal Constitutional Court than several SPD *Länder* complained again before the Court in 1988. In the meantime a new conflict arose over federal grants for public assistance, for which the *Länder* and their localities are responsible. This conflict was resolved in December 1988 via a compromise that was to provide the *Länder* with DM 2.5 billion in “structural funds” grants over a ten-year period.24 This change had barely gone into effect when the Wall came down in November 1989. German unification, which came eleven months later, meant that new and far-reaching changes in the German system of public finance were now required. But while experts were wrestling with these challenges, the Federal Constitutional Court’s decision in 1992 in response to the SPD challenge in 1988 led to the provision of additional federal funds for the purpose of reducing the debt of Bremen and the Saarland.

**Basic principles of German fiscal federalism**25

All constitutional provisions regarding finances are contained in Section X of the Basic Law, which consists of Articles 104a to Article 115. These
Articles and legislation dealing with finances are called the “financial constitution” (Finanzverfassung). They are supplemented by Article 28, para. 2, which provides certain guarantees of fiscal autonomy to local governments, and Article 91a and 91b which provide for federal–Land “joint tasks.”

The federation, that is, the federal government (cabinet) together with the Bundestag and Bundesrat, has most of the taxing authority (Article 105). It has exclusive jurisdiction over some taxes and concurrent legislative powers over most other taxes. In German constitutional law, the exercise of a concurrent power by the federation excludes any Land legislation on the matter. The Länder have the authority to pass legislation concerning local excise and consumer taxes, but this legislation usually allows their local governments to raise the taxes.

The term used by German economists to reflect the distribution of revenues between the units of the German federal system is Finanzausgleich. It has a basic meaning of fiscal balance among levels of government and is perhaps best translated as “fiscal equalization.” Nevertheless, it can have somewhat different specific meanings. “Vertical fiscal equalization” (vertikaler Finanzausgleich) refers to the distribution between different levels, while “horizontal fiscal equalization” (horizontaler Finanzausgleich) refers to transfers within the level.

The five stages of fiscal equalization

Stage one: vertical distribution of separate and joint tax revenues
Article 106, discussed below, deals with vertical fiscal equalization, sometimes also referred to as “primary fiscal equalization.” The vertical fiscal equalization goes a long way toward providing the federation and Länder with the funds necessary to carry out their responsibilities. Indeed, Article 106, para. 3, says that the federation and Länder have an equal claim to current revenue to cover their necessary expenditures and that necessary expenditures of each level are to be coordinated in such a manner as to achieve a fair balance, avoid an overburdening of taxpayers, and provide uniformity of living conditions in the territory of the federation. Nevertheless, given the differences in the economies of the German Länder and the autonomy of their governments, vertical or primary distributions of revenues do not bring about equality of resources.

The Germans distinguish between a Trennsystem, or separate taxes accruing to one or another level, and a Verbundsystem, joint taxes shared by the various levels. The American practice which is mostly one of separate taxes for each level but which allows the different levels to tap the
same source, as in the case of federal and state income taxes or federal and state gasoline or tobacco taxes, is unknown in Germany. The general rule is that any one source of funds can be taxed by only one level.  

Separate federal taxes are listed in Article 106, para. 1. They include taxes on the “finance monopolies,” now only brandy; customs duties, most of which go to the EU; excise taxes, such as tobacco, sparkling wine, coffee, and gasoline taxes; income and corporation surtaxes for expenses attributed to unification; and taxes raised within the framework of the EU. Separate taxes for the Länder, provided by Article 106, para. 2, include a wealth tax (no longer being raised); inheritance tax; motor vehicle tax; property acquisition tax; beer tax; and betting and casino gambling taxes. They also have a tax for the purpose of fire protection, and they raise additional revenues through lotteries.

Local governments are included in Article 106 of the Basic Law, but most of the details regarding their limited tax authority are provided by federal and Land statutory law. Separate local taxes include consumer or user taxes on such items as entertainment, nonalcoholic beverages, dogs, hunting and fishing, and licenses for the sale of beer. These are minor taxes that account for around 1–4 percent of local revenues, about the same proportion as in the United States. The most important separate taxes are the Realsteuern, which include taxes on municipal property (Grundsteuer B) and agricultural land and forests (Grundsteuer A). The latter consist of most of the land that surrounds the village or town and is included within its jurisdiction, that is, there is little land in Germany that is not incorporated. Property taxes accounted for about 12 percent of local tax revenues, or DM 11.1 billion, in 1994. Realsteuern also include the Gewerbesteuer, a tax on business enterprises in the municipality. This tax used to be divided into three kinds: a tax on gross profits, a tax on capital assets, and a payroll tax. The latter two taxes were eliminated in 1998 and 1979–80, respectively. The remaining business tax (Gewerbeertragssteuer) is a tax placed usually on around 5 percent of net profits. The municipalities are allowed within limits to set their own assessment rates on the different Realsteuern. The Gewerbesteuer is an important tax for most municipalities; however, it varies widely in yield based on the rate assessed by the localities and on the nature and location of the business enterprises. In the 1970s the localities shared 40 percent of their business tax revenue with their Land and the federation; today the amount assessed is about 20 percent in the old Länder, about 25 percent of which
goes to the federation. The assessment in the new Länder, which do not pay a supplementary contribution to the German Unity Fund, is about 10 percent.36

The most important taxes in Germany are not the separate taxes listed in table 5.1, but the joint, or shared, taxes authorized in Article 106, para. 3. These are the income tax, the corporation tax, and the turnover tax (since 1968 the VAT, a sales tax applied to each stage of production). Together they make up about 72 percent of total tax revenues and about 88 percent of Länder revenues.37 The local governments receive 15 percent of the income tax and since 1998 2.2 percent of the VAT after the federation has received 5.63 percent for old age pensions. The federation and the Länder each receive 42.5 percent of the income tax and 50 percent of the corporation tax. The proportion of the VAT received by each level is set by federal law and can change when developments in revenues and expenditures at the federal and Land levels so demand. In 1998 VAT revenues – the VAT was set at 16 percent of the sale of goods and services in 1998 – were divided between the federation, Länder, and municipalities as indicated in table 5.1.

Stage two: horizontal distribution of joint tax revenues38

Article 107, para. 1, first grants the Länder their “primary” revenue share yielded from the personal income tax and corporation tax according to the residency principle, the same “local yield” (örtliches Aufkommen) principle that is applied to the municipalities’ share of the income tax. In other words, the revenues from personal income taxes go to the municipality (up to an amount specified by law) and Land in which the taxpayer has his or her residence. The corporation tax revenues go to the location of production facilities, not to where the firm headquarters are located. The “local yield” principle has always been a source of controversy between the “richer” and “poorer” Länder. The former see the right to keep revenues generated in their own territory as a function of their autonomy, while the poorer Länder argue that funds should be distributed on the basis of need or population.

In contrast to the “local yield principle,” the distribution of 75 percent of the Land share of the VAT is based on population. This provides for an element of equalization of revenues based on an “abstract” general need39 and, more technically, according to certain assumptions of “final consumption.”40
Financing the federal system

Table 5.1  **Own source taxes/revenues and distribution of joint tax revenue, 1999**

<table>
<thead>
<tr>
<th>Source</th>
<th>Federation</th>
<th>Länder</th>
<th>Localities</th>
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<tr>
<td>Insurance premium tax</td>
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<td>Real property tax A</td>
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<tr>
<td>Bill of exchange tax a</td>
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<td></td>
<td>Real property tax B</td>
</tr>
<tr>
<td>Domestic investment tax a</td>
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<td>Second home tax</td>
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<tr>
<td>Road freight tax a</td>
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<td></td>
<td>Licensing tax</td>
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<td>Capital transfer/transaction tax a</td>
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<td>Entertainment tax</td>
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<td>Customs duties</td>
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<td></td>
<td>Hunting &amp; fishing tax</td>
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<td>Gasoline tax</td>
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<td></td>
<td>Dog tax</td>
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<tr>
<td>Coffee tax</td>
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<td>Local beverage tax</td>
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<td>Sparkling wine tax</td>
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<td>Business tax b</td>
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<tr>
<td>Tobacco tax</td>
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</tr>
<tr>
<td>Brandy tax</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Solidarity tax surcharge</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Joint taxes %</td>
<td></td>
<td></td>
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</table>

Turnover tax (VAT = a form of sales tax) c

<table>
<thead>
<tr>
<th>Source</th>
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<th>Localities</th>
</tr>
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<tbody>
<tr>
<td>Special Distribution</td>
<td>5.63</td>
<td></td>
<td></td>
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<tr>
<td>Federation earmarked for old age pensions</td>
<td>2.2</td>
<td></td>
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<tr>
<td>Municipalities compensation for elimination of capital business tax</td>
<td></td>
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<td></td>
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<tr>
<td>Remainder (92.17)</td>
<td>50.5</td>
<td>49.5</td>
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Corporation tax

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<tbody>
<tr>
<td></td>
<td>50</td>
<td>50</td>
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Personal Income tax and payroll tax

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<th>Localities</th>
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<tr>
<td></td>
<td>42.5</td>
<td>42.5</td>
<td></td>
</tr>
<tr>
<td>Municipalities</td>
<td>15</td>
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<td></td>
</tr>
</tbody>
</table>

Local business tax (Gewerbesteuer) b

<table>
<thead>
<tr>
<th>Source</th>
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<th>Localities</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Notes: a These taxes are authorized but are no longer being raised; b The business tax is legally a local tax, but de facto it is a joint tax; c figures for 1999.
Stage three: horizontal distribution based on tax capacity
At the third stage those Länder whose total share of revenues from the personal income tax, corporation tax, business tax, the 75 percent of the VAT distributed on the basis of population, and Land tax revenues is below the per capita average receive supplementary funds from the remaining 25 percent of the Länder share of the VAT. This “secondary” distribution brings the poorer Länder up to 92 percent of the average per capita revenue of all Länder.41

Stage four: horizontal fiscal equalization among the Länder
Same-level transfers from richer to poorer Länder are designed to provide more differentiated assistance.42 These transfers are sometimes called fiscal equalization “in a narrower sense.”43 The federal law that provides for transfers among the Länder requires approval by the Bundesrat.

Horizontal fiscal equalization among the Länder is a further refinement with the purpose of giving all Länder the means to provide virtually the same services. This is derived from the “federal principle of standing by one another,”44 which in turn is a form of federal comity. The further adjustments to produce even more equalization are considered necessary to secure for the poorer recipient Länder the budget autonomy they need and to meet the goal of equivalent living conditions throughout the country.

Horizontal fiscal equalization is based on a complicated scheme that contrasts the tax revenues a Land should have (fiscal needs) with those it actually has (fiscal capacity). Both indicators are calculated on the basis of average tax revenues, including 50 percent of the municipal tax revenues (excluding their minor taxes), but each is subject to certain modifications.

Fiscal needs include consideration of the size and density of population of municipalities. In accordance with the so-called “Brecht–Popitzches principle” first enunciated in the 1920s, it has been assumed that the larger the population and the greater the population density of a municipality, the higher are the per capita expenditures. Thus, the population of a town of 5,000 is factored in at 100 percent, but for a city of 500,000 it is 130 percent; density figures of 1,500–2,000 inhabitants per km2 are worth 2 percent, while for 3,000 inhabitants per km2 they are worth 6 percent. In recent years questions have been raised in the literature and in the Federal Constitutional Court about the empirical evidence for this principle.45

Another adjustment is made for the city-states, Bremen, Hamburg, and Berlin. Their real populations are multiplied by 135 percent, with the result...
multiplied in turn by the fiscal capacity of the city-state. Thus, by this procedure in 1993 the population of Hamburg (1,690,000) was increased to 2,280,000, which then raised Hamburg’s equalization index figure from DM 7.161 billion to DM 9.347 billion (see table 5.2). The justification for this adjustment is that the city-states provide many services for people in the metropolitan area who live outside the city-state boundaries.46

Fiscal capacity includes the total tax revenues of the Länders, special levies (e.g., on oil production in Lower Saxony), 50 percent of the total volume of municipal revenues based on the average assessment rate for property and business taxes, and harbor burdens. Thus the federal Fiscal Equalization Law allows Bremen, Hamburg, Mecklenburg-Vorpommern (Rostock), and Lower Saxony (Emden) to deduct from their fiscal capacity DM 142 million (Hamburg) to DM 18 million (Lower Saxony).47 If the financial need is greater than the fiscal capacity, the Land receives transfer funds. If the fiscal capacity is greater than the fiscal need, the Land must transfer funds to the recipient Länder.

As table 5.2 demonstrates, the calculation of the amounts to be transferred from and to the various Länder begins with the fiscal capacity of the individual Länder. This figure is then multiplied by the proportion of the Land population to total population in Germany to produce the equalization index figure. The fiscal capacity figure is then divided by the equalization index figure which results in a percentage indicating whether the Land is above or below average. The equalization index is subtracted from the figure for fiscal capacity to arrive at the surplus or deficit of each Land in comparison to the average.

The next step is for the Länder that are above average (payer Länder) to transfer to the recipient Länder 37.5 percent of any missing amount between 92 and 100 percent; this brings their fiscal capacity to 95 percent of the average. The Länder that have a higher figure for fiscal capacity than for their equalization index must transfer 15 percent of their “surplus” that lies between 100 and 101 percent, 66 percent of their surplus that lies between 101 and 110 percent, and 80 percent of any surplus above 110 percent. In case these transfers do not achieve their purpose of bringing all of the recipient Länder to 95 percent of the average, additional transfers might take place from the surpluses above 101 percent.

The Länder that are above average and transfer funds to the poorer Länder have varied over the years. In the first decades of the Federal Republic, for example, Bremen and North-Rhine Westphalia were later joined by Baden-Württemberg as perennial “payers,” whereas Schleswig-Holstein, Lower Saxony, Bavaria, and Rhineland-Palatinate were recipients. In the
Table 5.2  **Fiscal equalization in the old Länder, 1993**

<table>
<thead>
<tr>
<th></th>
<th>NW</th>
<th>BY</th>
<th>BW</th>
<th>NI</th>
<th>HE</th>
<th>RP</th>
<th>SH</th>
<th>SL</th>
<th>HH</th>
<th>HB</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fiscal capacity measure (FC)</td>
<td>74358.00</td>
<td>50113.00</td>
<td>44705.00</td>
<td>29148.00</td>
<td>28020.00</td>
<td>14646.00</td>
<td>10662.00</td>
<td>3893.00</td>
<td>9170.00</td>
<td>2931.00</td>
<td>267646.00</td>
</tr>
<tr>
<td>Compensation measure (CM)</td>
<td>74542.00</td>
<td>49157.00</td>
<td>42404.00</td>
<td>31717.00</td>
<td>24790.00</td>
<td>16223.00</td>
<td>11171.00</td>
<td>4537.00</td>
<td>9347.00</td>
<td>3758.00</td>
<td>267646.00</td>
</tr>
<tr>
<td>CM/actual inhabitants</td>
<td>4216.00</td>
<td>4176.00</td>
<td>4178.00</td>
<td>4186.00</td>
<td>4186.00</td>
<td>4180.00</td>
<td>4169.00</td>
<td>4185.00</td>
<td>5535.00</td>
<td>5479.00</td>
<td>4240.00</td>
</tr>
<tr>
<td>FC in proportion to CM in %</td>
<td>99.75</td>
<td>101.94</td>
<td>105.43</td>
<td>91.90</td>
<td>113.03</td>
<td>90.28</td>
<td>95.44</td>
<td>85.81</td>
<td>98.11</td>
<td>78.01</td>
<td>100.00</td>
</tr>
<tr>
<td>Surplus/Deficit</td>
<td>-185.00</td>
<td>956.00</td>
<td>2301.00</td>
<td>-2569.00</td>
<td>3230.00</td>
<td>-1576.00</td>
<td>-509.00</td>
<td>-644.00</td>
<td>-177.00</td>
<td>-826.00</td>
<td>0.00</td>
</tr>
<tr>
<td>Fiscal equalization (FE)</td>
<td>69.00</td>
<td>0.00</td>
<td>-1009.00</td>
<td>983.00</td>
<td>-2122.00</td>
<td>765.00</td>
<td>191.00</td>
<td>417.00</td>
<td>66.00</td>
<td>639.00</td>
<td>0.00</td>
</tr>
<tr>
<td>FC after FE</td>
<td>74427.00</td>
<td>50113.00</td>
<td>43696.00</td>
<td>30131.00</td>
<td>25898.00</td>
<td>15412.00</td>
<td>10833.00</td>
<td>4310.00</td>
<td>9236.00</td>
<td>3570.00</td>
<td>267646.00</td>
</tr>
<tr>
<td>FC after FE in proportion to CM</td>
<td>99.84</td>
<td>101.94</td>
<td>103.05</td>
<td>95.00</td>
<td>104.47</td>
<td>95.00</td>
<td>97.15</td>
<td>95.00</td>
<td>98.82</td>
<td>95.00</td>
<td>100.00</td>
</tr>
<tr>
<td>FC in DM/inhabitants</td>
<td>4210.00</td>
<td>4258.00</td>
<td>4306.00</td>
<td>3976.00</td>
<td>4373.00</td>
<td>3971.00</td>
<td>4050.00</td>
<td>3976.00</td>
<td>5469.00</td>
<td>5205.00</td>
<td>4240.00</td>
</tr>
<tr>
<td>in % of average</td>
<td>99.28</td>
<td>100.40</td>
<td>101.54</td>
<td>93.77</td>
<td>103.12</td>
<td>93.65</td>
<td>95.51</td>
<td>93.76</td>
<td>128.98</td>
<td>122.75</td>
<td>100.00</td>
</tr>
<tr>
<td>in DM/weighted inhabitants</td>
<td>4210.00</td>
<td>4258.00</td>
<td>4306.00</td>
<td>3976.00</td>
<td>4373.00</td>
<td>3971.00</td>
<td>4050.00</td>
<td>3976.00</td>
<td>4051.00</td>
<td>3856.00</td>
<td>4185.00</td>
</tr>
<tr>
<td>in % of weighted average</td>
<td>100.59</td>
<td>101.73</td>
<td>102.87</td>
<td>95.01</td>
<td>104.48</td>
<td>94.88</td>
<td>96.77</td>
<td>94.99</td>
<td>96.80</td>
<td>92.13</td>
<td>100.00</td>
</tr>
<tr>
<td>Inhabitants (millions)</td>
<td>17680.00</td>
<td>11770.00</td>
<td>10150.00</td>
<td>7580.00</td>
<td>5920.00</td>
<td>3880.00</td>
<td>2680.00</td>
<td>1080.00</td>
<td>1690.00</td>
<td>690.00</td>
<td>63.12</td>
</tr>
<tr>
<td>Weighted inhabitants</td>
<td>17680.00</td>
<td>11770.00</td>
<td>10150.00</td>
<td>7580.00</td>
<td>5920.00</td>
<td>3880.00</td>
<td>2680.00</td>
<td>1080.00</td>
<td>2280.00</td>
<td>930.00</td>
<td>63.95</td>
</tr>
</tbody>
</table>

1970s and 1980s the decline of smokestack industries had a very negative effect on North-Rhine Westphalia and the Saarland, and the decline of shipbuilding hurt Bremen. In the meantime Hesse and Baden-Württemberg prospered, and for the past few decades there has been a North–South gap in Germany that began to include Bavaria in the fiscally stronger group in 1989. Populous North-Rhine Westphalia returned to the payer or provider column in 1989 but was a recipient of transfer funds in 1993 and 1994. It has since returned to the provider column. With the accession of the five new Länder in the East, an even greater East–West gap has been superimposed on the North–South gap. Data for 1995–2000 are provided in table 5.3.

Stage five: federal supplementary grants

After the transfer of funds from the richer to the poorer Länder, which bring the poorer Länder to 95 percent of the average fiscal capacity of all

| Table 5.3 Fiscal equalization among the Länder, 1995–2000 (million DM) |
|-----------------|---|---|---|---|
| **Transfer Payment Länder (-)** |   |   |   |   |
| North-Rhine Westphalia       | 3,449 | 3,132 | 3,033 | 2,201 |
| Bavaria                     | 2,532 | 2,862 | 3,079 | 3,749 |
| Baden-Württemberg           | 2,803 | 2,521 | 2,423 | 3,873 |
| Hesse                       | 2,153 | 3,240 | 3,130 | 5,354 |
| Hamburg                     | 117   | 482  | 264  | 1,099 |
| Schleswig-Holstein          | 141   | --   | 5    | --   |
| **Recipient Länder (+)**    |   |   |   |   |
| Lower Saxony                | 452   | 553  | 672  | 1,113 |
| Rhineland-Palatinate        | 229   | 231  | 305  | 780  |
| Schleswig-Holstein          | --    | 16   | --   | 358  |
| Saarland                    | 180   | 234  | 203  | 329  |
| Bremen                      | 562   | 635  | 351  | 872  |
| Berlin                      | 4,222 | 4,336 | 4,425 | 5,521 |
| Saxony                      | 1,773 | 1,965 | 1,896 | 2,328 |
| Saxony-Anhalt               | 1,123 | 1,241 | 1,162 | 1,407 |
| Thuringia                   | 1,019 | 1,127 | 1,110 | 1,320 |
| Brandenburg                 | 864   | 1,035 | 976  | 1,263 |
| Mecklenburg-Vorpommern      | 771   | 856  | 835  | 983  |
| **Total**                   | +11,195 | +12,229 | +11,934 | +16,274 |

Länder, the federation again enters the picture with federal supplementary payments (Bundesergänzungszuweisungen, BEZ) designed to raise the average fiscal equalization deficits from 95 percent to 99.5 percent. In this process, special burdens carried by the recipient Länder may be considered. These include federal payments for above-average costs of operating the political system, e.g., legislative and executive salaries. These payments range from DM 219 million for Berlin and Rhineland-Palatinate to DM 126 million for Bremen. Other Länder receiving such funds are Brandenburg, Mecklenburg-Vorpommern, Saarland, Saxony-Anhalt, Schleswig-Holstein, and Thuringia. Special burdens grants also go to eastern Länder for municipalities with especially low fiscal capacity and for burdens associated with the division of Germany. Berlin and the five new Länder receive funds that range from DM 3.658 billion for Saxony to DM 1.479 billion for Mecklenburg-Vorpommern. These payments are to be continued until 2004. In recognition of disproportionate burdens, several western Länder also receive federal grants which ranged in 1995 from DM 507 million for Lower Saxony to DM 80 million for Bremen and the Saarland. Rhineland-Palatinate and Schleswig-Holstein also received DM 451 and DM 227 million, respectively. These grants are to be reduced 10 percent each year after 1995. In addition Bremen and the Saarland received DM 1.8 billion and DM 1.6 billion in 1995–98 for the purpose of debt reduction and important investments designed to improve the economies of these Länder.50 They will receive decreasing amounts until 2003.

While from an American perspective fiscal equalization measures in Germany may appear to reduce the autonomy of the poorer Länder by making them partially dependent on the federation and the richer Länder, the German view, especially in the poorer Länder, has been that it is precisely the general fiscal equalization among the Länder that makes it possible for them to carry out all of their functions autonomously and to meet the constitutional requirement of providing equivalent or uniform living conditions (Article 72, para. 2, and Article 106, para. 3). Equivalent living conditions do not mean the elimination of all differences in living conditions throughout Germany, but the concept does suggest generally equivalent public services and standards that only an adequate funding of all government units throughout the country can provide. The goal of equivalent living conditions is anchored in the principle of the sozialer (social welfare) state, the state of law (Rechtsstaat), and the federal state (Article 20, para. 1). Its specific application, however, is subject to interpretation.51
Unification and the Solidarity Pact of 1993

When it became increasingly clear in the months following the opening of the Berlin Wall on 9 November 1989 that Germany would be united again after more than forty years (but without the eastern territories lost to Poland and Russia after 1945), some attention began to be paid to the many financial problems that unification would bring – although these were underestimated. One of the most difficult of these was the question of providing “uniform” living conditions in a country that now had a huge gap in productivity, housing standards, infrastructure, and general standard of living between East and West. Two very different social and economic systems were to be integrated, although the eastern part had less than one-third of the per capita GDP of the western part. This was then reflected in a statistical reduction of about 15 percent in average per capita income for the united Germany. The result was that “from a state which had become poorer, more services were now demanded.”

Beginning in 1990, huge transfers of funds have flowed from West to East. The annual amounts have generally been estimated at around DM 150 billion annually; however, there is disagreement about the calculations of the transfers. Depending on what is counted, they range for 1992 from DM 100 billion to DM 234 billion. One expert suggests after a careful analysis that the net transfer in 1992 was between DM 162.5 and DM 183 billion, or about 6 percent of the West German GDP. This represented about 60 percent of the GDP of East Germany.

In May 1990 the two Germanies signed a treaty in preparation for the currency, economic, and social union to go into effect on 1 July 1990. In order to finance the anticipated East German deficits through 1994, a “German Unity Fund” was created. At that time it was thought that this deficit could be financed one-third each by East Germany, the federation, and the old Länder. The German Unity Fund was to contain DM 115 billion for payments through 1994, with the federation committing DM 20 billion through savings from previous expenditures connected to the division of the country (e.g., subsidies for border areas and West Berlin) and the federation and the old Länder providing DM 47.5 billion each from loans. Although it was argued that the federation was fiscally responsible for unification costs, the old Länder agreed to assume a heavy loan burden to avoid having to meet the demand by the federation that its share of VAT revenues be increased dramatically.

At the end of August 1990, the East and West Germans signed the Unification Treaty. Article 7 of this Treaty dealt with the financing of united
Germany from 1991 through 1994. In principle the East was to be integrated into the system of public finance in the Federal Republic. Thus, the provisions of Article 91a and 91b, which provided for certain grants to the Länder based on mixed financing, and the provisions of Article 104a that authorized the federation to give grants to the Länder for a variety of purposes, were to be applied to the five new Länder as of 1 January 1991. It was soon apparent, however, that the investments derived from these provisions were inadequate to meet the needs in the East that were proving to be much greater than had been anticipated. This led to an agreement between Chancellor Kohl and the prime ministers of the new Länder to establish an investment fund (Aufschwung Ost), that provided an additional DM 12 billion each for the years 1991 and 1992. Another investment program (Aufbau Ost) providing DM 6.6 billion annually was established in 1993 that went into effect in 1995 and is to expire in 2004.55

Until 1994 there were also some important exceptions in the East to the general rules of the financial system of the Federal Republic. The distribution scheme of VAT revenues to the Länder was not applied at first in the eastern Länder, and they did not participate in the transfer of funds from richer to poorer Länder. The eastern Länder were so much poorer that all of the recipient Länder in the West except Bremen would have had to make sizable transfers to the East.56 This was, of course, unacceptable to the old Länder. The “German Unity Fund,” which was originally established to cover East German debts but was revised in the Treaty on German Unity to provide the new Länder with transfer funds based on population, was to serve as a substitute for these exceptions. But it soon became apparent that these measures were inadequate as well. The budget pressures in the new Länder forced them to borrow heavily, and it was clear they needed additional funds. After 1 January 1991, the new Länder began receiving their full share of VAT revenues based on population, and the contributions of the old Länder were increased. The federation gave up the 15 percent portion of the German Unity Fund that it planned to use for “central purposes” and turned it over to the new Länder. As a result of these actions, the new Länder received an additional DM 10 billion, and the German Unity Fund was increased from DM 115 billion to DM 161 billion.57 By the end of 1991 the VAT on goods and services was increased from 14 to 15 percent (in part because of the EU) and the Länder share of VAT revenue was increased from 35 to 37 percent. A 7.5 percent temporary surcharge on income and corporation taxes was also imposed between 1 July 1991 and 30 June 1992.
In 1991 and 1992 the federation as well as the old and new Ländere were borrowing so heavily that many observers became alarmed. This was not only because of conventional economic arguments regarding the accumulation of excessive debt, but also because of the convergence criteria set by the EU for qualifying for the common currency, the “Euro.” It became apparent that the financial arrangements for meeting the fiscal challenges of unification were inadequate and would have to be changed significantly when these arrangements elapsed at the end of 1994. Voices were heard demanding an overall finance reform that would be incorporated into the package of constitutional changes being considered in 1993 and 1994 by a joint committee of the Bundestag and Bundesrat. However, a comprehensive finance reform was not taken up by this committee for several reasons, including the fact that there was no consensus on a general framework or concept of reform and, as a result, a lack of will to spend so much time and effort on a reform that would interfere with and delay other deliberations on constitutional change.58

The result of the strong pressures for revision of the fiscal equalization system was the Federal Consolidation Program (“Solidarity Pact”) of 1993 that provided the changes in the system of finances that have applied with only minor alterations since 1 January 1995. Change of some kind was made absolutely necessary by the fact that the temporary measures described above were to elapse at the end of 1994. Given the economic conditions in the East, the heavy burdens on the federation, and the realization by the old Ländere that admitting the new Ländere to the West German system of fiscal equalization would have devastating consequences for them, it became clear that a new financing system would have to be devised before 1995, when the new Ländere were scheduled to join the the equalization system as regular members. As a result of these pressures, the finance ministers of the sixteen Ländere formed in September 1991 a working group, “Finance Reform 1995.” This group met regularly until the spring of 1993, during which time the larger, mostly richer, Länder proposed reforms generally opposed by the mostly smaller, poorer, Länder. The new Länder were, of course, interested in being included as soon as possible in the fiscal equalization measures, but no model of reform could garner a majority.

Disagreements between the federation and the Länder were also a barrier to reaching consensus on a reform model. This encouraged the Länder to work together in order to counter the federal government’s efforts to push through reforms that the Länder saw as disadvantageous to them. After many months of wrangling between the federal government
and the Länder and among these as well, agreement was reached in May 1993.

Starting in 1995, the Solidarity Pact provided annual transfers of DM 56 billion for ten years to the East along with billions in loans for housing construction, infrastructure, environmental cleanup, and business promotion. It also provided DM 40 billion for old Eastern debts. The federation's contribution is financed as of January 1995 in large part by a 7.5 percent “solidarity surcharge” on personal income taxes and corporation taxes, a tax which had gone into effect briefly after unification but dropped again in 1992. By the late 1990s it had become very unpopular and politically controversial, at least in western Germany, owing in part to the incorrect belief held by many West Germans that East Germans do not have to pay the surcharge. The five new Länder were included in the horizontal equalization scheme, which, as we saw above, requires large transfers from the old to the new Länder. In compensation, the Länder share of VAT revenues was raised from 37 to 44 percent. In 1996 this was changed again to 49.5 percent for the Länder. The federation accepted the burden of giving up a large chunk of its share of VAT revenue and at the same time agreed to transfer large sums to the eastern Länder in order to bring their fiscal capacity up to 92 percent (stage three) and then, finally, from 95 percent to 99.5 percent of the average (stage five).

When compared to what the federal government had proposed initially for the solidarity pact, the Länder appeared to emerge as the victors in the struggle over a revised system of finances. Others argue that if one considers the costs incurred before the Solidarity Pact, the old Länder come up short. The federation conceded that it was responsible for most of the burdens of unification, although the Land share, which is only about 10 percent, is still very sizable. On the other hand, the new Länder have become far more dependent on the fiscal equalization procedures and on federal grants than the poor Länder in western Germany ever were. This adds fuel to the argument that the Länder have too little fiscal autonomy and need more own source revenue. Nevertheless, the solidarity pact represents incremental reform; it is not a major departure from the system in operation since the Finance Reform of 1969.

Other federal grants to the Länder

One could easily conclude that the large federal transfers to the Länder within the framework of the fiscal equalization scheme might exhaust the
possibilities for revenue distribution. But outside this scheme the federation has the constitutional authority to provide numerous other grants for investments in the Lände. Article 104a, para. 4, permits federal grants to the Länder and local governments (municipalities and counties) for “especially important investments” designed “to avert a disturbance of the overall economic equilibrium or to equalize differing economic capacities within the federal territory or promote economic growth.” Details must be provided by statutory law subject to approval by the Bundesrat.

Article 104a, para. 4, does not give the federation a general right to provide direct grants to the Länder and indirect grants to localities, but the Article’s provisions are not very specific. After all, determining what “a disturbance of the overall economic equilibrium” is cannot be based on precise calculations but rather on whether there is a stagnating or declining economy in the region. Any investments that would seem to help counter this decline would be appropriate. In contrast to this Article, Article 91a and 91b provide for more long-term aid. Some of the goals of Article 104a, para. 4, and Article 91a are the same or similar, but Article 91a is more “specialized,” because it calls for the participation of the federal government in a particular planning procedure and a predetermined financial scheme. But above and beyond the provisions of these Articles, the federal government has no right to participate in the selection of individual projects. It can only exclude projects that do not fit the provisions of the federal law.62

The Länder and especially their local governments are responsible for about 80 percent of all investments, which have a strong impact on the economy as a whole. The federation was therefore given indirectly a good deal of responsibility for the economy when Article 104a was introduced in the Finance Reform of 1969. In the case of federal financial grants under Article 104a, para. 3, if 50 percent or more of the project to be funded is paid from federal funds, the project is administered by the Länder on behalf of the federation. If the Länder contribute more than 25 percent, the program must be approved by the Bundesrat. Grants must be for projects with a broad purpose, not just for local or regional concerns. In 1994 federal aid included urban renewal (federal share = 33 percent); public housing (about 50 percent); local public transportation (60–75 percent); local streets (90 percent); public commuter transportation (90 percent); and others.63 A special investment program for the eastern Länder (Aufbau Ost) was established in 1995 under Article 104a as well. This program includes project grants worth DM 6.6 billion annually for ten years. The federation may not interfere in the Land or local planning for these
measures, nor is it responsible for the way the money is spent. It can, however, determine whether the funds are spent according to the law.64

Article 91a and 91b, also introduced by the Finance Reform of 1969, provide the Länder with additional funds for investing in “joint tasks.” Thus, the federation may participate in Land responsibilities when these are important for the general population and federal participation is necessary to improve living conditions. Three such areas are listed in Article 91a: expansion and construction of university buildings, including university clinics; improvement of regional economic structures; improvement of agricultural structure and coastal preservation. Joint tasks are regulated by federal law approved by the Bundesrat. The laws include provisions for joint planning for grants that must have the approval of the Länder to which they apply. For the construction of university buildings and for regional economic structures, the federation provides one-half of the funding for the project; for improvement of agricultural structure and coastal preservation the federation covers at least half of the cost for each Land. For universities and university clinics, plans called for DM 1.8 billion for the period 1998–2001; for regional economic structures, plans included investments of DM 5.7 billion in the new Länder and of DM 700 million in structurally weak regions of western Germany, with each level contributing 50 percent. For improving agriculture and preserving coastal regions, the plans called for a total of DM 3.22 billion, with the federation paying 60 percent for agricultural improvements and 70 percent for coastal preservation.65

Article 91b provides for cooperation between the two levels in the area of educational planning and in promotion of research institutions and research projects with broad impact. Educational cooperation exists, but it is not nearly as widespread or intrusive as originally planned during the “planning euphoria” of the late 1960s and early 1970s when the Finance Reform of 1969 was being debated. In the area of research institutions and research projects, including the Max-Planck-Gesellschaft scientific institutes and the German Research Association (DFG), federal assistance has become essential.

Fiscal equalization within the Länder

Horizontal fiscal equalization takes place not only among the Länder but also between them and their local governments. Article 106, para. 7, requires the Länder to share a percentage of their joint tax income with
their local governments. Land laws are also to determine whether and to what extent the Land taxes are to be shared with the localities in order to equalize to a considerable degree the finance capacity of the local governments. The percentage shared varies by Land, but in 1996 the total of all grants by the Länder to their counties, cities, towns, and villages was DM 95.3 billion.

There are two general categories of grants: general-purpose formula grants and special-purpose categorical or project grants. General-purpose grants are designed to provide local governments with the financial means to meet their general obligations and are not tied to any specific tasks. Most general-purpose grants are provided in the form of formula grants, distributed primarily on the basis of population; however, some general-purpose grants are provided on the basis of need. “Need” can apply to towns that have been designated “central places” that provide many services for surrounding towns, or they can be towns that have spas or military installations. Special needs may also result from the amount of public assistance the municipalities are providing to those who do not qualify for unemployment compensation. Population size is determined not only by a real count but also by size of municipality. Thus, the larger the municipality, the more each person “counts,” e.g., the population of a town of 5,000 may be multiplied by 100 percent, while the population of a town of 10,000 may be multiplied by 110 percent. As noted earlier, this practice is based on the view that larger towns and cities provide many services to the region and on the theory mentioned in an earlier section that the greater the population density, the higher the per capita costs.

Special-purpose grants are designed to finance all or part of certain functions. These include grants that compensate local governments for implementing specific delegated tasks, including grants that pay for various direct transfers of money and grants that help pay for schools, streets, and commuter transportation. Investment grants for infrastructure, like project grants in the United States, are awarded on the basis of application from the local units of government. They normally require financial participation by the applying unit. As in the United States, they are frequently criticized for distorting the priorities of local governments and thus limiting to some extent their local autonomy. But they make up only a small part of the total income of the localities and hardly play a significant role, so that, at least in the view of some experts, any measurable effect of Land investment grants on local priorities is unlikely.

Even in comparison to the Land and municipal governments, the counties have few taxes of their own; indeed, only about 1 percent of their
income is from their own tax sources. On the other hand, as noted at the beginning of this section, the Länder are required by the Basic Law to provide their local governments, which include the counties, with a proportion of their joint tax income, the percentage to be determined by each Land parliament. These revenues are then shared with the counties through formula grants as described above.

In addition to the formula grants received by the counties, they also receive transfer payments from the towns and villages that comprise the county (there is very little unincorporated territory in Germany) via a county assessment (Kreisumlage). Originally conceived as a complementary source of funds for the counties, the county assessment funds are now their most important source. The details of the county assessment procedures are found in Land legislation. As in the case of the fiscal equalization procedures for transfers between the Länder, the assessment is based largely on the fiscal capacity of the municipalities within the county. This consists of their income from property taxes and business taxes, i.e., Realsteuern; their share of the income tax; and the formula grants they received from the Land. The county council then decides on the standard rate to be assessed against the municipalities that make up the county. In some cases this rate might be made more progressive for the more affluent municipalities. Some Länder also take into consideration financial advantages or disadvantages that accrue to a municipality owing to certain facilities located in its jurisdiction. There seems to be agreement that the assessment rate is not to exceed 50 percent of the fiscal capacity of the municipalities, since a higher rate would undermine municipal autonomy. Some experts argue that 25 percent is the maximum that should be allowed, but a few Länder are above even the 50 percent level.

**Current pressures for reform**

As we have seen from the sections above, conflict between the federation and the Länder and between the rich and poor Länder has accompanied the German system of public finance from the beginning. The growing centralization of taxing powers over the decades has left the Länder with virtually no tax autonomy and the municipalities with a limited autonomy derived basically from their right to set assessment rates for property and business taxes. Almost 80 percent of Land expenditures are financed by federally regulated taxes and grants over which the Länder have no
influence except in the Bundesrat. The federation is always demanding more funds for its needs, while at the same time the poorer Länder are never satisfied with the financial resources available to them for meeting the constitutional requirement of uniform or equivalent living conditions for their inhabitants. The richer Länder, on the other hand, remain frustrated in their attempts to retain a larger proportion of the revenues they receive from their above-average fiscal capacity. In spite of several legislative reforms and some important decisions of the Federal Constitutional Court, the system of vertical and horizontal fiscal equalization has never been organized to everyone’s satisfaction.

Today perhaps even more than in previous decades this system is being challenged from a number of directions. The most general argument is that from the beginning, a majority of postwar Germans who were in positions of authority were confronted by the alternative of more autonomy for the Länder and thus the acceptance of regional differences, or a focus on uniform or equivalent living conditions and thus the demand for a degree of egalitarianism throughout the country. The second position prevailed. But as an American observer has noted, “independence” or autonomy for an American state usually means being “left alone.” In Germany autonomy has tended to mean giving the Länder the ability to achieve the goal of equivalent living conditions through a “fair” distribution of total tax revenues and not being forced to turn over tasks to the federation because of insufficient fiscal capacity.

Nevertheless, one especially common argument is that the current system serves to reduce or weaken the fiscal autonomy of the Länder and therefore weakens the federal system. While the Länder do participate in the Bundesrat in passing most financial legislation, they can still be said to lose autonomy when they are a minority in the Bundesrat or when they prefer a certain action and cannot act on their own owing to their lack of legislative power in raising own source revenues. In other words, the Länder have no autonomy for raising taxes or experimenting with new tax sources, because they do not have what the Germans call “the right to find taxes” (Steuerfindungsrecht). This means among other things that the Land governments and parliaments cannot raise or lower their most important taxes in order to pursue policies that may have popular support, i.e., they are not “fiscally responsible” for their actions. In the meantime there has been increased discussion among many prominent Germans, including former Federal President, Roman Herzog, about the need to secure for the Länder and local governments some fiscal autonomy and ability to engage in some degree of “competitive federalism.”
While they have little autonomy on the revenue side, the Ländler do enjoy considerable autonomy on the expenditure side. But here, too, there is a strong federal presence in many social policies, such as individual rent subsidies or the federal regulations pertaining to public assistance which is financed by Land and local governments.81 There is also a common complaint that the federal grants provided under Article 104a and the funds for joint tasks under Article 91a and 91b sometimes have the effect of manipulating or distorting Land plans and projects. This also produces more uniformity in expenditure policy, because the federal grants tend to be for more general than for narrower Land-specific purposes. Furthermore, the Ländler agreed in 1971 to a constitutional amendment (Article 74a) to give the federation the concurrent legislative power to regulate the salaries of all civil servants (Beamte) in order to prevent differences in salary scales that could lead to a self-destructive salary competition (which was a problem at the time). The local governments, in turn, add to this list of complaints by noting that the federation – as well as the Land governments – continue to devolve various activities to them without providing the funds. The latest example is children’s nursery schools, which federal law now requires and regulates but for which it provides no financial support.82 This issue is, of course, virtually identical to the issue of federal mandates in the United States that led in 1995 to passage of the Unfunded Mandates Reform Act.83

Another set of arguments concerns the transfer payments from the richer to the poorer Ländler. We have seen in the brief historical review presented above that even in the late 1940s there was tension between the Ländler that had above- and below-average financial strength. Since unification, with the addition of five new Ländler which all share extraordinary fiscal weaknesses, the gap between the rich and poor Ländler has grown significantly. If one takes seriously the constitutional command regarding equivalent living conditions, there has to be a massive transfer of funds to the new Ländler. This is in fact occurring, but, one can argue, at a high cost of dependency of these Ländler on the federation and richer Ländler. In contrast to the original optimistic predictions that took as a model for the new Ländler the “economic miracle” of West Germany in the late 1940s and early 1950s, it now looks as though the eastern Ländler will lag behind western Germany for a long time, probably several decades. What effect during this time the dependency of the eastern Ländler on transfers from the western Ländler and federation will have remains an open question. If it becomes a permanent condition, it is not difficult to predict increasing conflict among the Ländler.
In the meantime stage three of the fiscal equalization process which distributes 25 percent of the VAT to the poorer Länder to bring them to 92 percent of the average of per capita revenues, the horizontal transfers in stage four between the Länder that raise their capacity to 95 percent, and, finally, the supplementary federal grants in stage five that bring the poor Länder to 99.5 percent of average fiscal capacity, taken together, have come under increasing criticism. Article 107, para. 2, speaks of an “appropriate” equalization of the different fiscal capacities of the Länder. Critics argue that 99.5 percent is not just inappropriate, it is egalitarian “leveling” which the Federal Constitutional Court has rejected. The practical results, among other things, are said to include continuing tensions between the richer and poorer Länder, disincentives for the poorer Länder to govern more frugally and efficiently, and disincentives for the richer Länder to introduce cost-saving measures. Thus neither the provider nor the recipient Länder will do much to increase their own source revenues.

Indeed, conflict has been apparent. Bavaria and Baden-Württemberg, the latter a permanent “provider” of transfer funds over the decades, decided in 1997 to go to the Federal Constitutional Court with a complaint which they filed in July 1998 that the current system of fiscal equalization is unconstitutional. Hesse joined them several months later. The Bavarian minister of finance suggested somewhat provocatively that the recipient Länder enter negotiations with the provider Länder in order to avoid the uncertainties of a Court ruling against them; however, as noted in an earlier section, the Länder among themselves have never been able to agree on a major reform of the distribution of tax revenues. The federal government and the Federal Constitutional Court have always been necessary elements in financial reform efforts. The question arises, however, whether German politicians do not turn too often to the Court to resolve what are really political questions.

The finance ministers of Bavaria and Baden-Württemberg argued that the current system has gone beyond the constitutional requirement of an “appropriate” fiscal equalization (Article 107, para. 2) to an excessive “leveling” and that it is “absurd” that these two financially strong Länder and Hesse end up at the bottom of the ranking of Länder fiscal capacity (positions 16th, 15th, and 12th, respectively, at the time they brought their case to the Court) after all of the transfers of funds from the federation and richer Länder have been completed. The complaint asked that the richer Länder be allowed to retain at least half of their “surplus” above the general Land average of fiscal capacity. It alleged that the current system serves to penalize those richer Länder which, because of their
supposedly more cautious spending habits and efforts to promote eco-
monic development, have higher fiscal capacity. It also implied that the
system serves to permit “big-spender” Länder with bloated bureaucracies
and ineffective economic development policies to continue their behav-
ior while others pay the bills but have no voice.91

It is important to note that some experts reject the implications of table
5.4 and believe that the charges leveled by Bavaria and Baden-Württem-
berg are spurious, because the funds received by the recipient Länder
include grants for special burdens that the provider Länder do not have.92
The best example is the special burdens carried by the new Länder for the
costs related to unification.93 But there are also funds that are not counted
in the determination of fiscal capacity, e.g., 50 percent of the revenues of

| Table 5.4 Comparison of per capita fiscal capacity before and after fiscal
equalization transfers among the Länder and federal supplementary
equalization grants (BEZ), 1995 |
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the local governments and the financial burdens associated with harbors.94 One critic suggests that the complaint by the south German Länder is analogous to the millionaire who, after taking all of his numerous tax deductions, gives his taxable income as the standard for his wealth.95

Another powerful argument is that expenditures for public assistance, which is provided to those whose unemployment insurance payments have expired or to those who do not qualify for unemployment compensation, vary significantly among the Länder. Most public assistance is paid by local governments from their share of funds distributed by the Länder. Differences among the Länder are not due to profligate spending habits but rather are based on federal law, which the municipalities must implement. These expenditures amount to as much as 20 percent of the fiscal capacity of Bremen and 14 percent of the Saarland but to only about 7.5 percent of the fiscal capacity of Baden-Württemberg and Bavaria. A similar case could be made for the financial consequences of implementing other federal laws as well.96

Needless to say, the recipient Länder do not accept the critical analysis of their situation and have rejected the attempt to negotiate a settlement between richer and poorer Länder.97 They argue that the assumption that the poorer Länder are somehow responsible in part for their condition owing to wasteful spending habits, inappropriate economic development policies, or other shortcomings conveniently ignores the reality of fundamental economic factors over which the poorer Länder have virtually no control. For example, the decline of smokestack industries, the shipbuilding crisis, changes in agricultural conditions, or the collapse of whole industries in the eastern Länder have little to do with Land economic policies. In their view federalism in Germany cannot consist merely of competitive elements. Of course the Länder have policies designed to attract business from other Länder and therefore do engage in competitive practices. But this requires fair starting chances, e.g., in infrastructure, that are now provided by the current system of fiscal equalization.98 Some experts argue it is “absurd” to speak of competition among the Länder when the gap between eastern and western Länder is as great as at present. A serious decline in fiscal transfers that would bring about real differences in living conditions could be socially explosive.99

In spite of such arguments, the Kohl government reacted positively to the initiative by the two southern Länder, suggesting that it had warned in the past against too much egalitarian leveling (Nivellierung). On the other hand, a spokesman for the SPD said the initiative was an attack against the new Länder, which receive 87 percent of the funds transferred to the
poorer Länder. Some other Länder accused the southern Länder of attacking the fiscal equalization system for partisan election campaign purposes, while still others rejected the implication that Germany should return to a hodge-podge of separate, little independent states.100

In the summer of 1998 the federal minister of finance proposed a number of potentially far-reaching changes in the system of fiscal equalization.101 He suggested that the responsibilities or tasks of the federation and Länder be redistributed along with the system of vertical financial equalization. The numerous examples of “mixed financing” should be reduced sharply; this could be accomplished by ensuring that each level has its own tax autonomy. This might occur by giving the federation the revenues from the VAT, while the Länder would receive the income and corporation taxes.102 This was a rather remarkable proposal in that it seemed to offer a return to what was once thought to be an unsatisfactory tax distribution scheme that existed before the Finance Reform of 1969. Another alternative offered by the finance minister was to grant the Länder the right to set their own rates for the income and corporation taxes they share with the federation.103

The proposals raised suspicions among some Land finance ministers that one of the goals of the federal minister was really to provide the federation with a greater share of funds. After all, one of the reasons for the introduction of joint taxes in the Finance Reform of 1969 was the idea that the risks of rising and declining revenues from the different taxes would be shared. Thus, the revenues from the VAT are not affected nearly as much by the state of the economy as are the revenues received from income and corporation taxes. It is not surprising, then, that the federation wants to keep the VAT for itself in redistributing the various taxes between the federal and Land levels.104 Another criticism of the reform proposals by the federal government rests on the fear that tax autonomy for the Länder would lead to a competition to set the lowest rates; this would put the new Länder at a strong disadvantage, because they need all the revenue they can get to meet their obligations. Furthermore, the federal government has insisted on more tax conformity in the EU in order to prevent unfair tax competition among the member states. This is a position that seems at odds with the advocacy of more tax autonomy for the Länder.105

These proposals and reactions became major news items in the late 1990s, but they were not new in principle. For many years there has been a discussion of changes that would give the Länder taxing powers, even if this might mean less focus on uniform or equivalent living conditions.106
Some observers, however, suggest that a general financial autonomy would probably not be acceptable, because of the problems that would arise between Länder, particularly in border areas, over tax avoidance schemes. This problem already exists in the EU and is considered a major nuisance. It is for this and other reasons, e.g., the relatively small yield of the taxes that might be raised, that led some critics to argue that such taxes could not pass any cost-benefit test. Owing to these and other problems, it does not seem to be very realistic to advocate a comprehensive tax autonomy for the Länder.107

Another proposal that has been made many times in the past and was repeated by the federal finance minister at the beginning of August 1998 is to give the Länder and local governments the right to decide themselves within certain limits on the taxes they want to raise. More concrete proposals have been to allow them to set assessment rates on the income tax or VAT within a range set by federal law.108 This would avoid dramatic differences among the Länder while making it possible for Land and local politicians to take somewhat more responsibility for taxes. This, it is alleged, would also make the people more aware of the consequences of public spending policies and make the elected officials more cautious in their spending proposals.109 It would also serve to strengthen the role of Land parliaments and to reduce the dependence on the federation for various investments and “mixed financing.”110 Yet another benefit would be a slight reduction of the exaggerated leveling that occurs in the fiscal equalization process.111

The fear has been expressed that more fiscal autonomy and competition might lead to a “race to the bottom” in order to attract investment,112 as has often happened in the United States.113 One reaction to this argument is that there are already differences among the Länder in tax breaks, e.g., the opportunities for major tax deductions for investing in the eastern Länder or different tax assessment rates for the local business tax; or, in the past, one could point to special tax breaks for investing in West Berlin and in the border regions between East and West Germany. These measures seem not to have had a major impact in influencing private investment strategies. Nor does it seem likely that there would be a strong temptation for individual tax payers to change residency from one Land to another, any more than to change residency from one country to another, except perhaps in the cases of the very wealthy.114

A “race to the bottom” in the area of services also seems unlikely in Germany, because of general ethnic and cultural homogeneity and the strong tradition of equality which leads to such constitutional requirements...
as “uniform living conditions” and the highly developed social welfare state. The immediate reaction by many Germans that differences of almost any kind are “unsozial” and therefore really unacceptable is probably an important check on too much Land autonomy. This set of attitudes in the political culture makes it very difficult to believe that most Germans would be comfortable with conditions in the various Länder that differ by more than a small margin from the average. Thus, more competition among the Länder in any serious sense might become as or even more controversial than the status quo. On the other hand, numerous voices, for example, former Prime Minister Kurt Biedenkopf of Saxony, have urged that Germans learn to accept more differences among the Länder in order to strengthen the idea of federalism and ease the pressure to provide uniform living conditions.

All of these arguments, of course, revolve around the issue of “competitive federalism,” which would necessarily lead to a de-emphasis on equivalent living conditions. The FDP made a major point of promoting competitive federalism in a report produced by its Friedrich-Naumann Foundation in the summer of 1998. This may come as no surprise for a classical liberal party, but a special committee associated with the SPD also called for separate taxes and functions for the federal and Land levels. In response to the growing intensity of the discussion about fiscal federalism, the newly elected government of Chancellor Gerhard Schröder agreed on 17 December 1998 with the prime ministers of the sixteen Länder to form a commission to study a reform of the German system of fiscal equalization after the current system elapses in 2005.

This commission came under even more pressure to offer reform proposals after the Federal Constitutional Court decided in November 1999 that in the case brought before it in 1998 by Bavaria, Baden-Württemberg, and Hesse the current system of fiscal equalization had to be changed in its broad principles by the end of 2002 and in its legislative details by the end of 2004. The Court ruled that German legislators and the Bundesrat must decide just what changes should be made, but it indicated that the regular equalization payments may not exceed 95 percent of the average, in contrast to the current 99.5 percent; nor may the recipient Länder end up with a higher rank order in their financial capacity than the provider Länder after all transfers have taken place. While many observers seemed to think that this decision would force the politicians to come up with some creative changes in the system of fiscal equalization and quite possibly encourage a meaningful devolution of powers
to the Länder, a careful analysis of the decision and its implications for change suggested caution and even skepticism that German federalism would look very different after 2005.  

The commission’s deliberations did not lead to a consensus among the Länder, and by the third week in June 2001 it looked as though the sixteen prime ministers would not be able to come to an agreement. But on June 23 Chancellor Schröder stepped in to break the Gordian knot by offering to have the federation pay the price for agreement. The maximum payment the richer Länder make of 80 percent of above-average tax revenues to the equalization fund will be reduced to 72.5 percent, and Länder that enjoy an increase in tax revenues over the previous year will be able to set aside 12.5 percent before it is counted in the amount owed for the fiscal equalization transfer. These changes will cost the federation DM 1.5 billion annually, and they will save the richer Länder between DM 200 and 400 million (102–204 million Euros) annually.

In addition the new Länder will continue to receive heavy subsidies under a new solidarity pact that goes into effect in January 2005 following the expiration of the ten-year pact negotiated in 1993. The federation agreed to pay two-thirds of the DM 306 billion package the East is to receive between 2005 and 2019 in installments that are to be reduced every year after 2009. This means that the payments in the first years will be considerably higher than the current DM 20.6 billion. In 2020 special aid to the East is supposed to cease for good, but the unpopular solidarity surcharge on German tax payers will have to continue until then.

The issue of Länder consolidation

The system of fiscal equalization in Germany has probably produced more uniform living conditions throughout the country than in any other major European state, including unitary states such as Great Britain and France. Even the new Länder, whose per capita income is about half of the average of the old Länder, are able today to provide a level of services and infrastructure that is not significantly lower than in the western Länder. This is the obvious strength of the system. But criticism and dissatisfaction are growing, and the demands for change are strong.

It seems apparent that the major problem in the fiscal equalization system lies in the gap in fiscal capacity between the richer and poorer Länder. With the exception of Lower Saxony, the poorest Länder – Bremen and the Saarland in the West and Berlin and the five new Länder in the
East – are the smallest in population. Hamburg is the exception among the richer western Länder. One of the arguments against more autonomy for the Länder in their present form is that the small and poor Länder are simply in no position to take advantage of greater fiscal autonomy. If they are to continue to offer reasonably uniform or equivalent living conditions, they must have financial support from the federation and/or their richer counterparts. Thus, there is really little prospect of granting the Länder real fiscal autonomy. This is precisely why, according to some German critics, Article 29, para. 1, of the Basic Law says that the Länder “can” be consolidated (before 1976, Article 29 read: “The federal territory is . . . to be newly constituted”) in order to guarantee that they have the size and capacity to carry out their tasks effectively. Some experts who are opposed to the excessive emphasis on egalitarian leveling through increased centralization of tax legislation and fiscal transfers argue that if the Länder were to be given more fiscal autonomy, their populations would soon notice the difference in the ability of the Land government to provide the services they want and would, as a result, be amenable to a consolidation of their Land with a richer neighbor.\textsuperscript{124} A federal system with seven–ten Länder would mean the creation of Länder that would be more autonomous fiscally; would have lower costs \textit{per capita} for numerous services, personnel, and institutions, e.g., ministers, parliaments, and courts; and also be able to provide the equivalent living conditions that the public apparently demands.\textsuperscript{125} A “Europe of the Regions,” in which the EU Commission and Council of Ministers can devolve certain activities according to the subsidiarity principle, also requires fiscally and administratively strong Länder.\textsuperscript{126}

The pro-consolidation case thus presents a persuasive argument which draws on discussions that reach back to the early days of the republic;\textsuperscript{127} on the analogy of comprehensive county and municipal boundary reforms that were carried out in all of the territorial Länder in the late 1960s and early 1970s in the western Länder and took place the new Länder in the the 1990s;\textsuperscript{128} on the results of a comprehensive, highly detailed expert commission report in 1973\textsuperscript{129} on reorganizing Land boundaries; and on a massive scholarly literature that has appeared over the decades.\textsuperscript{130} But Bernhard Vogel, the former prime minister of Rhineland-Palatinate and the current prime minister of Thuringia, noted in 1990 that “now is the time,” and if action to consolidate the Länder does not take place early after unification, it will be far more difficult to act later.\textsuperscript{131}

Unfortunately for the advocates of Land boundary reform, there are also persuasive arguments against their position as well as practical diffi-
cultures of achieving reform. Article 29, para. 1, speaks not only of reorganizing Land boundaries in order to guarantee that they have the size and capacity to carry out their tasks effectively; it also says that in the process due regard shall be given to regional identities, historical and cultural ties, economic expediency, and the requirements of regional and Land planning. Thus, any large scale redrawing of boundaries would inevitably be rejected by large numbers of people who have developed feelings of identity with their Land. Even the people in the former East Germany, who lived in a highly centralized state that eliminated any pretense of being a federation in the early 1950s, apparently preferred creating five new Länder, which had at least some historical basis, to continuing to live in one territory that would have been roughly equivalent in population to North-Rhine Westphalia in the West. A related argument is that smaller Länder are “closer to the people” and perhaps therefore more responsive to the political and cultural wishes of the population. The small states, provinces, and cantons in the United States, Canada, and Switzerland, respectively, are not constantly targeted as obsolete and in need of being consolidated with surrounding neighbors, so why should small Länder in Germany be considered so dysfunctional? Of course, the proponents of reform in Germany would argue, among other things, that the Länder have functions unique to German federalism, i.e., implementing with their local governments most federal legislation with the responsibility of financing most of the expenditures incurred.

Perhaps even more formidable in overcoming the resistance to boundary change are the provisions of the Basic Law. Article 29, para. 2-8, that call for a complicated referendum process. This process begins with a federal law which must be approved by a majority vote in a referendum in all of the Länder whose territory is affected. If a majority in one Land does not approve, it can be overridden by a two-thirds vote in the territory that is directly affected (unless a two-thirds majority of the Land reject the referendum). Based on the American experience with referenda on the consolidation or annexations of local government units, these provisions probably make Land boundary changes unlikely if not impossible. An obvious example already exists in the defeat in May 1966 by voters in Brandenburg of the proposal that was approved by Berliners – at least West Berliners – and all of the major political elites in the two territories to merge the City of Berlin with the surrounding Land of Brandenburg. Again, proponents of reform may argue that this referendum was affected by too many extraneous matters, such as resentment by Easterners against their former capital city and the much richer West Berlin. But others
would suggest that if a fusion of these two obvious candidates cannot pass, there is little hope for other efforts. In any case, there are no current efforts to consolidate any Land territory in any part of Germany.

Conclusion

We have seen that several themes have been prominent in the discussions in Germany about fiscal federalism since the late 1940s. One theme has been the locus of the major taxing powers, i.e., the states, as in the Bismarck Reich, or the national government, as in the Weimar Republic. A system of shared taxes, which was finally adopted officially in the Finance Reform of 1969, seems to be a perfectly reasonable compromise; however, no clear consensus has ever developed over the proper distribution of the tax revenues. A second theme has been the richer vs the poorer Länder. From the period of Allied Occupation to the present time, the poorer Länder have expressed their dissatisfaction with their fiscal status, in spite of very significant transfers of funds to them from both the federation and the richer Länder. This suggests a third theme, which is the fiscal equalization payments made by the more affluent to the less affluent Länder. Tinkering with the amounts and procedures for equalization has been a preoccupation of some public finance experts and politicians over the years, especially from the poorer Länder. And, finally, a theme running throughout the discussion has been the proper relationship between the Länder and the federation.

The highly complex, systematic – and even perfectionist – nature of German fiscal equalization measures that have emerged from these years of controversy and compromise stands in sharp contrast to the far more laissez-faire and ad hoc American practices. Dual federalism in the United States, according to which the federal and state governments operated separately in different functional areas until the “cooperative federalism” of the New Deal, did not lead to the expectation that the states would have to pay for their own programs. Indeed, there are relatively few program areas today in which the federal, state, and/or local governments do not share financing, a practice which in Germany is generally frowned upon and authorized only to a limited extent under Articles 91a and 104 of the Basic Law. We have seen that in Germany the process begins with a vertical equalization that involves the distribution of joint taxes between the federal and Land levels. To ensure more balance in fiscal capacity, the federation distributes 25 percent of the revenues derived from the VAT to bring the financially weaker Länder up to 92 percent of the average per
capita revenues among the Länder. To reduce this gap even further, there is a horizontal transfer of funds from the richer to the poorer Länder, so that the poorer Länder are brought up to 95 percent of average per capita revenues. The federation then steps in to provide even more equity by distributing supplementary grants that raise the fiscal capacity of the poorer Länder to within 99.5 percent of average per capita revenues. The Länder are then required to share their portion of joint tax revenues with their local governments, i.e., counties, cities, towns, and villages. The various municipalities receive these funds in the form of general-purpose formula grants and special-purpose categorical or project grants. The counties receive general-purpose formula grants from the Länder, but an even more important source of income is the transfer of funds to them from the towns and villages that constitute the county. As we have seen on numerous occasions, the basic reason for this elaborate system of finance is the general idea of uniformity or equivalence of living conditions throughout the country, the individual Länder, among the cities, and throughout the counties. A 1998 OECD report raises the question whether this goal of equivalent living conditions has assumed a higher place in the scale of values than economic incentives; others ask whether it has not weakened the autonomy of the Länder and municipalities and served to undermine German federalism. Indeed, some experts have noted over the years that those who believe everything ought to be equal everywhere should be honest enough to admit that they have no interest in a federal organization of the country.

A decision by the Federal Constitutional Court in November 1999 led to some important, but not fundamental, changes in German fiscal federalism that were worked out by a special commission. These changes, beginning in 2005, will come largely at the expense of an already financially strapped federal government and do not deal to the satisfaction of many critics with the issue of “competitive federalism” and more autonomy for the Länder.

Notes

A somewhat different version of this chapter was published in German Studies Review 23, no. 3 (October 2000), pp. 533–555.

1 Zahlen zur wirtschaftlichen Entwicklung der Bundesrepublik Deutschland (Köln: Institut der Deutschen Wirtschaft, 1999), pp. 84, 86, 94, and 150.

Renzsch, *Finanzverfassung*, Ch. II.


Ibid., p. 77.


Renzsch, *Finanzverfassung*, Chs III, IV, V.

Ibid., p. 170.

Ibid., p. 172.

Ibid., pp. 180–182.

Kommission für die Finanzreform (Troeger Kommission), *Gutachten über die Finanzreform in der Bundesrepublik Deutschland* (Stuttgart: Verlag W. Kohlhammer and Deutscher Gemeindeverlag, 1966).


Ibid., p. 208.


Renzsch, *Finanzverfassung*, p. 207.

Ibid., pp. 223–229.

Ibid., pp. 221–223.

Ibid., pp. 231–232.

Ibid., pp. 232–234.

Ibid., pp. 257–259.

Ibid., p. 259.


Very little has been written in English about German public finances. However, an excellent current overview and assessment can be found in Clifford Larsen, “States Federal, Financial, Sovereign and Social: A Critical Inquiry into an Alternative to American Financial Federalism,” *The American Journal of Comparative Law* 47 (Summer 1999), pp. 429–488. Several brief overviews can also be found in Arthur B. Gunlicks, *Local Government in the German*
Financing the federal system


29 For a useful figure showing the distribution of taxes among the federal, Land, and local levels, see Heinz Laufer and Ursula Münch, Das föderative System der Bundesrepublik Deutschland (Bonn: Bundeszentrale für politische Bildung, 1997), p. 160.


32 German cities, towns, and villages receive revenues from rural properties, because they include within their municipal limits virtually the entire land area of the Federal Republic; that is, there is very little unincorporated territory. Legally, then, a German rural county is a territorial corporation (Gebietsverband) that contains the combined area of a number of smaller territorial corporations called cities, towns, and villages (Gemeinden). Larger cities, usually with populations in excess of 100,000, may form city-counties or county-free cities (Stadtkreise or kreisfreie Städte). In the United States, only Virginia has city-county separation on a state-wide basis.

33 Inhester, Kommunaler Finanzausgleich, pp. 93–94.

34 In a long list of selected cities, the assessment rate varied from 600 per cent to 375 percent for the urban property tax and 515 percent to 320 percent for the business profits tax. Hanns Karrenberg and Engelbert Münstermann, “Gemeindefinanzbericht 1998,” Der Städtetag 3 (1998), p. 159.

35 Inhester, Kommunaler Finanzausgleich, p. 95.


39 Ibid., p. 39.
40 Interview with Gisela Färber, German Postgraduate School of Administrative Sciences, 14 July 1999.
43 Huber, “Der Finanzausgleich,” p. 25.
44 BVerfGE 72, 330 (386).
49 Carl, *Bund-Länder-Finanzausgleich*, p. 68.
55 Ibid., pp. 56–61, p. 92.
58 Ibid., pp. 110–111.
brief overview in English, see Gunlicks, “German Federalism after Unification,” pp. 84–88.
62 Theodor Maunz, Grundgesetz-Kommentar, Article 104a, para. 4, Rdnr 43-51.
63 For the amounts of aid available for these programs, see BMF, Finanzbericht 1998, pp. 138.
64 Fischer-Menshausen, Grundgesetz-Kommentar, pp. 914–915, 923, 930.
66 Inhester, Kommunaler Finanzausgleich, p. 164.
68 Ibid., pp. 165–166.
69 Ibid., pp. 166–167.
70 Ibid., p. 183.
71 Ibid., p. 184.
72 Ibid., p. 179.
73 Ibid., p. 187.
74 Ibid., pp. 194–197.
75 Ibid., p. 191.
76 Fischer-Menshausen, Grundgesetz-Kommentar, p. 942.
77 Selmer, “Finanzverfassung im Umbruch,” p. 232; Renzsch, Finanzverfassung und Finanzausgleich, pp. 54–56.
79 See, for example, Frankfurter Allgemeine Zeitung, 10 August 1998, p. 4.
81 Ibid., pp. 46–47 and 651–654, respectively.
82 Horst Zimmermann, “Stärkung der kommunalen Finanzautonomie,” in Die Stärkung der Finanzautonomie im föderativen System der Bundesrepublik Deutschland, pp. 18–19.
84 BVerfGE 72. 398. For a detailed critical analysis of the perfectionism in fiscal equalization, see the report to the finance ministers of Baden-Württemberg and Bavaria by Hans-Wolfgang Arndt, Finanzausgleich und Verfassungsrecht, pp. 12, 36–42.
85 This is a very common complaint in the literature. See, for example, ibid., pp. 25–26; Rolf Peffekoven, “Reform des Länderfinanzausgleichs tut not,” Wirtschaftsdienst, no. II (1998), p. 81; a report by the “Reform Commission on the Social Market Economy” also makes this point: Frankfurter Allgemeine Zeitung, 17 August 1998, p. 10.

86 While the constitutional complaint was not brought officially before the Federal Constitutional Court until the last week of July 1998, these two Länder made public their intention to sue in October 1997. See German Information Center, Deutschland Nachrichten (24 October 1997), p. 2.


90 Not surprisingly, the Federation of Taxpayers in Baden-Württemberg is also critical of the fiscal equalization system. See Bund der Steuerzahler Baden-Württemberg, Der Finanzausgleich oder Der geschürfte Steuerzahler Baden-Württembergs, Finanzwirtschaftliches Institut, 1998.


92 Some experts are not persuaded by these rankings, because they do not reflect accurately enough the real financial situation of the Länder. Bremen, for example, receives large transfers of funds for a variety of “special needs” that Hesse does not have. See Stefan Homburg, “Im Gewirr der Kompetenzen,” Frankfurter Allgemeine Zeitung, 31 October 1998, p. 15.


94 Peffekoven, “Reform des Länderfinanzausgleichs tut not,” p. 81.


98 Ibid., 11 August 1998, p. 13; see also the arguments by Hartmut Perschau that the current system of Länder transfers is not nearly so bad as many critics suggest. “Es geht um Aufholchancen!,” pp. 73–76.

99 Carl, Bund–Länder–Finanzausgleich, p. 25.


101 A discussion among public finance experts concerning the initiative of
Bavaria and Baden-Württemberg was published in July 1998 under the title *Die Reform des Finanzausgleichs – Föderale, ökonomische und verfassungsrechtliche Aspekte, Expertengespräch*, edited by Finanzministerium Baden-Württemberg and Bayerisches Staatsministerium der Finanzen.

102 A similar proposal was made by the chairman of the finance committee of the parliament of Baden-Württemberg, Professor Dieter Puchta. See *Frankfurter Allgemeine Zeitung*, 28 June 1997; see also Homburg, “Im Gewirr,” p. 15.


104 Some experts, however, argue that the income tax revenue is just as stable as the VAT revenues. See Homburg, “Im Gewirr,” p. 15.


106 See, for example, the five proposals suggested by Reinhard Hendler, “Finanzverfassungsreform und Steuergesetzgebungshoheit der Länder,” *Die öffentliche Verwaltung*, no. 7 (April 1993), pp. 292–299.


111 Ibid., p. 44.

112 Ibid., p. 42.


120 *Frankfurter Allgemeine Zeitung*, 12 November 1999, p. 1 and 13 November


124 For example, see Fischer-Menshausen, Grundgesetz-Kommentar, p. 883; Henke, “Möglichkeiten,” p. 651.

125 For a strong argument for various reforms of German federalism, with territorial reform serving as “the key for the protection of German federalism against deformation,” see Uwe Leonardy, “Deutscher Föderalismus jenseits 2000: Reformiert oder deformiert?,” Zeitschrift für Parlamentsfragen 30, no. 1 (February 1999), p. 162.


127 Lower Saxony, North-Rhine Westphalia, and Hesse were created after 1945 by the British and Americans, by consolidating several older territories, and Baden-Württemberg was created by the Germans in the early 1950s by consolidating three former territories.


129 Bundesministerium des Innern, Bericht der Sachverständigenkommission für die Neugliederung des Bundesgebietes, Bonn, 1973 (Bericht der Ernst-Kommission).

130 For a recent comprehensive review of the literature, developments, and need for Länder consolidation, see Klatt, “Länder-Neugliederung,” pp. 137–149.


132 A strong critique of Land boundary reform based on financial considerations can be found in Gisela Färber, “Finanzverfassung,” p. 126.

133 Klatt points out that feelings of identity have much to do with the times. Thus, the artificial Länder created by the Allies after 1945 seem to have become a source of identity for most of their citizens. Klatt, “Länder-Neugliederung,” p. 149. Hans-Wolfgang Arndt, on the other hand, suggests that a strong identity of people with the Länder never developed after the war and that the small Länder have no right to exist indefinitely at the expense of

134 See, for example, Peter Badura, “Die Finanzverfassung im wiedervereinigten Deutschland,” in *Verfassungsrecht im Wandel*, edited by Jörn Ipsen *et al.* (Köln: Carl Heymanns Verlag, 1995), p. 20.


138 Horst Zimmermann, in Der Präsident des Niedersächsischen Landtages (ed.), *Die Stärkung der Finanzautonomie im föderativen System der Bundesrepublik Deutschland* (Hannover, 1995), p. 32.