AN INFORMATION REPORT

# Studies In Comparative Federalism: WEST GERMANY

ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS
Washington, D.C. 20575
JULY 1981

M-128

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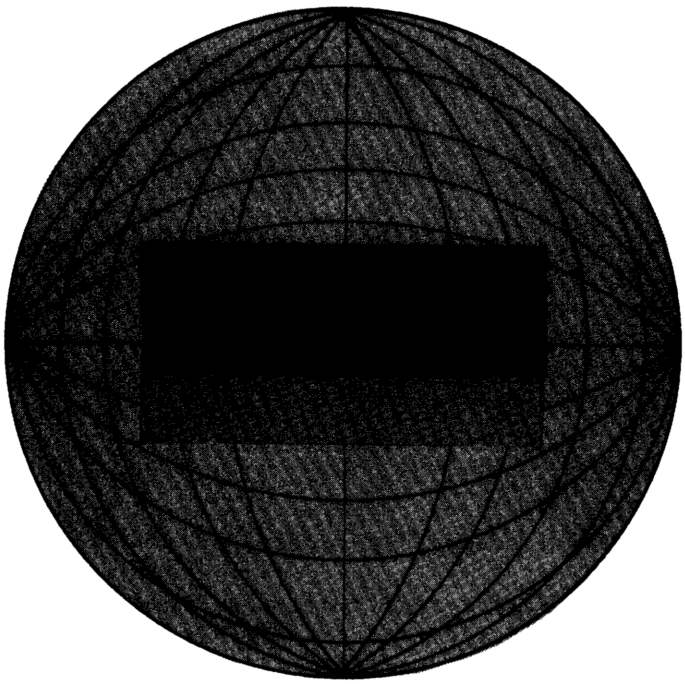


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# Preface

In the *State and Local Fiscal Assistance Amendments of 1976* (P.L. 94–488), Congress asked the Advisory Commission on Intergovernmental Relations to study and evaluate "the allocation and coordination of taxing and spending authorities between levels of government, including a comparison of other federal government systems." The objective of this research is to determine how federal systems in other industrialized nations have dealt with some of the issues of fiscal federalism that are of current concern in the United States.

To carry out this assignment, we have commissioned studies of federal systems in three highly developed industrialized countries with strong national governments: Australia, Canada, and West Germany. In addition, a comparative study of the United States and the three countries has been prepared. Individual country studies were assigned to eminent scholars of fiscal affairs; in this case, the author was a citizen of the country under study.

This analysis of fiscal federalism in West Germany describes a country whose federal constitution is only 30 years old. The West Germany Federal Constitution grants major powers to the states, although there is a tradition of strong national government in the country. The resulting tension has led to interesting new techniques of intergovernmental action such as the "cooperative federalism" described in the study.

Considerable attention is devoted to fiscal equalization in West Germany. The disparities in economic and fiscal capacity among West German states and local governments are relatively minor compared to the situations in the other countries which have been studied, and West German equalization techniques have been successful in alleviating the impact of these disparities.

The study was finished in February 1978, and is therefore based on figures and literature available up to that time. However, there are no indications of any important new trends. In general, the tendency toward more centralization and the reduction of local fiscal autonomy has increased rather than subsided.

**Abraham D. Beame**
**Chairman**

# Acknowledgments

The author of this study is Professor H. Zimmermann of the Philipps-Universität Marburg in West Germany. He specializes in the study of West German and comparative federalism.

John Shannon, assistant director for taxation and finance at the Advisory Commission on Intergovernmental Relations was the general director of the series of studies of comparative federalism. Because there are important variations in the terminology and technical terms used in West Germany and those used in the ACIR's other studies, the staff of the division of taxation and finance edited this study to make it more understandable to the American reader. For those readers familiar with German, the German equivalent phrases for technical terms have been retained in the text. Susannah E. Calkins and L. Richard Gabler edited the manuscript and the tables. Ruthamae Phillips typed the study and the bibliography; Emily Crews typed the tables and prepared the map.

**Wayne F. Anderson**
**Executive Director**

**John Shannon**
**Assistant Director**
**Taxation and Finance**

# Contents

# Tables

## Map, Chart, and Figure

Chapter 1

# The Political Framework of West German Fiscal Federalism: Federal, State, and Local Levels

The existence of more than one level of government within a nation distinguishes a federal system from a unitary (or centralized) system. As all nations beyond some minimum size have some kind of administrative entities on one or more levels other than the central government, the degree of federalism depends on the degree of autonomy given to the subnational levels.

Governmental autonomy cannot, however, be measured easily. In general, it is determined by the extent to which each governmental level is legally authorized to govern. The degree of autonomy is also influenced by the division of functions, expenditures, and revenues among the levels of government. This chapter describes the political organization of the West German federal system and the way in which functions, expenditures, and revenues are divided among the various levels of government.

## AN OUTLINE OF THE LEVELS OF GOVERNMENT

In the Constitution of 1949 several levels of government—states, counties, and communities—were given the right of self-government. Their governing bodies are elected in separate elections and they set their own budgets within given legal restrictions (*Table 1*).

West Germany has 11 states, but there are some major differences in their characteristics.


Population:
61,654,000
Area:
95,985 Sq. Mi.
SCHLESWIG
HOLSTEIN
Kiel
HAMBURG
BREMEN
LOWER SAXONY
Hanover
WEST BERLIN
EAST GERMANY
NORTH RHINE-
WESTPHALIA
Dusseldorf
Bonn
HESSE
Wiesbaden
RHINELAND
Mainz
PALATINATE
SAARLAND
Saarbrüchen
WEST GERMANY
Stuttgart
BADEN-
WÜRTTEMBERG
BAVARIA
Munich

*Table 1*

# POLITICAL SUBDIVISIONS IN WEST GERMANY, 1976

| | Number | Area (square miles) | Population[1] (in thousands) | Density[2] | Public Expenditures (in deutsche marks—DM) Total (in millions)[3] | Per Capita[2] |
|---|---|---|---|---|---|---|
| **West Germany, All Governments** | — | 95,985[4] | 61,645[4] | 642 | 368,613[5] | 5,980 |
| **Federal Government** | — | — | — | — | 170,621[6] | 2,768[6] |
| **States** | 11 | — | — | — | 153,304 | 2,487 |
| ***Area-States*** | | | | | | |
| **Northrhine-Westphalia** | — | 13,149 | 17,130 | 1,303 | 36,481 | 2,130 |
| **Bavaria** | — | 27,238 | 10,810 | 397 | 23,415 | 2,166 |
| **Baden-Württemberg** | — | 13,803 | 9,153 | 663 | 21,669 | 2,367 |
| **Lower Saxony** | — | 18,308 | 7,239 | 395 | 16,868 | 2,330 |
| **Hessia** | — | 8,151 | 5,550 | 681 | 13,805 | 2,487 |
| **Palatinate** | — | 7,658 | 3,666 | 479 | 8,650 | 2,360 |
| **Schleswig-Holstein** | — | 6,053 | 2,582 | 427 | 6,114 | 2,368 |
| **Saarland** | — | 992 | 1,096 | 1,105 | 2,616 | 2,387 |
| ***City-States*** | | | | | | |
| **Hamburg** | — | 291 | 1,717 | 5,900 | 8,724 | 5,081 |
| **Bremen** | — | 156 | 717 | 4,596 | 3,386 | 4,722 |
| **West-Berlin** | — | 185 | 1,985 | 10,730 | 13,661 | 6,882 |
| **Local Governments** | 10,718[7] | — | — | — | 105,783[8] | 1,716 |
| **Under 1,000** | 5,177 | — | 2,363 | — | — | — |
| **1,000–10,000** | 4,487 | — | 14,556 | — | — | — |
| **10,000–100,000** | 986 | 26,129 | 23,146 | 886 | 39,964 | 1,727 |
| **100,000–200,000** | 36 | 1,455 | 4,825 | 3,316 | 11,584 | 2,401 |
| **200,000–500,000** | 20 | 1,324 | 5,737 | 4,333 | 15,122 | 2,636 |
| **500,000 and Over** | 12 | 1,485 | 10,888 | 7,332 | 19,887[9] | 3,074[9] |
| **Counties** | 339[10] | — | — | — | —[11] | —[12] |
| **City-Counties** | 93 | 4,795 | 22,345 | 4,660 | 35,094 | 1,532 |
| **Rural Counties** | 246 | 91,198 | 39,168 | 429 | 56,331 | 1,437 |

[1] Population by residence as of 12/31/75.
[2] Author's calculations.
[3] Actual expenditures include payments to other levels of government.
[4] *Statistisches Jahrbuch deutscher Gemeinden*, 63, 1976, p. 526 ff.
[5] *Finanzbericht,* 1978, p. 230 and 240 ff. State figures differ slightly.
[6] Including Fund for Equalization of Burdens and European Recovery Program Fund.
[7] Figures for 6/30/76. *Statistisches Jahrbuch 1977 für die BRD*, p. 58.
[8] *Statistisches Jahrbuch deutscher Gemeinden*, p. 27.
[9] Excluding the city-states (1976 population: 4,419,000).
[10] *Statistisches Jahrbuch 1977 für die BRD*, p. 48.
[11] Figures for 1974. *Ibid*., p. 393.
[12] Population figures for 1/1/75; DM figures for 1974. *Statistisches Jahrbuch 1975 für die BRD*, p. 54.

Eight are states in the traditional sense and encompass substantial areas; they are sometimes referred to as area-states (*Flächenstaaten*). Hamburg, Bremen, and West Berlin are city-states (*Stadtstaaten*) and consist only of metropolitan areas.[1] West Berlin, in addition, has a special political status and is treated separately for statistical purposes.

These differences among the 11 states must be kept in mind, especially in discussions of fiscal equalization. For example, if Hamburg—the "state" with by far the highest gross domestic product (GDP) per capita (*Table 6*)—hands over part of its tax revenue to other states, this is a transfer among types of jurisdictions. Furthermore, to facilitate statistical comparisons, the city-states (including West Berlin) should be separated from the area-states since, being both cities and states, their revenues and expenditures are the equivalent of those two levels of government.

Because of the special status of the city-states and the fact that many of the larger states have both rural and metropolitan areas within their boundaries, the most frequently used political subdivision for research is probably counties (*Kreise*). Counties are divided into city-counties (*Kreisfreie Stadte*) and rural counties (*Landkreise*). Between the two, there are considerable differences in density and in expenditures (*Table 1*).

At the local level, after extensive consolidation during the past decade, there are now about 10,000 local governments. In *Table 1* they are grouped into five size classes with varying population densities. The table shows the increase in density and per capita expenditures as the size of the community increases.

## THE DIVISION OF FUNCTIONS AND EXPENDITURES

### The Federal Government

Article 30 of the Constitution gives all governmental powers to the states unless the Constitution explicitly provides otherwise. Such a sweeping provision might lead to an erroneous assumption that the federal government in West Germany is extremely weak. This is by no means the case. Indeed, other provisions of the Constitution, as well as events of the past 30 years, have resulted in the federal government of West Germany having greater powers than its U.S. counterpart.

Article 73 of the Constitution lists the functions which belong exclusively to the federal government; they are primarily international or are as clearly national as the right to issue currency. The federal government may also enact laws governing air traffic and federal railways. This gives the federal government a powerful instrument to influence the regional pattern of infrastructure because railways are still heavily used in the densely populated areas of West Germany and private railways are of minimal importance.

The Constitution also enumerates a series of functional areas of joint federal and state interest or *concurrent legislation* where federal legislation may be enacted with state concurrence (*Konkurrierende Gesetzgebung*—Article 74).[2] Included in this category are:

- social welfare policy;
- social security system;
- compensation for war damages;
- atomic energy;
- agricultural assistance;
- higher education;
- conservation of natural resources;
- land distribution;
- regional planning; and
- water resource management.

The federal government has enacted extensive legislation in all these functional areas. In most cases, the states could have vetoed the legislation in the state chamber (*Bundesrat*). However, since the federal initiative usually meant total or partial federal financing, the states accepted the federal legislation.

The federal government has the right to enact *framework legislation* (*Rahmengesetzgebung*—Article 75) for a third group of functions. Framework legislation may not prescribe detailed regulations nor may it be implemented with federal personnel or investments. This category also includes functions of importance to states and local governments.

Although legislation—particularly that relating to regional planning—is potentially influential in determining how and where federal and state agencies allocate their money and legislation (*Bundesraumordnungsgesetz*) has been on the books since 1965, impacts on federal and state agencies have been negligible so far.

A final category of legislation, possibly a unique feature of German fiscal federalism, is called *cooperative federalism* (*Kooperativer Foderalismus*). The 1969 constitutional changes provided that three functions of considerable state-local importance would be taken care of by the federal and state level cooperatively:

- planning for, and construction of facilities for higher education (including university hospitals);
- improvement of regional economic structure; and
- improvement of agriculture and of the seacoast.

The Constitution (Article 91a) also specifies the method of financing these cooperative functions.

In sum, the Constitution gives the federal government considerable power over functions important to the operation of a federal system and to the reduction of economic and state-local fiscal disparities.

Focusing on expenditures—a frequently used measure of the relative importance of functional assignments—some cautions should be noted. For example, when federal functions are listed by expenditures (*Table 2*), regulatory activity is underrepresented: 0.7% of the federal budget for internal security and legal protection does not express the importance of federal lawmaking; nor are foreign affairs (4.4%) necessarily less important than defense (22.5%).[3]

In monetary terms, two functions dominate the federal budget: social security (three items adding to 28.4%) and defense (22.5%). Whereas defense is typically a function of the national government, the major role of federal social expenditures in West Germany is a post-World War II development. Since World War II the federal government has placed increased importance on the reduction of unequal income distribution as a national goal, rejecting the possibility of tolerating state and/or local differences (as in Switzerland).

Other functions make up much smaller proportions of the federal budget, some because the activity is not intrinsically expensive; others, such as roads and housing, because high previous expenditures have reduced the present need.

## The State Level

The constitutional functions of the states are not as easy to enumerate as those of the federal government. Because all functions belong to the state unless the Constitution specifies that they belong to the federal government, the states' functions are (1) those which are not mentioned in the Constitution, and (2) those where only part of a function is allocated to the federal government.

The problems which arise in distinguishing state functions from federal and local functions have a logical explanation. In public finance theory it is easy to find criteria to call one function a typically federal function and another a typically local function. However, in drawing up the West German Constitution of 1949, there were pressures to define state functions as well because the Allied Governments in Germany wished to strengthen the states. The solution lay in promulgating a narrow definition of federal activity and reserving all the other powers for the states.

*Table 2* shows state expenditures for each function. The importance of regulatory activity is again not fully reflected in these figures. A comparison of the functions of states with those of local governments indicates that there are very few functions which are the exclusive province of either the state or the local level. In most cases there is a division of labor within the same function. The reason is that local government powers are derived from specific delegation of powers by the states. In assessing the state functions in terms of expenditures, the interrelationship with the local level should be borne in mind.

Internal security is one area in which state responsibilities have expanded. Over the recent past, the pay of policemen has been transferred from the local and county level to the state level.

Education is by far the largest state expenditure (31.5%). Universities and other institutions of higher education are state functions (and, to a smaller degree, functions of the federal government). Local governments do not support higher education. Elementary and secondary schools are supported by both states and local governments, with states financing payroll costs and local governments financing construction and maintenance. As personnel costs have been rising faster than construction and maintenance costs, state expenditures in this area have been increasing.

States also have responsibility for several other functions. Three items of social welfare (social security, social assistance, and other social affairs) account for about 10% of the states' budget; other functions all are below 5%, with only health, hospitals, and roads coming close to that percentage.

## Local Functions

Local functions are not clearly defined in the Constitution because the states were given the responsibility of delegating powers to their local governments. Article 28 guarantees the existence of communities and entitles them to "manage all affairs of the local community at their own responsibility within existing laws," but does not provide for the assignment to them of specific well defined functions. It is noteworthy that although local governments depend on the individual states for their powers, there is considerable similarity among the states as to the division of functions between state and local government.

Counties (*Kreise*) also have a role in governing West Germany. The Constitution (Article 28) provides that the governing bodies of counties must be elected directly. In the larger cities, county and city are coterminous (*Kreisfreie Stadte*).[4] In the rural counties (*Landkreise*), which are actually associations of communities (*Kommunalverbande*), the counties have a double function—first, acting for the state (*Auftragsangelegenheiten*) and, secondly, performing functions which are typically local but which are beyond the fiscal and administrative capacity of the individual small community. Because the rural counties do not rave any more responsibilities than city counties, this report groups all county activities among local activities and discusses county roles only when there is a particular reason to do so. In *Table 1* and elsewhere, expenditures are shown separately for the counties; to avoid double counting, county expenditures may be added to either state expenditures or local expenditures, but not to both.

Determining the degree of local autonomy or self-government is difficult. Even if a state constitution explicitly gives a specific function to local government, local autonomy can be considerably impaired either by state regulations or by the conditions attached to grants. State legislators have partially acknowledged this fact in their definition of types of local functions. Those with the least degree of autonomy are functions which are carried out to implement state or federal law (*Auftragsangelegenheiten*) and the Constitution provides that local governments are entitled to receive compensation. (The same provision applies to the states when they implement federal laws.) Contrasted to implementation activities are activities which are described in the United States as mandated functions (*Pflichtaufgaben*) because federal and state laws prescribe, often precisely, what the local government must do. However, the function itself is considered purely local and must be paid for from local revenues. The more strict the mandate, the lesser is local autonomy. The second factor influencing local autonomy stems from grants. The more strings attached to the grants, the lesser the degree of local autonomy.

These two influences on local autonomy, while related, are not the same thing. A function can be mandated; but if there are few precise requirements for its implementation, considerable autonomy is left to the local government. On the other hand, acceptance of a "voluntary" grant may severely curtail local autonomy if the strings attached to a grant force the local government to comply with a host of requirements.

Because the delegation of specific functions to local governments is left to the individual states, it would be necessary to work through the constitutions of all eight area-states of the Federal Republic to describe the political division of functions exactly. To avoid this, *Table 2* combines local government expenditures by function and compares such expenditures to the federal and state levels. Because regulatory activity is relatively unimportant at the local level, local expenditures probably serve as a better indicator of the scope of the local services than do expenditures at the state or even

*Table 2*

## FEDERAL, STATE, AND LOCAL EXPENDITURES,[1] BY FUNCTIONS, 1974

(in millions of deutsche marks—DM)

| | Federal Government[2] | | State Governments | | Local Governments | | Total | |
|---|---|---|---|---|---|---|---|---|
| | DM | Percent | DM | Percent | DM | Percent | DM | Percent |
| **General Administration** | 3,955 | 2.9% | 7,484 | 6.8% | 8,058 | 11.9% | 19,497 | 6.2% |
| **Foreign Affairs** | 6,140 | 4.4 | 36 | —[3] | — | — | 6,176 | 2.0 |
| **Defense** | 30,734 | 22.5 | — | — | — | — | 30,734 | 9.8 |
| **Security** | 861 | 0.6 | 6,153 | 5.6 | 2,269 | 3.3 | 9,283 | 3.0 |
| **Legal Protection** | 106 | 0.1 | 4,512 | 4.1 | — | — | 4,618 | 1.5 |
| **Education** | 3,084 | 2.3 | 34,577 | 31.5 | 9,667 | 14.2 | 47,328 | 15.1 |
| **Cultural Affairs** | 93 | 0.1 | 1,467 | 1.3 | 1,789 | 2.6 | 3,349 | 1.1 |
| **Social Security** | 18,785 | 13.8 | 310 | 0.3 | — | — | 19,095 | 6.1 |
| **Social Assistance** | 4,859 | 3.6 | 4,978 | 4.5 | 10,634 | 15.6 | 20,471 | 6.5 |
| **Other Social Affairs** | 15,058 | 11.0 | 5,642 | 5.1 | 1,290 | 1.9 | 21,990 | 7.0 |
| **Hospitals (other than university hospitals)** | 1,112 | 0.8 | 3,858 | 3.5 | 8,473 | 12.5 | 13,443 | 4.3 |
| **Other Health Affairs, Recreation** | 404 | 0.3 | 1,566 | 1.4 | 4,553 | 6.7 | 6,523 | 2.1 |
| **Housing** | 915 | 0.7 | 2,982 | 2.7 | 746 | 1.1 | 4,643 | 1.5 |
| **Sewerage** | 30 | —[3] | 369 | 0.3 | 4,201 | 6.2 | 4,600 | 1.5 |
| **Other Community Services** | 95 | 0.1 | 640 | 0.6 | 4,885 | 7.2 | 5,620 | 1.8 |
| **Roads** | 6,927 | 5.1 | 5,168 | 4.7 | 5,595 | 8.2 | 17,690 | 5.6 |
| **Agriculture, Forests** | 2,225 | 1.6 | 2,315 | 2.1 | 356 | 0.5 | 4,896 | 1.6 |
| **Other** | 41,262 | 30.2 | 27,819 | 25.3 | 5,459 | 8.0 | 74,540 | 23.7 |
| **Total** | 136,645 | 100.0% | 109,876 | 100.0% | 67,975 | 100.0% | 314,496 | 100.0% |

[1] Net expenditures = expenditures without special financing transactions and without grants from other levels of governments.
[2] Including Fund for Equalization of Burdens and European Recovery Program Fund.
[3] Less than 0.05%.

SOURCE: *Finanzbericht 1978*, p. 225 ff., preliminary results.

the federal level where regulatory activity is relatively much more extensive.

The main functions at the local level in West Germany are health (19.2%) social policies (17.5%), and education (14.2%). In all three fields states and the federal government also have a significant role. In recent times the federal government has started to finance the major part of the costs of hospital construction. Although welfare law is federal law (*Bundessozialhilfegesetz*), most of the money comes from the local budget and such expenditures have been increasingly important in local budgets in recent years. With the economic slowdown since 1974 and rising minimum welfare standards, the number of welfare recipients and the amount per recipient have increased considerably. In education, localities finance only the costs of buildings and their maintenance; decisions on how to run the schools in terms of curriculum and hiring of teachers are state decisions.

Other typical local functions—such as sanitation, sewerage, and other community services—make up 13.4% of local budgets with state financing. Road construction and maintenance (8.2%) is another major item in local budgets, but much of the funding for this function has begun to come from the federal government. It is difficult to determine how much of the expenditure for local roads is financed directly from the state and federal government because many streets in the city area are state roads or even federal roads crossing the city.

Delegation of functions to local governments is an expression of decentralization and adjustment to regional preferences and thus of the degree of federalism. At the same time, delegated functions provide the potential for regional disparities. Because of disparities in fiscal resources and differences in local political objectives, service levels vary from one community to another. This leads to variations in per capita expenditures and to variations in the per capita stock of public goods. While all functions carried out by upper level governments have a potential for implicit fiscal equalization, functions carried out by local governments may require explicit fiscal equalization if unacceptable regional or individual disparities result.

## THE VERTICAL DISTRIBUTION OF REVENUES

### Types of Revenues

To the extent that government autonomy depends on access to varied revenue sources, it is necessary to note the distribution of revenues among governmental sectors. Decisions concerning some types of revenues are almost totally left to the discretion of individual governments—e.g., borrowing in West Germany. Most West German taxes are either fixed in type or by the proportion to which each level is entitled by the Constitution or by agreement. Still others (such as the grants received by local governments) depend on decisions made by states or the federal government. *Table 3* shows the allocation of the types of revenues to the three levels of government.

Federal, state, and local levels in West Germany depend to different degrees on tax revenue. Taxes finance 86.5% of the federal budget, but only 30.4% of the average local budget. However, local governments receive 28.7% of their budget in grants and transfers, while the federal government receives only 1.5%. Local governments draw relatively more revenue from fees and from government enterprises. Net borrowing used to be almost equally important at all three levels, but this picture changed during the 1975 recession because the federal government heavily increased its net borrowing in the process of deficit spending.

### The Vertical Distribution of Taxes

Taxes are the major source of government revenue in West Germany and account for 74.8% of the revenues of all levels of government. Article 106 of the Constitution spells out which tax revenues belong to which level of government. *Table 4* shows the major taxes (1) by receiving government unit, and (2) by type of tax.

The federal government has exclusive use of excise taxes—like the tax on oil, on tobacco, on alcohol—as well as a few other taxes. With the exception of the tax on oil, the yield of these taxes has increased far less than the average of all taxes over the years. The states have exclusive title to only a few taxes (which provide

*Table 3*

**MAJOR REVENUES,[1] BY LEVELS OF GOVERNMENT, 1974**

(in millions of deutsche marks—DM)

| | Federal | | State | | Local | | Total | |
|---|---|---|---|---|---|---|---|---|
| | DM | Percent | DM | Percent | DM | Percent | DM | Percent |
| **Current Revenues** | | | | | | | | |
| **Taxes** | 120,712 | 86.5% | 86,603 | 64.6% | 29,544 | 30.4% | 236,859 | 74.8% |
| **Economic Enterprises** | 895 | 0.6 | 3,494 | 2.6 | 4,775 | 4.9 | 9,164 | 2.9 |
| **Grants, Transfers[2]** | 2,154 | 1.5 | 18,103 | 13.5 | 27,881 | 28.7 | 48,138 | 15.2 |
| **Fees** | 544 | 0.4 | 5,858 | 4.4 | 17,543 | 18.1 | 23,945 | 7.6 |
| **Capital Revenues[2]** | 3,293 | 2.4 | 11,067 | 8.3 | 13,618 | 14.0 | 7,591 | 2.4 |
| **Net Borrowing** | 9,049 | 6.5 | 7,737 | 5.8 | 6,023 | 6.2 | 22,809 | 7.2 |

[1] Individual level of government sums do not add to 100%.
[2] Contains double-counting through transfers from other governmental units.
SOURCE: *Statistisches Jahrbuch 1977 für die BRD*, p. 390 ff. (Version a).

*Table 4*

## TAX RECEIPTS, BY LEVELS OF GOVERNMENT,[1] 1978

(in millions of deutsche marks—DM)

| Receiving Unit and Type of Tax | Federal | | State | | Local | | Total Tax Receipts | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | DM | Percent | DM | Percent | DM | Percent | DM | Percent | Increase[2] 1973–78 | Elasticity to GNP[3] |
| **Shared Taxes** | 115,119 | 75.0% | 97,087 | 88.0% | 33,794 | 76.8% | 246,000 | 77.4% | 47% | — |
| **Income Tax** | 57,809 | 37.7 | 57,809 | 52.4 | 18,822 | 42.8 | 134,440 | 42.3 | 53 | 1.78[4] |
| **Corporate Profits Tax** | 10,265 | 6.7 | 10,265 | 9.3 | — | — | 20,530 | 6.5 | 59 | 0.79 |
| **Net Valued Added Tax** | 42,716 | 27.8 | 24,684 | 22.4 | — | — | 67,400 | 21.2 | 36 | 0.97 |
| **Business Tax** | 4,329 | 2.8 | 4,329 | 3.9 | 14,972 | 34.0 | 23,630 | 7.4 | 33 | 1.13 |
| **Federal Taxes** | 38,369 | 25.0 | — | — | — | — | 38,369 | 12.1 | 9 | — |
| **Oil Tax** | 19,700 | 12.8 | — | — | — | — | 19,700 | 6.2 | 15 | 1.34 |
| **Tobacco Tax** | 10,500 | 6.8 | — | — | — | — | 10,500 | 3.3 | 16 | 0.70 |
| **Alcohol Tax** | 3,700 | 2.4 | — | — | — | — | 3,700 | 1.2 | 17 | 0.54 |
| **Other** | 4,469 | 2.9 | — | — | — | — | 4,469 | 1.4 | −31 | — |
| **State Taxes** | — | — | 13,201 | 12.0 | — | — | 13,201 | 4.2 | 15 | — |
| **Property Tax** | — | — | 3,200 | 2.9 | — | — | 3,200 | 1.0 | −2 | 1.49 |
| **Automobile Use Tax** | — | — | 6,100 | 5.5 | — | — | 6,100 | 1.9 | 22 | 1.29 |
| **Beer Tax** | — | — | 1,310 | 1.2 | — | — | 1,310 | 0.4 | 3 | 0.76 |
| **Other** | — | — | 2,591 | 2.3 | — | — | 2,591 | 0.8 | 30 | — |
| **Local Taxes** | — | — | — | — | 10,180 | 23.1 | 10,180 | 3.2 | 48 | — |
| **Real Estate Tax** | — | — | — | — | 5,400 | 12.3 | 5,400 | 1.7 | 68 | 0.53 |
| **Payroll Tax** | — | — | — | — | 3,550 | 8.1 | 3,550 | 1.1 | 40 | 1.04 |
| **Other** | — | — | — | — | 1,230 | 2.8 | 1,230 | 0.4 | 10 | — |
| **Other Receipts[5]** | — | — | — | — | — | — | 10,150 | 3.2 | 193 | — |
| **Total Tax Receipts** | 153,488 | 100.0% | 110,288 | 100.0% | 43,974 | 100.0% | 317,900 | 100.0% | 41% | 1.02 |

[1] Estimate.
[2] Reflects elasticity as to GNP, but also changes in the tax laws.
[3] 1950–1973.
[4] Wage tax.
[5] Customs duties and share of net value added tax given to the European Economic Communities; "tax" collected by Fund for Equalization of Burdens.

SOURCES: Adapted from *Finanzbericht 1978*, pp. 180–183.
Elasticity: B. Rurup, WISU-Studienblatt, *Das Wirtschaftsstudium*, 5, (8) 1976.

*Table 5*

**TAX SHARING IN WEST GERMANY, 1978**

| | Percent of Total Tax | | | |
|---|---|---|---|---|
| | **Federal** | **State** | **Local** | **All Levels** |
| **Income Tax** | 43% | 43% | 14% | 100% |
| **Corporation Profits Tax**[1] | 50 | 50 | — | 100 |
| **Net Value Added Tax**[2] | 67.5 | 32.5 | — | 100 |
| **Business Tax**[3] | 20 | 20 | 60 | 100 |

[1] Includes withholdings on capital earnings.
[2] Percentages open to periodic negotiation.
[3] Percentages shown are average values, from which actual figures may deviate slightly; not including payroll tax.

SOURCES:

| | |
|---|---|
| Constitution: | Article 106. |
| Income Tax: | *Gemeindefinanzreformgesetz*, 9/8/69. |
| Net Value Added Tax: | *Fünftes Gesetz zur Änderung des Gesetzes über den Finanzausgleich zwischen Bund und Ländern*, Bundesratsdrucksache, 399/77, 9/2/77. |
| Business Tax: | *Gemeindesfinanzreformgesetz*, 9/8/69. |

12% of total state tax revenue). These taxes are the property tax, the tax on automobile use, the tax on beer, and a few others. At the local level there are only two "exclusive" taxes of any importance: the real estate tax and the payroll tax. The latter is tied in some technical aspects to the business tax and was scheduled to be abolished in 1980. Each of these taxes belongs exclusively to one level of government; taken together, they make up 19.5% of total tax revenues in the Federal Republic for 1978.

In 1978, the vast majority of tax revenue (77.4%) came from shared taxes, used by two or three levels of government. This extensive system of tax sharing was introduced in 1969. The tax-sharing system is important because it was developed as a way of giving each level of government an appropriate share of tax revenue and as an instrument to reduce disparities (*Chapter 3*).

## The Tax-Sharing System

*Table 5* shows the specific taxes shared and the proportion which goes to each level of government. Among the taxes included are some of the "modern" taxes like the personal income tax and the net value added tax. The "corporation profits tax" was included because its rate structure closely parallels that of the personal income tax. The business tax became part of the tax-sharing system because, as the major local tax source before 1969, it had not only encouraged procyclical spending at the local level but had also led to great disparities in local revenue.

Because these taxes are highly elastic, some argue that they should be used only by the federal level of government which is responsible for business cycle policy. On the other hand, the sharing of the revenues from these tax sources spreads the burden of cyclical revenue variations among the several levels of government. The 1969 reform still may be criticized because the major tax source given to local governments was 60% of the procyclical business tax. (The only other tax shared by local governments is 14% of the income tax.) It would have been better to give local governments part of the net value added tax or a larger share of the income tax, with an offsetting reduction of its share in the business tax.

Tax sharing has several advantages. A high proportion of shared taxes in the tax system means that each level of government has an interest in a variety of tax sources. Hence, the decision on how a particular tax and a large segment of the total tax system is to be developed can be made in terms of a national—i.e., federal, state, and local—tax system. The fight for enough tax revenue then is not so much for or against a specific tax source, but over the percentages which each level of government receives. Negotiations over percentage shares are limited too by the Constitution which prescribes fixed shares of the income tax and the corporation profits tax. The share of the net value added tax is agreed upon annually. In 1978, the federal share was 67.5%, the state share 32.5%.

Tax sharing also gives each level of government a fixed share of national tax revenue for a specified time period, thus providing greater certainty about the amount of revenues. Although each shared tax responds differently to changes in the economy, these differences may be less in the total than in the particulars of all shared taxes.

One of the disadvantages of the tax-sharing system lies in the decreasing amount of state and local government control over revenues. If state-local fiscal autonomy consists of more than the determination of expenditures, then tax sharing should be a major issue in the discussion about the desired degree of fiscal federalism. At present, individual states and local governments have no power to alter tax rates to provide for special government needs. If a metropolitan government is more "expensive" in terms of budgetary costs, and the private sector can bear that cost because it is offset by high productivity, that government should have the authority to levy additional taxes. From the standpoint of the federal government, offsetting such costs through grants involves unnecessary subsidies to the state or local government. State-local authority to levy additional taxes is quite compatible with the tax-sharing system. It can take the form of limited or unlimited variation of state or local rates or of "piggybacking" (i.e., allowing a state or local government to introduce a separate tax on the same tax base, using the legal construction of the existing tax). At present, local governments have limited authority to vary rates for the business tax (and the payroll tax) and the real estate tax. The Constitution also provides for introducing such variations for the local share of the income tax.

## 1949 AND 1969 AS MAJOR EVENTS IN THE HISTORY OF FISCAL FEDERALISM IN WEST GERMANY

### The Constitution of 1949

In the Constitution of 1949 most of the public functions (the collection and spending of funds) were described and assigned to one or two levels of government. These definitions were bound to lead to some problems in future years.

It is possible that a strict division of functions, expenditures, and revenues by level of government could have avoided these problems. Yet, specification can lead to its own set of problems because in a modern federal system nobody knows what particular assignment of functions would be appropriate ten years later. Because of concern in 1949 about the possibility of excessive government disparities in a decentralized system, functions were very often not given to one level exclusively but instead divided up by "type of competence."[5] Framework legislation (by which the federal government sets the goals but leaves implementation, financing, and personnel to the lower level of government) is a typical way of dividing responsibility for the same function.

The gradual tendency toward more nationwide rulings leads step-by-step toward more centralized decisions. If the Constitution of 1949 intended to safeguard the lower-level governments against intrusion by upper-level government, it would have been wiser to provide for a more distinct separation of functions. When a function is given to one level exclusively, a change in power from one level to the other is more clearly visible. However, exclusive assignment of functions does not avoid agreements between two levels of government to share a function, as in the "cooperative federalism" of West Germany.

Taking the three elements—functions, expenditures, revenues—together, the Constitution of 1949 tried to strike a balance between establishing a clearly federal system on the one hand and trying to integrate the elements of that federal system on the other hand.

### The Reform of 1969

The following 20 years showed that there was little tendency toward more decentralization of functions (or elements of functions) than had been prescribed by the Constitution. However, the relations between the federal and state levels set forth by the Constitution proved inadequate for day-to-day operations. The constitutional provisions for intergovernmental relations—exclusive, concurrent, and framework legislation—did not make any provision for direct cooperation. The governments solved the problems by entering into agreements (described in *Chapter 6*).

When the Commission on Fiscal Reform prepared its 1966 report,[6] it was confronted with so much empirical evidence on cooperative action that even without its preference for "cooperative federalism" it would have had to deal with this issue and find some solution.

One possible approach would have been to nullify the cooperative agreements and enforce a clear division of functions. The commission did not, however, feel that the cooperative agreements had resulted in significant impairment of the powers of local governments. In addition, cooperative agreements played an important role in moving toward the nationwide uniformity which is desirable in a highly industrialized society. Therefore, the commission proposed that the Constitution make provision for cooperatively performed functions and that this enabling clause be implemented by future legislation.

The revised 1969 constitutional provision was not general; instead, the Constitution enumerated three functions which *must be* performed cooperatively (Article 91a) and two further functions which *could be* performed cooperatively (Article 91b). Federal-local relationships were defined in general terms which have been spelled out by current legislation. The final version limited the degree of cooperative federalism more than the general clause proposed by the Commission on Fiscal Reform.

In the field of revenues, the commission proposed an even wider degree of tax sharing than was finally adopted. Thus, on the revenue side, too, the three levels of government were more distinctly defined than the commission had proposed.

In all, the constitutional change of 1969 adjusted the Constitution to reflect both the trends of the preceding 20 years and the situation in 1969, even though it did not completely accept the proposals of the Commission on Fiscal Reform.

## RECENT TRENDS

Since 1969 there has been another major effort to reconsider the need for fiscal reform. In 1977 the *Bundestag* called together the Enquete-Commission on Constitutional Reform. This commission recommended changes in many parts of the Constitution, including some proposals for fiscal reform (Part II, Chapter 12).[7] These reform proposals have not yet been considered by the legislature. The delay in legislative action is not because the proposal is unrealistic, but because of the commission's position that existing constitutional provisions on revenues and expenditures are reasonably adequate for present and future needs.[8]

The commission evaluated several possibilities for revision of functional assignments among levels of government, ranging from a general clause in favor of the federal government (which would reverse the previous constitutional provision that the states are responsible for a function unless the Constitution rules otherwise) to a simple clarification of the division of responsibilities. Enactment of such a clarification might enhance the federal role, especially in the area of concurrent legislation. However, more analysis of the implications of such legislation is necessary before determining the specific need for it.

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### FOOTNOTES

[1] The major difference between area-states and city-states is not in population, since Hamburg has more inhabitants than Saarland and more than 50% of the population of Schleswig-Holstein. In area, however, Hamburg has less than one-third the area of the smallest of the eight area-states (Saarland), but a population density four-and-a-half times that of Saarland (which is by far the most densely populated area-state). Bremen's situation is roughly similar.

[2] Professor Zimmermann calls these "competitive legislation," but concurrent legislation seems a more appropriate translation: ACIR.

[3] On the importance of regulatory vs. fiscal activity in the fulfillment of public functions, see H. Zimmermann, "Die Ausgabenintensitat der öffentlichen Aufgabenerfullung," *Finanzarchiv*, 32, 1973, p. 1 ff; for an English summary see: "The Expenditure Intensity of Public Goal Achievement," *German Economic Review*, 12, 1974, p. 66.

[4] The previously mentioned city-states (*Stadtstaaten*) are city-counties which are at the same time states.

[5] F.W. Scharpf, "Theorie der Politikverflechtung," F.W. Scharpf, B. Reissert, and F. Schnabel, *Politikverflechtung*, Kronberg, 1976, p. 19.

[6] Kommission für die Finanzreform, *Gutachten über die Finanzreform in der Bundesrepublik Deutschland*, Stuttgart, 1966.
[7] Enquete-Kommission Verfassungsreform des Deutschen Bundestages, *Beratungen und Empfehlungen zur Verfassungsersreform*, Part II, *Bund und Länder*, Bonn, 1977.
[8] *Ibid.*, p. 37.

*Chapter 2*

# Regional Disparities at the State and Local Levels

## REGIONAL DISPARITIES

A federal system can be put to considerable stress if there are severe subnational disparities at the state and local level. If subnational governments have widely different economic resources or different cultural backgrounds (as in Canada), then the need to find ways to blunt these heterogeneous elements is heightened. In spite of the brief history of West German federalism, regional differences are relatively small and national unity is very strong.

This chapter examines the economic and fiscal disparities among West Germany's states and cities. It also describes how federal and state policies concerning regional economic development, social security, and taxation have directly or indirectly impacted upon economic and fiscal disparities.

Economic and fiscal disparities are not necessarily identical. Local fiscal pressure, for example, can exist in areas of economic affluence if other levels of government withdraw revenues or if the locality is prohibited from drawing on the regional economic base. To a degree this is true in West Germany in rural areas because agriculture is taxed far below its economic contribution to the GDP.[1]

Differences between economic and fiscal well-being, however, are the exception rather than the rule. The uniformity of both tax and expenditure patterns of state and local governments suggests that economic and fiscal disparities are highly related. Therefore, the analysis that follows examines state and local economic disparities in order to explain the fiscal disparities.

Disparities among governments are probably best interpreted in the form of per capita differences. An exception may be some expenditure categories (like streets and mass transportation systems), where expenditures depend heavily on the geographic size of the area. The degree of all disparities depends on the size of the areas which are compared. Since extremes of wealth and poverty exist in small clusters, disparities among small governments tend to be greater than disparities among either large local governments or states.

It should be noted that economic disparities, in and of themselves, are not a reason for equalization. The notion of "disparity" does not imply the need for equalization; the need can only be established through a political goal. The economic disparities are therefore briefly discussed under the goals of regional policy in West Germany, and fiscal disparities are dealt with in *Chapter 3* under the goals of fiscal equalization.

## ECONOMIC DISPARITIES

### The State Level

*Table 6* lists significant fiscal and economic characteristics of the West German states with ranking based on the revenue-raising ability of the individual states. The three "city-states" are shown separately because, as earlier indicated, they cannot be directly compared to even the smallest "area-state."

Revenue-raising ability is measured by a variable called "tax potential" (*Steuerkraft*). This figure, which is commonly used in West Germany, is calculated by adding together the state and local tax bases, multiplied by the average of state and local tax rates. Thus the first column in *Table 6* shows the relative tax potential, irrespective of the tax rates actually applied in the individual states or localities. This statistic is similar in concept to American measures of property valuation per capita, where assessed value is divided by an assessment-sales price ratio to compute true property valuation per capita.[2]

The differences among the area-states in standard tax potential of local and state taxes in West Germany are small. They range from the high of 1,943 deutsche marks (DM) per capita to the low of 1,568 DM per capita—a ratio of 1.24 to 1. The reasons for the small variation are twofold: (1) the states are large in terms of population and number of cities so that many internal differences are evened out within one state; and (2) the tax system is practically uniform for all the states.

The remaining differences in tax potential can be explained largely by economic differences. One of the most widely used indicators for the relative economic well-being of local governments in West Germany is the GDP. The second column of *Table 6* shows per capita GDP at the state level. The relative range of 1.26 to 1 is similar to that of the tax potential and the correlation is apparent. The Saarland is a slight exception because it is a small region with a sectoral bias toward coal and steel. If it were joined to the Rhineland-Palatinate to form an area-state comparable to the others, the correlation between GDP and tax potential would be nearly perfect.

Some of the differences in state GDP are explained by the relative share of agriculture (primary activities) in the state economy. With the exception of the Saarland, the three states with the highest GDP have the lowest share of the economy devoted to agriculture, while the four states with the lowest GDP per capita are most reliant on agriculture. The difference cannot be explained by the proportion of the GDP devoted to manufacturing (secondary activities). Nor does there seem to be a clear relationship between the remaining share of tertiary (service-oriented) activities and GDP per capita.

This reflects what has been called the national problem of "overindustrialization."[3] It is thought that developed economies have highly developed tertiary activities, that there is a positive relationship between personal income and the tertiary share of the economy, and that in developed tertiary economies there is a negative relationship between the manufacturing share of the economy and personal income. Among West German states, however, while the three "rich" city-states have a below-

*Table 6*

## ECONOMIC INDICATORS FOR STATES, 1976

(in deutsche marks—DM)

| States | Tax Potential State-Local (DM per capita) | Gross Domestic Product: Total (DM per capita) | Gross Domestic Product: Share of Agriculture (percent) | Gross Domestic Product: Share of Manufacturing (percent) | Gross Earnings Per Employed 1969 (DM per capita) | Unemployment Rate (percent) | Job Openings to Unemployed (percent) |
|---|---|---|---|---|---|---|---|
| **Area-States** | | | | | | | |
| **Baden-Württemberg** | 1,943 | 18,971 | 2.6% | 56% | 11,591 | 3.0% | 36% |
| **Northrhine-Westphalia** | 1,880 | 18,669 | 1.7 | 51 | 12,308 | 4.5 | 21 |
| **Hessie** | 1,870 | 18,954 | 1.9 | 43 | 12,171 | 3.9 | 25 |
| **Bavaria** | 1,692 | 17,836 | 3.2 | 50 | 10,677 | 4.1 | 18 |
| **Schleswig-Holstein** | 1,607 | 15,032 | 6.27 | 39 | 10,945 | 4.4 | 20 |
| **Palatinate** | 1,606 | 17,200 | 3.7 | 54 | 11,086 | 4.2 | 18 |
| **Lower Saxony** | 1,586 | 15,591 | 5.3 | 48 | 10,918 | 4.6 | 18 |
| **Saarland** | 1,568 | 16,402 | 1.3 | 51 | 11,502 | 6.3 | 9 |
| **Range**[1] | (1:1.24) | (1:1.26) | | | (1:1.15) | | |
| **City-States** | | | | | | | |
| **Hamburg** | 2,853 | 31,100 | 0.6 | 38 | 13,309 | 3.6 | 34 |
| **Bremen** | 2,240 | 24,262 | 1.1 | 43 | 12,145 | 5.9 | 19 |
| **West Berlin** | — | 20,939 | 0.2 | 48 | 11,771 | 3.8 | 29 |
| **Federal Government** | 1,817[2] | 18,436 | 2.6 | 50 | 11,660 | 4.1 | 22 |

[1] Range in relative terms: the lowest to the highest number.
[2] Without West Berlin.

SOURCES:

Tax Potential: *Erste Verordnung zur Durchfuhrung des Gesetzes über den Finanzausgeich zwischen Bund und Landern im Ausgleichsjahr 1977*, Bundesratsdrucksache, 425/77, 9/12/77, Appendix 1, lines 13 and 22.

Gross Domestic Product and Unemployment: *Statistisches Jahrbuch 1977 für die BRD*, p. 46, and p. 38 ff.

Gross Earnings: Deutsches Institut fur Wirtschaftsforschung, *DIW-Wochenbericht*, 39 (34), 1972, p. 295.

For Population Basis: Gross Domestic Product from *Table 1* of this study; Gross Earnings Per Capita from Deutsches Institut, *ibid*.

average share of the manufacturing (perhaps due to central functions), the two "rich" area-states have an above-average share. Hence, there is no clear relationship in West Germany between the wealth of a state and its share of manufacturing or, by inference, the share of its economy devoted to tertiary activities.

Gross earnings per person employed show the same pattern as GDP per capita but seem to explain less of the variation. The figure in *Table 6* stands for possible income indicators.[4] Neither of the labor market statistics is revealing: both the unemployment rate and the ratio of job openings to unemployment (indicating the tension or ease of the labor market) vary widely among the states. Only the highest

*Table 7*

## ECONOMIC INDICATORS FOR SELECTED LOCAL GOVERNMENTS

(in deutsche marks—DM)

| By Size Group | Local Tax Potential, 1974 (DM per capita) | Gross Domestic Product: Total 1972 (DM per capita) | Gross Domestic Product: Share of Manufacturing 1972 (percent) | Density 1976 (population/ square mile) | Population 1976 (in thousands) |
|---|---|---|---|---|---|
| **500,000 and Over:** | | | | | |
| **Frankfurt** | 730 | 31,680 | 35% | 2,864 | 631 |
| **Stuttgart** | 718 | 25,700 | 48 | 2,898 | 594 |
| **Düsseldorf** | 710 | 26,100 | 37 | 2,883 | 658 |
| **Duisburg** | 500 | 18,520 | 61 | 2,540 | 587 |
| **Essen** | 460 | 15,850 | 50 | 3,223 | 674 |
| **Dortmund** | 389 | 15,050 | 52 | 2,254 | 628 |
| **Range**[1] | (1:1.88) | (1:2.10) | | (1:1.43) | (1:1.15) |
| **100,000–200,000:** | | | | | |
| **Leverkusen** | 915 | 24,120 | 83 | 2,104 | 165 |
| **Ludwigshafen** | 810 | 28,660 | 79 | 2,203 | 168 |
| **Pforzheim** | 678 | 21,430 | 62 | 1,111 | 108 |
| **Trier** | 384 | 16,730 | 44 | 857 | 100 |
| **Wilhelmshaven** | 372 | 9,820 | 29 | 994 | 103 |
| **Bottrop** | 296 | 8,840 | 62 | 1,160 | 101 |
| **Range**[1] | (1:3.09) | (1:3.24) | | (1:2.57) | (1:1.68) |
| **20,000–50,000:** | | | | | |
| **Rural Counties**[2] | | | | | |
| **Bietigheim-B.** | 862 | 12,030 | 60 | 1,088 | 34 |
| **Schwäbisch-Hall** | 807 | 10,650 | 48 | 313 | 32 |
| **Neu-Isenburg** | 695 | 11,970 | 59 | 1,875 | 35 |
| **St. Wendel** | 265 | 6,960 | 36 | 243 | 28 |
| **Bergkamen** | 243 | 9,860 | 65 | 1,043 | 47 |
| **Osterholz-Sch.** | 203 | 6,430 | 36 | 155 | 23 |
| **Range**[1] | (1:4.25) | (1:1.87) | | (1:12.10) | (1:2.04) |
| **Federal Government** | — | 13,530 | 52 | 247 | 61,513 |

[1] Range in relative terms: the lowest to the highest number.
[2] Comprises more than the city.

SOURCES:
- Local Tax Potential: *Statistisches Jahrbuch Deutscher Gemeinden*, 63, 1976, p. 501 ff.
- Gross Domestic Product: *Das Bruttoinlandsprodukt der kreisfreien Städte und Landkreise 1970 and 1972*, Gemeinschaftsveröffentlichung der Statischen Landesämter, 1975.
- Density: *Statistisches Jahrbuch Deutscher Gemeinden*, 63, 1976, p. 26 ff.
- Population: Figures for 6/30/76, *Statistisches Jahrbuch 1977 für die BRD*, p. 52 ff.
- Federal Republic: Density and Population: *Ibid.*, p. 55.

and lowest unemployment rates correspond as expected to lowest and highest GDP per capita.

With the exception of the labor market data, there are no indicators which bear a direct relation to expenditure needs.[5] Unless it is thought that high GDP per capita goes along with a high need for infrastructure, the expenditure side of the state budget is not reflected in these indicators. Differences in per capita costs which may be caused by differences in age structure, in the proportion of poor people, in the mix of "old industrial" versus "new industrial" sectors, are also not shown in *Table 6*. A few of these "expenditure-intensive" state and local functions are, however, included in the determination of explicit fiscal equalization grants (discussed in *Chapter 3*). To deal fully with expenditure needs, a set of regional social indicators would be needed.

In sum, the differences in economic structure among the states, by themselves, are not a pressing problem. This may be one reason why the rather recent federal system in West Germany has not been confronted with the problem of one or several states wanting to leave the federal system. Nevertheless, these economic differences were considered to be too great under national goals to be left unaddressed.

## Economic Disparities Among Local Governments

### A SAMPLE OF 18 CITIES

In choosing a sample of cities, city size must be considered. A city of a million inhabitants has more functions and usually a more complex economy than a community of 100,000 inhabitants or less. Eighteen cities have been selected for the following discussion. They are first grouped in three size categories and then ranked within each size category by tax potential (*Table 7*). The six cities of less than 50,000 inhabitants are not cities by themselves but are incorporated in rural counties. The standardized figure for "tax potential" refers only to the tax revenue supporting the local budget. It is used to describe the cities in terms of their own fiscal capacities.

Among the cities of more than 500,000 inhabitants, the three with very low tax potential are "old industrial" cities.[6] They are part of the Ruhr Valley region (*Ruhrgebiet*), i.e., the coal and steel area of West Germany. Business taxes are based on profits, and profit levels have grown more slowly in the coal and steel sectors than in the economy as a whole. As a result, the tax base of the old industrial cities has grown very slowly. The three cities with high tax potential all have a lower share of manufacturing in GDP than the three other cities. Though two of the cities are state capitals (Stuttgart and Düsseldorf), this is probably not the main reason for the discrepancy. The third, Frankfurt, has the lowest share in manufacturing but is the banking center of West Germany. Frankfurt exemplifies the economic changes that many desire: it has an extensive tertiary economy and it is less dependent on manufacturing than are other communities. The size of GDP per capita again corresponds clearly with the tax potential while population density does not. The differences in tax potential for the six cities range from a high of 730 DM per capita (Frankfurt) to a low of 389 DM per capita (Dortmund)—a ratio of 1.88 to 1.

For the cities in the 100,000 to 200,000 population category, the relative range in tax potential is much wider—3.09 to 1. In part, this may simply reflect the fact that differences tend to be greater among the smaller jurisdictions. The economic base of both Leverkusen and Ludwigshafen consists largely of one industrial plant which happens to be growing, while the economies of the three less endowed cities in this size category center around declining industries. GDP per capita varies from 24,120 DM per capita (Leverkusen) to 8,840 DM per capita (Bottrop)—a range of 3.24 to 1, corresponding roughly to the range in tax potential (3.09 to 1). The fact that the manufacturing share is very high in the three well-off cities is another sign that wealth—in this case at the local level—possibly depends too much on manufacturing. Population density in cities of this (or even smaller) size tends to be a rather arbitrary measure because a city may be geographically defined more narrowly in one state than in another.

The three cities with low tax potential differ considerably. Trier is the center of a less developed region of West Germany, as is Wilhelmshaven, although the latter is a major port; and Bottrop is another aging industrial city of the Ruhr Valley. Within this size category the need for fiscal equalization becomes more apparent. The cities are large enough so that it is not possible to explain their differences by bad delimitation of administrative borders. Grouping these cities with surrounding areas would not decrease existing differences decisively. There are in West Germany, as there are probably in all industrial nations, small regions with much below-average tax potential.

Cities in the size group of 20,000 to 50,000 inhabitants reveal the greatest degree of disparities—in part due to their relatively small size. While it is more difficult to pick a "representative sample" in this size group, the range in tax potential among those selected is 4.25 to 1. A similar range would probably be reflected in GDP per capita, if this ratio could be calculated for these small cities. (The GDP figures in *Table 7* for these small cities are an average for the whole rural county which includes the city as well as many surrounding communities.) Nevertheless, it is interesting to see that the ratio between high and low in GDP per capita is only about 1.87 to 1, which means that the larger regions (rural counties in this case) are not as divergent as the cities selected from within their boundaries.

The small range in GDP values per county shows that in this smallest size group new borders (or a fiscal equalization process within the county) could reduce the fiscal disparities of the fiscal system. Such a procedure, however, would work directly against one reason for having a federal system (i.e., leaving to local decision what can be dealt with at the local level).

In sum, considering the results for all 18 cities, it is clear that the differences are greatest for the small cities. While this may partly reflect the size difference, there remains some need for fiscal equalization for at least certain local governments. It should be noted that the data analyzed, like that for the states, do not relate to the need for public expenditure. Whether the middle-size industrial cities, such as Leverkusen or Ludwigshafen, have the greatest need because of their expanding industries, or whether the largest cities have the greatest need because of their central place functions, remains an unanswered question.

## LOCAL GOVERNMENTS IN DIFFERENT TYPES OF REGIONS

In interpreting the results for the 18 cities, different types of regions were mentioned—for instance, the Ruhr area or the underdeveloped region surrounding Trier. To further emphasize the differences among regions, *Table 8* shows economic indicators for various regions in Hesse. Tax potential is by far the highest in the central cities, partly due to size. Size differences do not, however, clarify the differences

*Table 8*

### ECONOMIC INDICATORS FOR REGIONS IN HESSE

(in deutsche marks—DM)

| Type of Region | Local Tax Potential 1971 (DM per capita) | Gross Domestic Product: Total 1970 (DM per capita) | Gross Domestic Product: Percent Increase 1961–70 | Earnings per Person Employed 1970 (DM per capita) | Population 1974 (in thousands) |
|---|---|---|---|---|---|
| **Hesse** | 280 | 11,773 | 222% | 10,688 | 5,580 |
| **Metropolitan Areas** | 365 | 15,775 | 226 | 12,109 | 2,591 |
| **Central Cities** | 481 | 23,014 | 218 | 12,893 | 1,009 |
| **Suburban** | 279 | 10,252 | 243 | 10,872 | 1,582 |
| **Intermediate** | 215 | 9,904 | 229 | 9,435 | 702 |
| **Developing** | 178 | 6,974 | 208 | 7,646 | 496 |

SOURCE: R. Pauksztat, *Raumordningspolitische Effekte des kommunalen Finanzausgleichs,* Diss., Marburg, Europäische Hockschulschriften, Vol. 166, Frankfurt, 1977, pp. 49, 72, appendix tables 10 ff. Total gross domestic product per capita was calculated on the basis of 1969 population, p. 91.

among the other types of regions. As one would expect, GDP per capita, as well as tax potential, decreases with distance from the centers of economic activity. Differences in GDP per capita correspond closely to differences in tax potential—a result found when states and communities were compared.[7] If density figures were available, they probably also would correspond closely.

## THE ECONOMIC DISPARITIES AND NATIONAL GOALS

### Regions Affected by the Separation of the Germanies

In West Germany several regions receive preferential treatment as part of regional economic policy. The division of the German territory in 1945 separated Berlin from the main territory and left the regions bordering the German Democratic Republic (East Germany) cut off from their traditional economic partners.

To alleviate the burden of a situation over which these regions have no control, special programs were started soon after the founding of the Federal Republic. While these programs are certainly part of the system of fiscal equalization in West Germany, the reasons for their enactment, as well as their technical features,[8] relate to the special situation of these regions. Such programs are not found in other countries, and thus are not dealt with further in this report.

### Regional Planning Goals

Goals and policies concerning regionalism have several sources in West Germany. There is the long-standing interest in German thought in optimum spatial order, as represented by the scientific work of such individuals as Thunen, Christaller, and Losch.

After World War II, this search for the best spatial order led to enactment of a law in 1965 *(Bundesraumordnungsgesetz)* and to promulgation of a program in 1975 describing the impact of private and public activity in newly defined regions *(Bundesraumordnungsprogramm)*.[9] In this program and its supporting documents,[10] the desirable spatial or regional order is defined according to minimum levels of specific indicators. This demanding and extensive program came to a standstill after the "rediscovery of the budget constraint" in 1975 occurred in West Germany.[11] The approach has the advantage of looking at the complete regional pattern and thus offers a framework for evaluating the impact of both private and public activity (including fiscal equalization) on regions of different structure. Under this set of objectives, the economic disparities per se are a reason for political activity.

Defining the problem in terms of undesirable economic or social indicators, however, is only a first step. If GDP per capita or a measure of educational quality is considered to be too low in one region, then hypotheses about the type of public policy which can change the situation must be developed. Usually it is not known which mix and which level of public (and/or private) activity is needed to achieve the desired change.[12] Increasing public input may not cause a proportionate change in the measures of economic or social well-being. Whether adding more schools and more teachers will raise a low level of education enough to justify the additional public cost has been questioned as much in recent times as the dubious relation between an increasing number of hospitals and the health situation of the population.

If this approach to area planning is continued, then it must be known which of several public activities bring about which desired change. The feeling at the moment is that this program is overambitious and that it may be more useful to concentrate on a few public activities of regional importance, such as public investments in infrastructure and the regional pattern of federal fiscal flows.

### Regional Economic Policy Goals

After World War II, beginning with a program for the border regions adjacent to the German Democratic Republic, a fairly consistent regional economic policy program has been developed. Until recently it was only directed at less developed regions as they were generally defined by low income and high unemployment rates. The program attempted to concentrate development around regional growth centers, and the instruments to bring about regional economic development were mainly subsidies to influence the location of industry and infrastructure.

This program, which since 1969 has been part of the "cooperative federalism" described earlier, is not as direct a means of regional equalization as is area planning. A successful policy of economic development in underdeveloped regions, however, would contribute to regional equalization. More jobs and higher income per capita improve some basic economic and social indicators. Moreover, an increasing local tax base leads to more local expenditure and, hopefully, to improved citizen well-being. All these effects are intended, but not achieved directly, by regional economic policy.

## Aspects of Fiscal Federalism

Area planning as well as regional economic policy assume that some or all regional economic disparities should be equalized to some extent. Such goals can be interpreted as part of either an economic redistribution objective (area planning) or a growth goal (regional economic policy). The success of the regional system can therefore be judged according to how well the goals are achieved.

It can be argued, however, that in order to achieve the optimal allocation of resources, people's preferences must be also considered. This would require leaving a considerable share of decisionmaking, including the right to tax at the local or state level.[13] In a decentralized system some governmental officials may choose a higher level of private activity, others, more public activity (which could be matched by lower or higher levels of taxation). Therefore, high levels of aid may not reflect expenditure need but rather differences in local preferences for public goods and services. A political decision on the degree of federalism in general and its concomitant acceptable economic disparities is a necessary step before equalization mechanisms—fiscal or other—are instituted. A high degree of federalism established as a political goal means that economic and fiscal disparities would not have to be eliminated. Rather, equalization would take place to the extent that is deemed necessary under regional distribution goals. Beyond that limit, the disparities which remain would be acceptable as a possible expression of divergent preferences.

Interest in this issue of federalism had subsided in past years under the influence of redistribution goals. However, the extensive consolidation of cities and counties has apparently left many people with the feeling that local control and diversity have been lessened. It therefore remains to be seen whether this issue becomes a political counterweight to the apparently strong tendency toward equalization in West Germany.

## Policies with Effects on Economic Disparities

The need for direct fiscal equalization is diminished or increased by the regional effects of all other public policies. As many policies have at least some regional effect, they are briefly reviewed in the following section.

### POLICIES AIMING EXPLICITLY AT REGIONAL DISPARITIES

As indicated earlier, in West Germany there are two sets of policies aimed at the reduction of regional disparities: area or regional planning on the one hand and regional economic policy.[14]

Federal regional planning (*Bundesraumordnung*) attempts, by means of statute or by agreements between ministries, to direct a portion of public expenditures into less developed regions. The same is done by the state authorities responsible for regional planning (*Landesplanung*). Since this targeting of public expenditure is not reflected in the budgets of regional planning agencies, there is no existing estimate of the impact of this economic redistribution program. To make an estimate of the impact, one would have to start with the monetary flows of each ministry and then determine the degree to which the regional distribution has changed as a result of regional planning. While such figures do not exist for West Germany, it can be assumed that, in general, the effect has not been great. If the regional planning approach gains political momentum, however, its effect could be much greater than that of all fiscal equalization taken together.

Policies in the fields of transportation, agriculture, and environment also impact upon regional goals. For example, if the federal ministry of transportation decides to reduce the federal railways to major lines connecting only metropolitan areas, this decision has clear implications for both less developed regions and metropolitan areas.

### Regional Impacts of Other Policies

An effective policy of personal income redistribution reduces differences in personal income and thus reduces regional disparities. If high income tax rates and high levels of minimum welfare payments prevail, then part of the difference between rich communities and poor communities would be diminished. In West Germany, figures are not available to measure the influence of social policy on the regional disparities below the state level. At the state level a recent publication shows that the regional effect is unequalizing, "because poorer groups of inhabitants (e.g., old age pensioners and other net social security transfer receivers) are more concentrated in the 'richer' regions which consequently also receive higher transfer payments."[15]

Economic policy to counteract business cycles has been used in Germany in recent years to direct some of the additional expenditures into less developed regions. To some extent this has been successful.[16] It is possible that the degree of regional equalization in the future will vary with the business cycles, if regionally relevant public expenditure is used as a countercyclical instrument.

Housing policy, a major area of concern in West Germany after the destruction of World War II, resulted in major investments in the larger cities because they had been destroyed to a greater degree. Long after that period of reconstruction had ended, however, public policy continued to provide more money per number of houses built in cities above 100,000 inhabitants, compared to communities below 2,000 inhabitants. Also, if regions in and outside metropolitan areas are compared, the number of publicly subsidized apartments per 1,000 families is 50% greater inside than outside metropolitan areas.[17]

A last example concerns defense purchases. In 1960 the flow of defense purchases in relation to population or to people employed in manufacturing was far below average in the less developed regions and far above average in the metropolitan areas. Though this is understandable because factories supplying defense goods usually are concentrated in metropolitan areas, it nevertheless induces a multiplier effect in those regions which are well-off already.[18]

## FISCAL DISPARITIES

Fiscal disparities between regional entities are presumably caused by three sets of factors.

1. They reflect economic disparities because the economic output of a region measured in terms of GDP or personal income is the basis for any type of regional revenue "from own sources," and also for expenditure needs.

Following that, the degree to which economic disparities influence fiscal disparities in turn depends on:

2. The revenue system which the regional level is given by the higher level of government or which, in the absence of a higher level government, it chooses itself; and

3. The expenditure needs of a region which may be caused by regional economic activities (concentration of manufacturing and/or population), but can also be due to specific demographic (large school-age population), political (refugees), geographical (seacoast), or other reasons.

### The State Level

Several fiscal indicators are listed by state in *Table 9*. Before evaluating the state fiscal situation, it is necessary to decide whether only the state budget should be included or whether the combined state and local budgets are the better indicator. In West German fiscal equalization mechanisms between the states, both types of indicators are used; therefore both are included in the table.

In general, the differences in per capita-revenues are much lower between the states (if, as usual, the city-states are left out of the picture) than they are among local governments. One reason was mentioned before; many differ-

*Table 9*

# FISCAL INDICATORS FOR STATES, 1976

(In deutsche marks—DM)

| States | State and Local: Tax Potential | State and Local: Tax Revenue | State Taxes: Total Revenue | State Taxes: Income and CP Tax[1] | Local Taxes: Total Revenue | Local Taxes: Business and PR Tax[2] | Local Taxes: Income Tax | State and Local Debt Outstanding |
|---|---|---|---|---|---|---|---|---|
| | (In deutsche marks per capita) | | | | | | | |
| **Area-States** | | | | | | | | |
| Baden-Württemberg | 1,943 | 2,227 | 1,576 | 955 | 651 | 278 | 271 | 2,166 |
| Northrhine-Westphalia | 1,880 | 2,167 | 1,525 | 916 | 642 | 281 | 271 | 2,156 |
| Hesse | 1,870 | 2,206 | 1,531 | 919 | 675 | 302 | 266 | 3,304 |
| Bavaria | 1,692 | 1,973 | 1,400 | 775 | 573 | 224 | 229 | 1,905 |
| Schleswig-Holstein | 1,607 | 1,822 | 1,312 | 769 | 510 | 166 | 237 | 2,743 |
| Palatinate | 1,606 | 1,830 | 1,295 | 737 | 535 | 208 | 212 | 3,124 |
| Lower Saxony | 1,586 | 1,798 | 1,306 | 692 | 492 | 187 | 208 | 2,877 |
| Saarland | 1,568 | 1,737 | 1,303 | 622 | 434 | 156 | 193 | 3,141 |
| Range[4] | (1:1.24) | (1:1.28) | (1:1.21) | (1:1.54) | (1:1.56) | (1:1.94) | (1:1.40) | (1:1.73) |
| **City-States** | | | | | | | | |
| Hamburg | 2,853 | 3,316 | 22,259 | 1,454 | 1,058 | 549 | 421 | 4,438 |
| Bremen | 2,240 | 2,619 | 1,736 | 1,123 | 883 | 515 | 314 | 4,506 |
| West Berlin | — | 1,676 | 1,134 | 494 | 542 | 279 | 167 | 2,738 |
| **Federal Government** | 1,817[3] | 2,081 | 1,469 | 853 | 612 | 259 | 251 | 2,511 |

[1] Corporation profits tax.
[2] Payroll tax.
[3] Without West Berlin.
[4] Range in relative terms: the lowest to the highest number.

SOURCES:

| | |
|---|---|
| Tax Potential: | *Erste Verordnung zur Durchführung des Gesetzes über den Finanzausgleich zwischen Bund und Ländern im Ausgleichsjahr 1977*, Bundesratsdrucksache, 425/77, September 12, 1977, Appendix 1, lines 13 and 22. |
| State and Local Tax Revenue Totals, and Debt: | *Statistisches Jahrbuch 1977 für die BRD*, p. 46 ff. |
| State Income Tax: | *Erste Verordnung zur Durchführung des Gesetzes über den Finanzausgleich zwischen Bund und Ländern im Ausgleichsjahr 1977*, Bundesratsdrucksache, 425/77, September 12, 1977, Appendix 1, line 3. |
| Local Business and Payroll Tax, and Income Tax: | *Statistisches Jahrbuch 1977 für die BRD*, p. 400 ff. |
| Population: | *Table 1*. |

*Table 10*

## BALANCE OF FEDERAL GOVERNMENT AND SOCIAL SECURITY REVENUES AND EXPENDITURES, BY STATES, 1960–70

| States | State and Local Tax Potential (DM per capita) | Balance of Public Finance Flows (revenues-expenditures)[1] (in millions of deutsche marks—DM) 1960–63 DM | 1960–63 Percent of GDP | 1964–67 DM | 1964–67 Percent of GDP | 1968–70 DM | 1968–70 Percent of GDP |
|---|---|---|---|---|---|---|---|
| **Area States** | | | | | | | |
| Baden-Württemberg | 1,943 | −2,687 | −5.4% | −3,323 | −4.8% | −5,424 | −5.9% |
| Northrhine-Westphalia | 1,880 | −6,477 | −6.2 | −6,267 | −4.6 | −7,935 | −4.5 |
| Hesse | 1,870 | −1,042 | −3.5 | −1,542 | −3.7 | −1,635 | −2.9 |
| Bavaria | 1,692 | +40 | +0.1 | +93 | +0.1 | −1,206 | −1.2 |
| Schleswig-Holstein | 1,607 | +543 | +4.7 | +948 | +6.0 | +1,231 | +6.0 |
| Palatinate | 1,606 | +519 | +3.0 | +581 | +2.3 | +308 | +0.9 |
| Lower Saxony | 1,586 | +551 | +1.5 | +1,749 | +3.7 | +2,063 | +3.4 |
| Saarland | 1,568 | +271 | +4.5 | +637 | +8.4 | +830 | +9.0 |
| Range[2] | (1:1.24) | | | | | | |
| **City-States** | | | | | | | |
| Hamburg | 2,853 | −3,803 | −20.7 | −4,464 | −18.3 | −6,163 | −20.4 |
| Bremen | 2,240 | −408 | −7.2 | −689 | −9.2 | −1,255 | −13.4 |
| West Berlin | — | +143 | +1.0 | +847 | +4.7 | +1,633 | +7.0 |

[1] A (+) indicates the state received more in payments than it contributed; fiscal equalization flows are not included in these figures.
[2] Range in relative terms: the lowest to the highest number.

SOURCE: H. Reichenbach, *Estimates of Länder Trade Balances and Net Balances in Flows of Federal Public Finance in Germany 1960–1970*, Commission of the European Communities, Study Group on the Role of Public Finance in European Economic Integration, unpublished working paper, FPE–26, 11/312/76, Brussels, April 28, 1976, p. 3; state and local tax potential from *Table 6* of this study.

ences between local governments are evened out within the great number of communities of each area-state. Beyond that, *Table 9* reflects some tendencies which are partly determined by the vertical division of taxes (*Chapter 1*).

The business tax is the tax with the widest range among states (1.94 to 1). The income and corporation profits tax share of the state follows (1.54 to 1) and comes close to the income tax share of the local budget (1.40 to 1). The smallest disparity is for total state tax revenue (1.21 to 1). This results from other state taxes, not discussed here, such as the share in net value added tax and the automobile-use tax (*Chapter 1, Table 4*).

If the city-states are counted the same way as the area-states, the differences are much greater. Whereas between the area-states the difference in total state and local tax revenue is 1.28 to 1, the relative range over the ten states (excluding Berlin) increases to 1.91 to 1.

It is remarkable with respect to the economic base discussed earlier (*Table 6*) that none of the taxes runs counter to the economic indicators. The first four states in *Table 6* show the highest GDP per capita and they have the highest tax receipts in total and for each tax component with one exception (*Table 9*).[19] The change in the vertical distribution of taxes (discussed in *Chapter 1*), narrowed the range among the states, and did not lead to counteracting taxes. Such an occurrence would have meant that a poor state would be forced to extract from its low economic base a more than proportionate share of revenues—a process which would hamper rather than enhance its development.

In the last column of *Table 9*, outstanding debt per capita is shown. The figures do not bear a direct relation either to tax revenue or to economic base. Instead, debt per capita depends on past performance in debt policy,

*Table 11*

# FISCAL INDICATORS FOR SELECTED LOCAL GOVERNMENTS, 1975

(in deutsche marks—DM)

| | | Local Tax Revenue | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | | Total | | Business and Payroll Tax | | Income Tax | | Other Taxes | | |
| By Size Group | Local Tax Potential (DM per capita) 1974 | (DM per capita) 1975 | Percent of Local Tax Potential | (DM per capita) 1975 | Percent of Local Tax Revenue 1975 | (DM per capita) 1975 | Percent of Local Tax Revenue 1975 | (DM per capita) 1975 | Percent of Local Tax Revenue 1975 | Debt Outstanding (DM per capita) 1975 |
| **500,000 and Over:** | | | | | | | | | | |
| **Frankfurt** | 730 | 1,509 | 207% | 964 | 64% | 352 | 23% | 193 | 13% | 2,503 |
| **Stuttgart** | 718 | 1,072 | 149 | 553 | 52 | 374 | 35 | 145 | 14 | 1,333 |
| **Düsseldorf** | 710 | 1,040 | 147 | 571 | 55 | 341 | 33 | 128 | 12 | 2,639 |
| **Duisburg** | 500 | 676 | 135 | 331 | 49 | 267 | 39 | 78 | 12 | 1,476 |
| **Essen** | 460 | 706 | 153 | 334 | 47 | 278 | 39 | 94 | 13 | 1,268 |
| **Dortmund** | 389 | 661 | 170 | 313 | 47 | 257 | 39 | 91 | 14 | 1,614 |
| **Range**[1] | (1:1.88) | (1:2.28) | | (1:3.08) | | (1:1.46) | | (1:2.47) | | (1:2.08) |
| **100,000–200,000:** | | | | | | | | | | |
| **Leverkusen** | 915 | 692 | 75 | 290 | 42 | 318 | 46 | 84 | 12 | 1,442 |
| **Ludwigshafen** | 810 | 972 | 120 | 553 | 57 | 288 | 30 | 131 | 13 | 2,888 |
| **Pforzheim** | 678 | 907 | 134 | 482 | 53 | 323 | 36 | 102 | 11 | 1,425 |
| **Trier** | 384 | 559 | 146 | 224 | 40 | 219 | 39 | 116 | 21 | 2,225 |
| **Wilhelmshaven** | 372 | 555 | 149 | 234 | 42 | 230 | 41 | 91 | 16 | 1,809 |
| **Bottrop** | 296 | 471 | 159 | 192 | 41 | 212 | 45 | 67 | 14 | 781 |
| **Range**[1] | (1:3.09) | (1:2.06) | | (1:2.88) | | (1:1.52) | | (1:1.96) | | (1:3.70) |
| **20,000–50,000:** | | | | | | | | | | |
| **Bietigheim-B.** | 862 | 679 | 79 | 399 | 59 | 231 | 34 | 49 | 7 | 1,595 |
| **Schwäbisch-Hall** | 807 | 980 | 121 | 688 | 70 | 231 | 24 | 61 | 6 | 2,409 |
| **Neu-Isenburg** | 695 | 895 | 129 | 437 | 49 | 374 | 42 | 84 | 9 | 522 |
| **St. Wendel** | 265 | 310 | 117 | 96 | 31 | 168 | 54 | 46 | 15 | 943 |
| **Bergkamen** | 243 | 419 | 172 | 202 | 48 | 179 | 43 | 38 | 9 | 741 |
| **Osterholz-Sch.** | 203 | 284 | 140 | 60 | 21 | 189 | 67 | 35 | 12 | 1,142 |
| **Range**[1] | (1:4.25) | (1:3.45) | | (1:11.47) | | (1:2.23) | | (1:2.40) | | (1:4.61) |
| **Federal Government**[2] | — | 659 | — | 303 | 46 | 262 | 40 | 94 | 14 | 1,282[3] |

[1] Range in relative terms: the lowest to the highest number.
[2] Average of communities of 20,000 and more inhabitants.
[3] Communities of 10,000 and more inhabitants.

SOURCE: *Statistisches Jahrbuch Deutscher Gemeinden, 63*, 1976: Local Tax Potential, p. 501 ff.; Total, Business, and Income Tax Revenues, p. 488 ff.; other figures, author's calculations.

which may have led to high debt per capita for two completely different reasons: high expenditure need combined with low-tax base, or high debt servicing capacity due to high tax base.

The results of the European Communities study regarding the states should be noted. Regional and fiscal disparities of the states are defined in terms of national income account elements. Compared with aggregates of data collected from individuals, e.g., gross earnings per employed person (*Table 6*), the results are sensitive to border-crossing activities,[20] and some influences can be *wholly* attributed to border-crossing activities. Whether a state in relation to the federal level has a net "surplus" or "deficit" (big or small)—in terms of taxes, social security and other revenue payments made compared to grants, social security, and other expenditure payments received—certainly influences its economic position.[21]

In this respect there is an overall tendency in German federal-state relations for taxpayers in "rich" states to contribute more in federal revenues than they receive in federal expenditures. In *Table 10*, where the states are again listed by combined state and local tax potential, the first four states show deficits (contribute more in revenues than they receive in payments) in terms of shares in GDP (Bavaria since 1968–70) in the rank order of tax potential. Saarland, as the "poorest" region, also has the highest surplus of expenditures received over taxes paid. This means that a regional redistribution of income has occurred (if tax potential and/or GDP are taken as an income indicator) which advances West German federalism closer to the equalization goal.

## Fiscal Disparities Among Local Governments

In *Table 11* fiscal disparities in the previously used sample of 18 cities are defined in terms of tax revenues per capita. The cities are again listed within each size group by local tax potential.

It can be seen easily that the business tax is the major cause for fiscal disparities among the cities. Within the size group of 500,000 and more population, the ratio of high to low is 3.08 to 1. As these figures have not been altered in the process of fiscal equalization, the figures reflect both differences in tax base and tax effort.

In the table, the business tax is shown together with the payroll tax, whereas the tax potential figures do not include the payroll tax. If a payroll tax exists, the business tax rate is often lower. It is therefore useful to look at both of these taxes on business together. While all cities have a business tax, the payroll tax is clearly of less importance. Only 5.5% of all communities in all size classes levy the payroll tax,[22] and some states, like Bavaria, do not have that tax at all. However, most cities above 50,000 inhabitants have this tax, with its relative importance increasing with city size.[23] Frankfurt, for example, levies a payroll tax at a considerable rate.[24] Thus a judgment as to whether Frankfurt has high business taxes should be made by considering tax bases for both the payroll tax and general business taxes. This is difficult because the payroll tax is not available to each community at its own discretion. It is essentially an "emergency tax" which may only be levied in case of fiscal need and after the state has given its approval.[25]

Among the medium-sized cities, the differences in business and payroll tax revenue per capita are not much lower than among large cities: the ratio of high to low is 2.88 to 1. In the small cities included in the sample, the ratio is much wider: 11.47 to 1. Such cities either may be dominated by one growing industry or may be of a rather rural character.

In all three size classes the differences in income tax per capita are considerably lower. The ratios of high to low are 1.46 to 1 for large cities, 1.52 to 1 for medium-sized cities, and 2.23 to 1 for the smaller cities.

The comparatively small range in income tax per capita is significant since many reform proposals recommend that there be decreased reliance on business and payroll taxes and increased reliance on income tax or on new local sales or net value added taxes. These changes would significantly reduce fiscal disparities at the local level in the same way as the reforms of 1969. The business tax is responsive to changes in the business cycle and this influences fiscal disparities over time. The effect on the local level would also be reduced if local reliance on business taxes were lessened.

Other local taxes,—mainly the real estate tax—also differ widely within each size class but, with the exception of Trier, they make up only a small portion of total revenues.

## FOOTNOTES

[1] This is true not only for local taxes like the real estate tax, but for the national tax system as a whole.

[2] U.S. Department of Commerce, Bureau of the Census, *Census of Governments, 1972, Taxable Property Values and Assessment-Sale Price Ratios*, Vol. 2, U.S. Government Printing Office, Washington, DC, 1972.

[3] For the empirical basis, see G. Fels, K. W. Schatz, and F. Wolter, "Der Zusammenhang zwischen Produktions-struktur und Entwicklungniveau," *Weltwirtschaftliches Archiv*, 106, I, 1971, p. 240 ff.

[4] Income statistics are not well developed in West Germany, especially for the local level. Income figures from national income accounting are discussed below.

[5] In West Germany even the labor market figures indicate federal rather than state or local fiscal need because the initial period of unemployment compensation is financed through a federal institution (*Bundesanstalt für Arbeit)*.

[6] For comparison of old industrial cities in the USA and West Germany, see U.S. House of Representatives Committee on Banking, Finance and Urban Affairs, Subcommittee on the City, H. Zimmermann, *Cushioning the Fiscal Effects of Economic Changes in Cities: West-German and US Federal/State-Local Fiscal Relations*, Washington, DC, U.S. Government Printing Office, Hearings, April 4, 1977, p. 24 ff.; see also *ibid.*, p. 17 ff. for the oral testimony.

[7] Here again, GDP figures for other than city-counties pertain to rural counties and thus tend to show too low per capita figures.

[8] The programs for Berlin are listed in: *Finanzbericht 1978*, Bonn, 1977, p. 1118 ff.; the preferential treatment of the eastern border regions is documented in *Gesetz zur Förderung des Zonenrandgebietes*, August 5, 1971.

[9] Bundesministerium für Raumordnung, Bauwesen und Stadtebau, *Raumordnungsprogramm für die groBraumige Entwicklung des Bundesgebietes* (Bundesraumordnungsprogramm), Schriftenreihe, 06.002, Bonn, 1975.

[10] Additional indicators are found in: Bundesforschungsanstalt für Landeskunde und Raumordnurg, *Daten zum Raumordnungsprogramm*, Bad Godesberg, November 15, 1975.

[11] G. E. Peterson, "Finance," W. Gorham, and N. Glazer, eds., *The Urban Predicament*, Washington, DC, The Urban Institute, 1976, p. 35.

[12] For the methodology see, e.g., D. F. Bradford, R. A. Malt, and W. E. Oates, "The Rising Cost of Local Public Services: Some Evidence and Reflections," *National Tax Journal*, 32, 1969; K. D. Henke, *Offentliche Gesundheitsausgaben und Verteilung*, Part I, Göttingen, 1977.

[13] Assuming satisfactory distribution to be given in order to be able to discuss allocation goals apart from distribution goals.

[14] The author reported on the relation of these two policies to fiscal equalization policy during the International Seminar in Public Economics in Toledo, Spain, in September 1979. The paper will be published as H. Zimmermann, "Fiscal Impact on Regional Disparities: Basic Issues and European Examples," *Fiscal Policy in Regional Economics*, special issue of *Regional Science and Urban Economics*, forthcoming.

[15] D. Biehl, "Germany," Commission of the European Communities, *Report of the Study Group on the Role of Public Finance in European Integration*, Vol. II, Brussels, 1977, p. 100.

[16] See *Abschlussbericht der Bundesregierung über das Erste Konjunkturprogramm und das Zweite Programm für besondere Konjunktur-und Strukturpolitische Massnahmen 1967/68*, Bundestagsdrucksache, V/3630, December 9, 1968.

[17] D. Häring, *Zur Geschichte und Wirkung Staatlicher Interventionen im Wohnungssektor*, Hamburg, 1974, p. 183 ff.

[18] H. Zimmermann, *Öffentliche Ausgaben und Regionale Wirtschaftsentwicklung*, Basel, 1970, Appendix Table A9.

[19] Income tax revenue in Schleswig-Holstein is slightly above that of Bavaria.

[20] See H. Reichenbach, *The Relationship between Gross Domestic Product, Personal Income, Disposable Income and Private Consumption Exemplified by the Case of Germany in 1970*, Commission of the European Communities, Study Group on the Role of Public Finance in European Integration, unpublished working paper, FPE-23,II/67/76-E, Brussels, March 8, 1976, p. 2.

[21] For further information see D. Biehl,"Germany," *ibid.*, p. 99 ff.

[22] H. Pagenkopf, *Kommunalrecht*, 2nd ed., Vol. 2, Köln, 1976, p. 62.

[23] Compare *Statistisches Jahrbuch Deutscher Gemeinden*, 63, 1976, p. 501 ff.

[24] *Ibid.*

[25] H. Pagenkopf, p. 62.

*Chapter 3*

# Fiscal Equalization

## THE SYSTEM OF FISCAL EQUALIZATION

### Equalization and Personal Income Redistribution

The existence of economic and fiscal disparities does not necessarily create a need for an equalization program to offset those disparities. Indeed, the federal system might politically accept wealthy and poor regions with per capita expenditures ranging from far above to far below the "average" fiscal need. Rich governments could be regarded as the growth centers supporting the nation[1] by providing jobs for the people who migrate from the poorer governments. Fiscal disparities then can be accepted and even defended on other than distribution grounds.[2]

The distribution goal in modern high income countries is approached through a combination of taxes and transfers aimed at adjusting personal income at the level of the individual household. A system of fiscal equalization at the subnational government level is an additional way to narrow income differences in real terms. If a high income government gives money to a low income government, the "richer" individuals will have paid their redistributive taxes to the federal budget[3] out of their gross income and then end up receiving fewer public services.

If the demand for fiscal equalization stems from the same source as the demand for personal income redistribution, then the two mechanisms should be judged together as a way to achieve the desired redistribution. If fiscal equalization is demanded for other reasons, the effect on personal redistribution should at least be assessed and then evaluated separately. These comments seem necessary because the objectives of the equalization mechanisms discussed below do not refer explicitly to the goal of personal income redistribution, but rather to seemingly different types of goals—like leveling differences between similar governments in the supply of specific public goods.[4]

In this discussion, it is assumed that fiscal equalization—whether or not it is coordinated with personal redistribution policy—is best understood as some kind of evening out of fiscal disparities by reference to norms for both fiscal need and the degree to which personal income should be equalized.

### THE WILLINGNESS TO EQUALIZE

An expression of the willingness to equalize could be derived from the general attitude toward nationwide regulation. In West Germany, a "cooperative federalism" (*Kooperativer Foderalismus*) has emerged. (*Chapter 1.*) Two levels of government work together on areawide or nationwide policies. Up to a few years ago cooperative federalism existed only between the federal and state levels, but more recently the same relationship has developed between the federal and local levels.

This different approach toward centralization reflects a balance between two historical forces at work in Germany. After World War II, the Allied Governments favored a strong feder- ative element in the Constitution which was willingly accepted as a safeguard against a cen- tral government which had been too powerful in the preceding era. The states gained a strong status of their own. Nevertheless there is a con- sistent desire for a nationwide minimum standard which encourages federal rulings ap- plicable even in state domains (*Chapter 1*). Furthermore, there is often striking uniformity in state rulings and activities, including the choice of equalization mechanisms.

Whether a stronger or weaker tendency toward a decentralized government is better for the future development of a high income country remains to be seen. On one hand, increasing income per capita leaves more and more leeway for equalization.[5] Postwar social policy in the U.S.A. is possibly the best proof. On the other hand, decentralized decision making is better suited to meet the diverse and refined needs of a postindustrial society (i.e., the desire for decentralization may increase as income increases).[6] Some reconciliation of the two tendencies are possible by decentralizing part of the distribution goal. How much of it remains at the federal level depends on the degree to which redistribution is considered a merit good—this time in the sense that fragmented public (not private) action is regarded as reflecting distorted preferences.

Thus the willingness to equalize will probably remain and the equalization mechanisms discussed below will not decline in importance. Whether the process of intergovernmental equalization takes place between states and their local governments, or between the federal government and its state and/or local governments, remains to be seen.

## "Implicit" Equalization

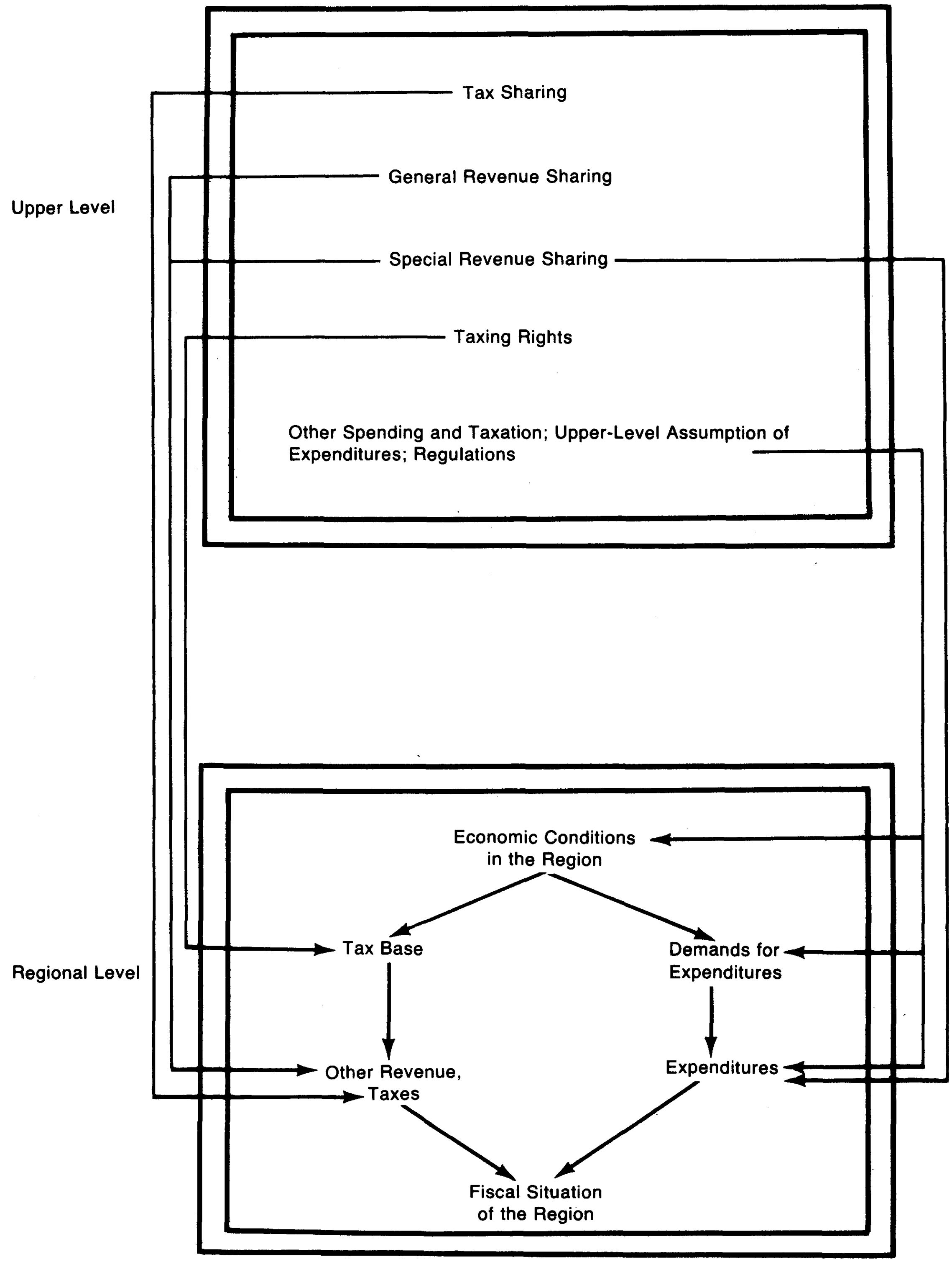
### THE NOTION OF IMPLICIT EQUALIZATION

West German federalism forms the framework for what might be called "explicit" fiscal equalization (i.e., mechanisms like the grants system between state and local governments). The political framework also contains a great number of used and unused changes for "implicit" fiscal equalization. These implicit equalizers, which consist of numerous regulations and mechanisms, reduce the need for explicit equalization.

Because each federal system has its own implicit equalizers, explicit equalization must be described and judged according to the remaining tasks it must perform in its federal system. For this purpose *Chart 1* outlines all of the fiscal influences of an upper-level government on the fiscal situation of a lower-level government. The fiscal situation of a subnational government depends first of all on the internal conditions of the government, shown

*Chart 1*

**UPPER LEVEL FISCAL INFLUENCES ON THE FISCAL SITUATION OF A REGION**



in the lower part of the chart. Economic conditions determine which tax bases are available under a given tax system and which expenditures—either for the infrastructure needs of private enterprises or the social transfer needs of the poor people in the jurisdiction—can be met. The tax and expenditure laws and regulations then determine to what degree the economic condition is reflected in the fiscal situation of the jurisdiction (*Chapter 2*).

Fiscal influences from other governments touch upon every aspect of the internal conditions. The economic condition in a city is influenced, for instance, by federal investments in infrastructure, such as the intercity rail system in West Germany. The assumption of functions relieves lower-level government expenditures. Of course, state and local expenditures are heavily influenced through any form of special transfer from higher levels given for specific programs. On the revenue side, the question of to what degree the economic base of the jurisdiction can be used for taxing purposes depends on the division of taxing rights between levels of governments. After the system of taxes has been established, the question of which revenues are tapped depends on tax-sharing arrangements. Nontax-revenue is influenced by general revenue sharing and by upper-level regulations concerning the size and type of public debt which a lower-level government may incur.

Since the division of taxing rights between levels of government and the system of tax sharing were already dealt with in *Chapter 1*, only the vertical division of functions and the redefinition of government boundaries require discussion at this time. After the establishment of the general fiscal background, the explicit equalization mechanisms at the state and local level are treated extensively.

## FISCAL EQUALIZATION EFFECTS OF THE VERTICAL DIVISION OF FUNCTIONS

The constitutional rules on the division of responsibilities and the actual division of expenditures do not fully explain the fiscal equalization effects of the actual allocation of functions to the individual levels of government. While the expenditures by function show, for instance, that state and local levels both have a big share in educational expenses (*Chapter 1, Table 2*), it is still important to know that the state finances personnel costs and the local government finances construction and maintenance. If it is assumed that existing school buildings can house more or fewer classes (by introducing shifts or leaving some classrooms empty), then the short-term national and regional changes in student population places the main burden of adjustment on the state budget. This shifting of the more sensitive part of the budgetary burden of the education—from the local to the state level—helps promote fiscal equalization.

Although the previous example points to equalization effects, some other developments may increase disparities. The division of functions by the national and state constitutions leaves considerable room for government activities which increase regional disparities in the supply of public services. Especially since the growth rates of GNP and of public revenues have decreased, the fight over the division of total public revenue has increased. The danger here is that short-term needs are most clearly visible in metropolitan regions. As their needs are acknowledged, the less visible needs of nonmetropolitan government can be overlooked. This tendency is furthered by the high number of voters in metropolitan areas who articulate their needs intensely. To the degree that such reactions to short-term need increases fiscal disparities, it increases at the same time the need for explicit fiscal equalization.

Apart from this process, it seems that many functions which have been given to upper-levels of governments contribute to fiscal equalization. The bulk of local functions, at least as far as their financing is concerned, does not leave much room for fiscal disparities. Moreover, the German practice of "cooperative federalism" also leads to more equalization because the three "cooperative functions"—university construction, regional economic policy, and agricultural policy (including seacoast improvements)—are functions with a highly equalizing effect. If, in spite of this implicit equalization, there seems to be a great need for explicit fiscal equalization, then the reason must be more in the distribution of revenue sources than in the distribution of functions.

Among states, the state-local distribution of functions, as measured by expenditures, does not vary substantially (*Table 12*). This is another indicator of tacit nationwide rulings. The Saarland apparently has an exceptional division of functions, but otherwise the division of expenditures between state and local governments varies by only a few percentage points. There are no cases where a major function is provided by the state in one state and by local government in another state.

### THE REDRAWING OF STATE AND LOCAL BOUNDARIES AS AN EQUALIZATION INSTRUMENT

At the outset of the Federal Republic in 1949, it was understood that reasonably drawn state and local boundaries could reduce the need for fiscal equalization among governments and could thus ease the way for a newly created federal system without a long tradition. Since the Constitution gave all power to the states (unless it explicitly gave functions to the federal government), it could not rule on local boundaries. Therefore, constitutional provisions could only pertain to the state boundaries. Article 29, one of the longest articles in the Constitution, stipulates exactly how a new designation of the state boundaries would have to be executed. It should be noted, however, that horizontal fiscal equalization among the states was a concern from the beginning and took its earliest form in the designation of state boundaries. The states themselves may redesig-

*Table 12*

**SHARE OF STATE AND LOCAL GOVERNMENTS IN EXPENDITURES FOR SELECTED FUNCTIONS, BY STATES, 1974**

| States | All Functions | Public Safety and Legal Protection | Schools | Cultural Affairs | Social Affairs | Health, Recreation | Streets, Transportation |
|---|---|---|---|---|---|---|---|
| | | | (in deutsche marks per capita) | | | | |
| **Area-States** | | | | | | | |
| **Baden-Württemburg** | 3,265 | 185 | 510 | 59 | 343 | 429 | 262 |
| **State:Local**[1] | (1.12:1) | (3.49:1) | (1.86:1) | (1.00:1) | (0.59:1) | (0.28:1) | (0.54:1) |
| **Northrhine-Westphalia** | 3,033 | 206 | 570 | 61 | 426 | 261 | 243 |
| **State:Local** | (1.19:1) | (2.93:1) | (1.38:1) | (0.36:1) | (0.42:1) | (0.23:1) | (0.66:1) |
| **Hesse** | 3,402 | 232 | 522 | 61 | 397 | 354 | 267 |
| **State:Local** | (1.14:1) | (2.89:1) | (2.00:1) | (0.55:1) | (0.43:1) | (0.12:1) | (0.54:1) |
| **Bavaria** | 2,861 | 203 | 529 | 56 | 278 | 327 | 259 |
| **State:Local** | (1.16:1) | (2.52:1) | (1.58:1) | (1.18:1) | (0.84:1) | (0.13:1) | (0.67:1) |
| **Schleswig-Holstein** | 2,793 | 213 | 493 | 42 | 341 | 294 | 160 |
| **State:Local** | (1.14:1) | (3.52:1) | (1.65:1) | (0.62:1) | (0.86:1) | (0.29:1) | (0.93:1) |
| **Rhineland-Palatinate** | 2,734 | 184 | 497 | 42 | 312 | 234 | 233 |
| **State:Local** | (1.31:1) | (5.51:1) | (1.96:1) | (0.85:1) | (0.89:1) | (0.32:1) | (0.87:1) |
| **Lower Saxony** | 2,613 | 189 | 535 | 41 | 336 | 286 | 183 |
| **State:Local** | (1.55:1) | (3.25:1) | (1.44:1) | (0.66:1) | (1.07:1) | (0.25:1) | (0.81:1) |
| **Saarland** | 1,858 | 62 | 270 | 41 | 294 | 290 | 192 |
| **State:Local** | (1.00:1) | (1.00:1) | (1.00:1) | (0.41:1) | (0.95:1) | (0.30:1) | (0.74:1) |
| **City-States** | | | | | | | |
| **Hamburg** | 4,205 | 386 | 597 | 66 | 536 | 397 | 305 |
| **Bremen** | 3,841 | 327 | 610 | 83 | 479 | 504 | 133 |
| **West Berlin** | 2,688 | 497 | 437 | 92 | 940 | 588 | 154 |

[1] 1.12:1 reads: for each 112 of state expenditures, local expenditures are 100.
SOURCE: *Taschenbuch der Finanzstatistik für Rheinland-Pfalz, 1976*, Bad Ems, 1976, p. 26 ff.

*Table 13*

**CONSOLIDATION AMONG LOCAL GOVERNMENTS, 1970 AND 1976**

| Local Governments | Number of Governments 1970 | Number of Governments 1976 | Population: Total (in thousands) 1970 | Population: Total (in thousands) 1976 | Population: Average per Government 1970 | Population: Average per Government 1976 |
|---|---|---|---|---|---|---|
| **Communities:** | 22,550 | 10,718 | 61,508 | 61,513 | 2,728 | 5,739 |
| **Under 1,000** | 15,141 | 5,177 | 6,392 | 2,367 | 422 | 456 |
| **1,000–10,000** | 6,627 | 4,487 | 17,722 | 14,556 | 2,674 | 3,244 |
| **10,000–100,000** | 722 | 986 | 17,388 | 23,146 | 24,083 | 23,475 |
| **100,000–500,000** | 49 | 56 | 9,395 | 10,561 | 191,735 | 188,595 |
| **500,000 and Over** | 11 | 12 | 10,611 | 10,888 | 964,636 | 907,317 |
| **Counties:** | 542 | 339 | — | — | — | — |
| **City Counties** | 136 | 93 | 23,466 | 22,345 | 172,544 | 240,269 |
| **Rural Counties** | 406 | 246 | 37,729 | 39,168 | 92,929 | 159,220 |

SOURCES:
Number of Governments, 1970: *Statistisches Jahrbuch 1971 für die BRD,* p. 30.
Communities, 1976: *Statistisches Jahrbuch 1977 für die BRD,* p. 48.
Counties, Jan. 1, 1977: *Ibid.,* p. 48.
Population, 1970: *Statistiches Jahrbuch 1971, op. cit.,* p. 34.
1976: *Statistisches Jahrbuch 1977, op. cit.,* pp. 55, 58.
Average per Government: Author's calculation.

nate the boundaries of local government by their own methods and they do so frequently.

Within states, the number of local governments has been sharply reduced. In 1976 there were less than half as many communities as in 1970 (*Table 13*); a similar development took place at the county level. The equalization effects on the local level may seem insignificant if in each case two average communities formed a new one. However, in many cases, poor and wealthy communities were grouped together so that resources of high and low per capita tax governments tended to even out. This was particularly important under the West German state-local grants system which provides only for grants to needy communities, but not for direct horizontal contributions from rich communities.

Counties also have been combined with other contiguous counties. In the city-county, a city and its county are coterminous, but the rural county (as in the U.S.A.) takes over many functions of its individual communities. If poor and rich counties are grouped together, another equalization effect is induced.

The importance of this procedure for fiscal equalization is probably greater at the local and county levels than at the state level, because the smaller the region the greater the divergences. It is difficult to judge whether more or less fiscal equalization would have resulted in a different assignment of functions than the consolidation process at the county and local level.

In addition to the equalizing aspect, it is possible that the major effect of these consolidations was exerted on the quantity and quality of local and county services and on the capacity for planning. This, as well as the induced equalization, might have been considerably greater if in the metropolitan regions even more consolidation had taken place. Within the metropolitan area, however, the differences between central city and surrounding communities in revenues per capita, as opposed to expenditure needs per capita, are still very large.

## EQUALIZATION OF REVENUES AMONG THE STATES

### The Concept of Horizontal Equalization Mechanisms

The equalization mechanisms designed to decrease fiscal disparities among the states and between communities both have the objective of bringing expenditure need and tax revenues closer together.

Expenditure need could be calculated directly by assessing the "normal" expenditure in a rather precisely specified situation of a state or of a local government. As the report of the Commission of the European Economic Communities shows, this direct calculation of expenditure need is only rarely used.[7] Calculation of such "normal" expenditures would have to take into account the distribution of functions between levels of government because it may, as mentioned before, alleviate the expenditure situation of one governmental entity more than that of another. Moreover, it would be necessary to calculate "admissable" higher per capita expenditure in metropolitan areas, but only so far as it represents higher costs. In general, such a calculation would require a definition of the priorities of the upper-level government and an assumption that the preferences are appropriate for each state or community.

In the West German equalization mechanisms, only a few factors are included which seem to bear a close relation to higher or lower cost in the state or local government. The fact that the calculation of revenues instead of the calculation of expenditures is used to include these factors is unimportant for the equalization effects.

Tax revenue and its relation to tax potential—the second necessary concept to bring out fiscal equalization—has been explained before. The previous tables (*Tables 10 and 11*) for the states and for the selected local governments were built up according to tax potential. However, to discuss fiscal equalization, it is preferable to use all revenues from own sources instead of just tax revenues. In *Table 3* (*Chapter 1*) total revenues were listed by levels of government.[8] The comparison of federal, state, and local levels shows that taxes are a good approximation of total revenues only at the federal level, where taxes support 86.5% of total expenditures. At the other levels of government (besides additional revenues from own sources), the combined categories of transfers received and debt incurred form a considerable share of the budget.

A final task consists of determining the *degree of equalization*—that is, how far differences of expenditure and total revenue potential can and should be equalized so as not to eliminate the incentive to efficient budget and expenditure management at the lower level.

### Equalization Among the States

#### THE HORIZONTAL TRANSFER SYSTEM

Article 107 of the Constitution provides for a system of fiscal equalization among states, consisting of horizontal transfers, as well as some equalization built into tax sharing. The law which spelled out these regulations was passed in 1969 [9] and revised in September 1977.[10]

##### Calculation of Tax Potential

Since the fiscal potential of a state is regarded as the sum of its own fiscal resources plus those of its local jurisdictions, tax potential as well as tax need are calculated for both levels of government and then added; when only the equalization effect is measured, the state budget alone is taken as the reference base.

The calculation of state taxes is straight forward (Article 7 of the law). Actual tax receipts can be used because the states have no right to deviate from the given rates of the shares taxes. (The communities have such a right.) Therefore, the total tax receipts in *Table 9* (*Chapter 2*) is the starting point in *Table 14* for the calculation of horizontal transfers (*line 1*). At this point allowances are made for a few "special burdens," such as major ports and the University of the Saarland. In *Table 14* Lower Saxony has a "special burdens" figure representing its North Sea ports (*line 2*).

The calculation of the local taxes to be included is much more difficult and is not shown in *Table 14*. The extra difficulty stems from the fact that local governments may vary the rates

*Table 14*

**TECHNIQUE OF HORIZONTAL REVENUE EQUALIZATION AMONG THE STATES, 1976[1]**
(in millions of deutsche marks—DM)

| | | Baden-Württemberg | Lower Saxony | All States |
|---|---|---|---|---|
| 1. | State Tax Receipts | 13,631 | 8,953 | 83,371 |
| 2. | −Special Burdens | — | 6 | 179 |
| 3. | State Taxes as Included | 13,631 | 8,947 | 83,192 |
| 4. | +Local Taxes as Included | 2,771 | 1,641 | 16,523 |
| 5. | Tax-Potential Indicator | 16,402 | 10,588 | 99,715 |
| 6. | −Tax-Need Indicator | 15,057 | 11,930 | 99,715 |
| 7. | Surplus (+) or Deficit (−) | +1,345 | −1,342 | ±3,663 |
| 8. | Deficit of 92–100% | — | 954 | 2,933 |
| 9. | Deficit up to 92% | — | 388 | 730 |
| 10. | Surplus of 100–102% | 301 | — | 1,128 |
| 11. | Surplus of 102–110% | 1,044 | — | 2,203 |
| 12. | Surplus Beyond 110% | — | — | 333 |
| 13. | Surplus to be Included | — | — | — |
| 14. | (a) 102–110%: 70% | 731 | — | 1,542 |
| 15. | (b) Beyond 110%: 100% | — | — | 333 |
| 16. | (a) and (b) Together | 731 | — | 1,875 |
| | Receipts | | | |
| 17. | (a) 92–100%: 37.5% | — | +358 | +1,100 |
| 18. | (b) up to 92%: 100% | — | +388 | +730 |
| 19. | (a) and (b) Together | — | +746 | +1,830 |
| 20. | Contributions (97.618820% of "Surplus to be Included"—line 16) | −713 | — | −1,830 |
| 21. | Contributions (−) or Receipts (+) | −713 | +746 | ±1,830 |
| 22. | Population 1976 (1000) | 9,134 | 7,229 | 59,546 |
| 23. | Population Weighted | 9,892 | 7,880 | 66,037 |

[1] Based on tax receipts between October 1, 1975 and September 30, 1976.
SOURCE: *Erste Verordnung zur Durchführung des Gesetzes über den Finanzausgleich zwischen Bund und Ländern im Ausgleichsjahr 1977,* Bundesratsdrucksache, 425/77, p. 8 ff.

of some taxes, and may, or may not, levy a payroll tax.

The taxes to be included consist of (1) the local government's share of the income tax, (2) the real estate tax, and (3) the business tax, as they are enumerated in the Constitution. To even out differences in revenue due to higher or lower local tax rates, tax potential is used. The business tax and the real estate tax on agricultural real estate are calculated by applying one "normal" or standardized rate to the actual tax base. The real estate tax on nonagricultural property is treated differently because, with a higher per capita tax base per locality, the per capita levy rises—with the highest yield being 2.5 times the lowest. This means that the per capita tax potential of a state with a great number of small communities is relatively low, and it therefore tends to receive relatively more in equalization transfers.

The second step involves adding about 50% of this local tax potential to the state tax potential—a compromise between using only the state budget as the indicator for the fiscal situation of the state and, on the other hand, including all local governments. This 50% rule would be easy to apply if the payroll tax did not exist. Since some communities levy payroll taxes and others do not, those levying it would be better off in the equalization process if it were not included at all.[11] Nevertheless, the actual tax receipts of real estate tax, business tax, and payroll tax are all adjusted by the 50% rule.[12] The result is the figure for "local taxes as included" in the equalization process (*Table 14, line 4*). State and local taxes "as included" are used as the indicator for tax potential (*Steuerkraftmeßzahl*) for the states (*line 5*) and the local tax potential. This indicator is then compared with the indicator for tax need.

### Calculation of Tax Need[13]

At this point, one would calculate expenditure need in a direct way if it were possible. Instead, in West Germany average nationwide tax revenue per capita is used as the basic proxy for expenditure need. This seems reasonable because the tax revenue of all states and communities could sustain actual spending—or same amount of money on an average-per capita basis—even though the actual revenue per capita varies from state to state.

At this point adjustments to the basic proxy measure are made to reflect the presence of "special burdens." In local fiscal equalization, many types of burdens are taken into consideration; but at the state level, only two modifications of the average per capita figure are used:

1) A local government population/size adjustment so that:[14]
   - the first 5,000 inhabitants are weighted by 100%;
   - the next 15,000 inhabitants are weighted by 110%;
   - the next 80,000 inhabitants are weighted by 115%;
   - the next 400,000 inhabitants are weighted by 120%;
   - the next 500,000 inhabitants are weighted by 125%; and
   - the next inhabitants are weighted by 130%.

This procedure is to account for the higher per capita cost for larger communities.

2) A population/density adjustment density. For all communities of more than 500,000 inhabitants, the "number of inhabitants" (representing the average tax revenue per capita) is increased:
   - by 2% for those communities with a density of 1,500 to 2,000 inhabitants per square kilometer;
   - by 4% for those communities with a density of 2,000 to 3,000 inhabitants per square kilometer; and
   - by 6% for those communities with a density of more than 3,000 inhabitants per square kilometer.

Without an adjustment for density, there would be an incentive for annexation and consolidation of communities of all sizes. For communities of under 500,000 inhabitants, this incentive still exists. However, if big cities are made bigger through annexation and consolidation, density is likely to be reduced and any additional benefits to be gained in the equalization process may be lost.

Thus, the amount which the federal government gives to each state is dependent on city size and population density; states then make equalization grants to local governments—following the same general principle, but not necessarily using an identical formula. (*See pages 42–47.*)

After these two modifications have been applied, tax-need figures are calculated separately for state taxes, and for the local taxes as far as they are included. Taken together they form the state tax-need indicator (*Table 14, line 6*). Comparing the tax potential indicator (*line 5*) and the tax-need indicator (*line 6*), a state will have either a surplus or a deficit (*line 7*).

## THE ACTUAL EQUALIZATION

The indicators of both need and potential are adjusted tax figured in absolute amounts. Tax potential approximates the figure for actual tax revenues, whereas the tax-need indicator is a normative tax figure. Assuming that the differences were equalized completely: (e.g., if Baden-Württemberg gave its entire surplus to Lower Saxony), Lower Saxony would have no incentive to tap its own tax base, knowing the shortfall would be made up by the equalization process. Therefore, the actual equalization process only aims at a partial reduction of disparities—raising the revenues of states to at least 95% of the average tax revenue of all states. In order to bring about this degree of equalization, the contributions of surplus states and the receipts of the deficit states are calculated separately.

For deficit states, the deficit is stated as a percentage of the tax-need indicator. The objective is to provide the amounts needed to bring such states up to 92% of their tax-need indicator. Full supplementation of this part of the deficit, it is argued, would not lead to any disincentive to tax. The remaining deficit—between 92% and 100% of the tax-need indicator—is only supplemented by 37.5%, by the same rationale. In *Table 14*, these two parts of the deficit are calculated first showing figures, of course, only for Lower Saxony (954 and 388 in *line 8* and 9). On *lines 17* and *18* in this table the calculations for Lower Saxony are completed and show, on *line 19*, that Lower Saxony is entitled to receipts of 746 million DM (i.e., 358 million DM + 388 million DM).

The contributions of the surplus states are similarly calculated. Their surplus is also expressed as a percentage of tax need. The surplus between 100% and 102% of the tax-need indicator (*line 10*) is disregarded so that the state always has the incentive to increase its tax revenue a bit beyond the average. Of the surplus between 102% and 110%, 70% is contributed to the equalization fund. The entire surplus beyond 110% of the tax-need indicator is contributed. In *Table 14* these two surplus shares amount to 301 and 1,044 million DM respectively in the case of Baden-Württemberg (*lines 10* and *11*). Of this surplus, 1,044 million DM belong to the category between 102% and 110% of the tax potential indicator, which under the 70% rule lead to a total contribution of 731 million DM (*lines 14* and *16*).

The separate calculation of contributions and receipts means that total contributions may not necessarily equal total receipts. However, in a strictly horizontal equalization process, surpluses must equal deficits. To accomplish this, contributions as a whole are reduced to the percentage necessary to finance total receipts (*line 19*). In 1976 only about 98% of the surplus was necessary to cover the deficits. Thus, total transfers for the Federal Republic evened out at 1,830 million DM (*line 21*).[15] The equalization results for all states are presented in *Table 15*.

## EQUALIZATION THROUGH SHARING OF THE NET VALUE ADDED TAX

### Mandatory Equalization

In the tax-sharing system in West Germany, the net value added tax is the buffer which evens out changes in the relative expenditure needs of the federal and state levels. As this tax revenue changed over time, it was regarded as appropriate that it should also assume part of the equalization task. Leaving all horizontal equalization between the states to the mechanisms described above would require very large sums of money to move from one state budget to the other. This would lead to particular political difficulties because every state would try to put forward additional reasons why it should receive more, or pay less, in terms of their "special burdens."

In Article 107, the Constitution specifies that up to 25% of total revenue of the net value added tax—which partly belongs to the states—may be distributed in an equalizing way. It would have been difficult at best to distribute the total net value added tax to its geographic source because part of the receipts come from imported goods which, if distributed by reference to source, would have unjustifiably benefited those states with heavy border traffic and important ports.

This equalization procedure also uses two steps.

First, those states whose revenue from state taxes (without net value added tax share) lies below the national average are identified. They receive sufficient receipts from the net value-added tax to brings them up to 92% of the national average. (The law provides that as a group these states should receive at least as much as if the share of 25% had been distributed by population.)

Second, the remaining part of the 25% fund is distributed to counties which receive taxes above the national average in relation to their population. If tax revenues of any one of these states (including the net value added tax) are still under the average of all states, this difference is evened out by taking the necessary amounts from the other states of this group.

In this equalization process, it must be noted that the law of 1969 established a mechanism by which there are only receiving—but no contributing—states. The revenue comes from a source which does not belong to a group of states already (as the "contributions" in *Table 14* did), but is a set-aside of the net value added tax. Some equalization effects can also be seen in the rule that at least 75% has to be distributed on the basis of population. Distribution by reference to the regional source of revenues would have favored the states with a high share in production, as opposed to states with a high share in nonproductive suburbs. This problem is particularly acute in the relation between the city-states and their surrounding area-states.

### FEDERAL SUPPLEMENTS

Article 107 of the Constitution rules that the federal government, out of its share of the net value added tax, may give additional amounts to states in fiscal need. The federal government has done this over a number of years. Usually these contributions are not completely voluntary, but are agreed upon in the process of adjusting the federal and state shares of the net value added tax. *Table 15* shows that, in 1976, only Bavaria, Schleswig-Holstein, Rhineland-Palatinate, Lower Saxony, and Saarland received such payments.

## Equalization Effects Among the States

The equalization mechanisms discussed in the previous section are only part of the equalizing (or nonequalizing) programs in the system of fiscal federalism. Special programs affecting the state budget, such as "cooperative federalism" (*Chapter 6*), are not included in the equalization programs shown in *Table 15*.

In *Table 15*, the states are again listed in the order of total tax potential (local and state). Though this is probably one of the best figures for the fiscal potential of the state as a whole, fiscal equalization effects are measured in terms of the state budget alone. The states are almost completely free to set the part of the state tax revenue they hand over to the communities. The fiscal equalization effect between the states can therefore be described by the influences which determine actual state tax revenues (last column in *Table 15*). As a reference base in this table, a hypothetical state tax revenue was calculated. It approximates what the states would have collected in taxes if the explicit equalization steps already explained had not been taken. Then adjustments are made to this hypothetical revenue figure in order to arrive at actual state tax revenue after equalization.

The last column shows the actual tax revenue of the state—the amount available either for expenditures by states or grants to local governments. Compared to the relative range in state and local tax potential (1.24 to 1) and the hypothetical state tax revenue (1.41 to 1), the range in actual revenue is very low—1.07 to 1. This means that a substantial degree of equalization has been achieved. If the minimum is 95% of the average state's revenue and if 2% beyond the average is admitted for incentive reasons, then a relative range of 1 to 1.07 describes almost exactly the maximum permissible difference.

This remarkable equalization is accomplished by the combination of two effects: the richer states which collect taxes above the average must contribute so that the poorer states may receive. The equalization process extends to the community level with eligible communities receiving support; but no community has

*Table 15*

## EFFECTS OF FISCAL EQUALIZATION AMONG THE STATES, 1976

| States | Tax Potential State and Local | Hypothetical State Tax Revenue | Net Value Added Tax: Equalization | Net Value Added Tax: Federal Grants | State Tax Revenue Before Equalization | Horizontal Equalization | State Tax Revenue After Equalization |
|---|---|---|---|---|---|---|---|
| | (in deutsche marks per capita) | | | | | | |
| **Area-States** | | | | | | | |
| Baden-Württemberg | 1,943 | 1,507 | −18 | — | 1,489 | −78 | 1,411 |
| Northrhine-Westphalia | 1,880 | 1,456 | −18 | — | 1,438 | −25 | 1,413 |
| Hesse | 1,870 | 1,459 | −18 | — | 1,441 | −30 | 1,411 |
| Bavaria | 1,692 | 1,292 | — | +18 | 1,310 | +32 | 1,342 |
| Schleswig-Holstein | 1,607 | 1,186 | +2 | +51 | 1,239 | +101 | 1,340 |
| Rhineland-Palatinate | 1,606 | 1,200 | — | +50 | 1,250 | +72 | 1,322 |
| Lower Saxony | 1,586 | 1,124 | +68 | +45 | 1,237 | +103 | 1,340 |
| Saarland | 1,568 | 1,067 | +121 | +47 | 1,235 | +165 | 1,400 |
| Range[1] | (1:1.24) | (1:1.41) | | | (1:1.21) | | (1:1.07) |
| **City-States** | | | | | | | |
| Hamburg | 2,853 | 2,143 | −19 | — | 2,124 | −308 | 1,816 |
| Bremen | 2,240 | 1,706 | −18 | — | 1,688 | +47 | 1,736 |
| West Berlin | — | — | — | — | — | — | — |
| **Federal Government**[2] | 1,817 | — | +11 | — | 1,397 | ±31 | 1,397 |

[1] Range in relative terms: the lowest to the highest number.
[2] Without West Berlin.

SOURCES:

Tax Potential: *Erste Verordnung zur Durchführung des Gesetzes über den Finanzausgleich zwischen Bund und Ländern im Ausgleichsjahr 1977,* Bundesratsdrucksache, 425/77, Sept. 12, 1977, Appendix 1, lines 13 and 22.

Net Value Added Tax Equalization: *Ibid,* Appendix 2, line 22.

Net Value Added Tax Federal Grants: Federal Ministry of Finance.

Hypothetical State Tax Revenue: Author's calculations based on the following three columns.

Population: *Table 1* of this study.

to contribute, even if it collects above-average taxes.

## EQUALIZATION OF REVENUES AMONG LOCAL GOVERNMENTS

### Objectives of a Specific Equalization Mechanism for Local Governments

The constitutional guarantee of local autonomy (Article 28) is meaningful only if it goes along with considerable fiscal autonomy. The general rule is that all governmental activity is state activity, unless the Constitution rules differently (Article 30). No such general rule, however, applies to local governments. Article 28 only says that the communities must have the right to manage all affairs of the local "community," but "within the framework of the laws." As these laws are state or federal laws, the communities are heavily dependent on the legislative activities of the other levels of government.

On the revenue side, the Constitution is somewhat more specific. A share of the income tax, which Article 106 and later laws have fixed, must be given to the communities on the basis of population. Localities also are entitled to part of the real estate and business taxes, as well as to a share of local excise taxes. Localities also have the right to vary a number of tax rates. Local autonomy, however, is circumscribed because taxes make up only about 30% of local revenue and because the real estate and business tax law are federal laws.

While the Constitution rules that states have to give a share of the income, corporation profits, and net value added taxes to localities, the states determine what this percentage will be. Thus, the constitutional guarantee of local fiscal autonomy is very weak. The provision that, if federal or state governments mandate specific expenditures at the local level, they have to reimburse the cost, applies only if the local level cannot be expected to bear that cost (Article 107).[16]

The Constitution is silent on the subject of this chapter—whether or not the vertical grants system has to take disparities among localities into account. The equalization effect of the grants system is thus totally left to the states. The Constitution offers no rules for the specific equalization mechanisms among communities, and only the general rule that regional disparities should be reduced (Article 72) can justify, to a degree, the demand for horizontal equalization among communities.

The individual laws of the states concerning the grants system between a state and its localities[17] contain numerous explicit objectives for such a policy. As an example, the proposed law for 1977 in Hesse can be used, since it is the most recent effort to streamline the numerous pertinent legal provisions of a state.[18] Article 5 gives two reasons for the equalization mechanisms: (1) to strengthen the fiscal power of the communities as a whole, and (2) to reduce the differences in this fiscal power between the receiving units. The explanatory preamble of this bill stresses that a considerable amount of general revenue sharing is necessary if local self-determination is to be secured.

At the same time special aid, particularly for investment purposes, is regarded as necessary, especially to reduce deficiencies of local infrastructure in rural areas[19]—thereby explicitly addressing the horizontal equalization issue. An additional reason for some provisions in this bill is seen in the need to stimulate overall economic development[20]—mostly by investments (*Chapter 4*).

A review of the existing laws in all eight area-states would show that these and similar objectives appear in almost all of them. Despite the absence of any federal rules concerning state-local fiscal relations then, there is a uniformity of purposes among the states with regard to state-local fiscal relationships.

### The Technique of Equalization Among Local Governments

#### OUTLINE OF THE SYSTEM

State grants to local governments are discussed mainly under two aspects: (1) their influence on fiscal autonomy, and (2) their equalization effects. Whether a grant means an interference with local decisionmaking depends on the degree to which the grant leads to different expenditures than local authorities would originally have determined. Under this aspect, general purpose grants (*Schlusselzuweisungen*) clearly constitute one end of the

*Table 16*

**ASSIGNMENT OF STATE TAX REVENUE TO THE LOCAL GRANT FUND, BY STATE, 1977**

(in percent)

| States | Mandatory Sharing[1] | Optional Sharing: State Share of Business Tax | Optional Sharing: Real Estate Sales Tax | Optional Sharing: Property Tax | Optional Sharing: Automobile Use Tax | Optional Sharing: Other Taxes |
|---|---|---|---|---|---|---|
| Baden-Württemberg | 23.0% | 23.0% | — | — | 35.0% | — |
| Northrhine-Westphalia | 28.5 | 28.5 | — | — | 30.0 | — |
| Hesse | 20.6 | 20.6 | 100.0% | 61.5% | 22.5 | — |
| Bavaria | 11.1 | 11.1 | 100.0 | — | 75.0 | — |
| Schleswig-Holstein | 21.0 | — | 21.0 | — | 21.0 | 21.0% |
| Rhineland-Palatinate | 21.0 | — | — | 15.8 | 21.0 | — |
| Lower Saxony | 20.8 | — | — | — | 20.8 | — |
| Saarland | 24.5 | — | 19.6 | — | 19.6 | 19.6 |

[1] From the income, corporation profits and net value added taxes ± horizontal equalization among the states.

SOURCE: Münstermann, E. and H. Becker, *Finanzausgleichsleistungen an Kommunen: Ein Vergleich der Finanzausgleichssysteme in den Bundesländern*, DST-Beiträge zur Finanzpolitik, Heft 7, Köln 1978.

scale: there are no strings attached. The other grants can be categorized by the degree to which they influence local decisionmaking.

## GENERAL PURPOSE GRANTS BY THE STATE

### Determination of the Grant Fund

As the Constitution does not determine the amount of state taxes to be distributed among local governments, each state must decide this matter. The amount may be fixed for general purpose grants only or it can be defined as the amount of all state taxes to be allocated to general purpose as well as some specific purpose grants (*Verbundmasse*, *Finanzausgleichs–Masse*).[21] The Constitution, as mentioned before, only prescribes that three of the shared taxes somehow have to enter into this process; it leaves open whether the states want to include some of their own taxes. In 1977, all area-states included the automobile-use tax and some of them included the property tax, etc. (*Table 16*).

The decision on which taxes to include in the pool is much less important than the decision as to the percentage of each tax. In a sense, the constitutional provision that the local budgets should receive a share of some taxes is, by itself, not particularly significant because the states might set a share close to 0%. In reality, however, most states apply a percentage between 20% and 30%, depending on how many different taxes they include in the pool (*Table 16*).

### Calculation of Tax Potential

The rationale of calculating tax potential was previously explained (*Chapter 2*). Local tax potential included the real estate tax, the business tax, and the local share of the income tax.

The income tax share can be included in terms of actual revenues. The states include the local share of the income tax in a varying degree (between 70% and 100%).

The other taxes have to be standardized by average rates. The states apply different average or standard rates to these taxes. Thus, even if the taxing capacity of two communities in different states were exactly the same in terms of tax base and economic base, their calculated tax potential could differ. The fact that the business tax is weighted less heavily than the income tax in the tax potential figures makes heavily commercial cities appear "poorer" than they are.

In spite of a few relatively small differences among the states, this procedure is basically the same for all eight area-states. Thus, a community is "valued" in terms of its tax potential practically the same way in each part of West Germany.

## Calculation of Tax Need

In the second part of the equalization mechanism, the calculation of tax need (or, in a wider sense, the approximation of expenditure need), there is less similarity among the states. In principle the procedure is the same as at the state level.[22] A "basic amount" (explained below) represents the average available grant per capita. This average per capita amount is not multiplied by the actual number of inhabitants in a community, but with an adjusted (*veredelt*) number of inhabitants. This adjustment occurs in two steps which again bear some similarity to the calculation of state tax need.

First, the size of a community is taken into account (*Hauptansatz*). Following "Brecht's law,"[23] bigger communities are given larger per capita amounts (*Table 17*). The way these amounts are calculated may differ between the states, and not all states have elaborated systems of this kind. The relative range for the city size adjustment in Saarland is 1 to 1.24; in Bavaria and Lower Saxony, 1 to 1.5.

It is assumed that most of the differences in per capita expenditures are due to additional activities being performed by governments of increasing size. Whether increasing unit cost—diseconomies of scale—also contributes to this fact is not usually discussed. To separate these influences, it would be necessary to do research in the comparative cost of providing the same service in Germany communities of different size.

Once the size adjustment is made, certain other adjustments may be made, followed by several supplementary improvements (*Ergänzungsansatze*). *Figure 1* presents these added adjustments by each state in 1961 and 1977. If a state uses a particular adjustment, it does not mean, however, that the locality receives a specific purpose grant for this function. The locality may use the funds as it sees fit.

One of the main issues during the past years has been the question whether a state should provide an additional amount of money (by introducing a supplementary adjustment factor) for those communities which have been sorted out by area development planning as regional growth centers. In *Figure 1* a number of states show such an improvement factor for 1977, whereas in 1961 not a single state provided general purpose grants for that reason.[24] Of course, general purpose grants are not the only way of providing communities with additional money under the area planning objective. Other state grants may be directed into these communities and a coordinated federal-state program is the main instrument of assisting such communities (*Chapter 6*).

The additional adjustment factors are an equalization instrument. The effects, however, cannot necessarily be seen in comparing revenue before and after the receipt of the grant. Such a comparison might show that the city receiving additional money for one or the other purposes was already well off before in terms of tax revenue per capita. Yet, if tax need is judged in relation to expenditure need—as it results from demographic factors, etc.—then a community rich in taxes per capita may be poor when its expenditure needs are compared to its tax revenues. Therefore, this system of supplementary factors, may, together with the principle adjustment concerning city size, be regarded as an effort to approximate expenditure need.

## The Actual Equalization

The calculation of how much money a particular community receives differs from state to state due to the difference in estimating tax potential as well as tax need. Fortunately the basic calculation system itself is similar in most states. An example from North Rhine-Westphalia is shown in *Table 18*. Two cities are compared to illustrate the community size adjustment factor. Dortmund is a "big city," Remscheid, "small." In Dortmund, tax need greatly exceeds tax potential; in Remscheid, there is a near equivalence between the two.

Tax potential (*line 9*) is not calculated here explicitly because it follows the rules spelled out before. The tax-need calculation starts with the population figure from interim census estimates (*line 1*). To this population figure are added soldiers, foreign officials, and other nonpermanent residents. The city size factor is then applied to the adjusted population figure (*line 3*). Inhabitants of Dortmund, the bigger

*Table 17*

## COMMUNITY SIZE FACTORS IN STATE-LOCAL GRANTS SYSTEM, BY STATES, 1977

**Community Size Factors**

| Size Group up to . . . People | Northrhine-Westphalia | Hesse: Communities in Rural Counties | Hesse: City-Counties | Bavaria | Rhineland-Palatinate | Lower Saxony: Communities in Rural Counties | Lower Saxony: City-Counties | Saarland |
|---|---|---|---|---|---|---|---|---|
| 1,000 | — | | | — | — | 100 | | — |
| 1,500 | — | | | — | — | — | | — |
| 3,000 | — | 100 | | 100 | — | — | | — |
| 4,000 | — | 107 | | — | — | — | | — |
| 5,000 | 100 | 112 | | — | — | 110 | | — |
| 6,000 | — | 117 | | — | — | — | | — |
| 7,500 | — | 122 | | — | — | — | | — |
| 8,000 | — | — | | — | — | — | | — |
| 10,000 | 105 | 130 | | — | 115 | 120 | | — |
| 15,000 | — | 135 | | — | — | — | | 100 |
| 20,000 | 108 | 137 | | — | — | 140 | | — |
| 25,000 | — | — | | 125 | 125 | — | | 104 |
| 30,000 | — | 139 | | — | — | — | | — |
| 35,000 | — | — | | — | — | — | | 108 |
| 40,000 | — | 140 | | — | — | — | | 112 |
| 50,000 | 115 | — | | 135 | 135 | 150 | 100 | — |
| 60,000 | — | 141 | | — | — | (for each further 3,000 + 1%) | — | — |
| 75,000 | — | 142 | | — | — | | — | 116 |
| 100,000 | 120 | | | — | 140 | | 110 | 120 |
| 150,000 | — | | | — | 145 | | — | — |
| 200,000 | 125 | | 100 | — | 150 | | 115 | — |
| 250,000 | — | | — | 145 | — | | — | — |
| 300,000 | — | | — | — | — | | 120 | — |
| 500,000 | 132 | | 102 | 150 | — | | 130 | — |
| More Than 500,000 | 135 | | 103 | (for each further 100,000 + 1%) | — | | 140 | — |

SOURCE: Münstermann, E. and H. Becker, *Finanzausgleichs-leistungen an Kommunen: Ein Vergleich der Finanzausgleichssysteme in den Bundesländern,* DST-Beiträge zur Finanzpolitik, Heft 7, Köln 1978.

*Figure 1*

## SUPPLEMENTARY IMPROVEMENT FACTORS IN STATE-LOCAL GRANTS SYSTEM, BY STATES, 1961 AND 1977

| States and Year | Area Planning | Pupils | Border Regions | Spa | Dependent Population | Population Growth | Consolidation | Roads | Mining | Military Base | War Damages | Welfare |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Baden-Württemberg** | | | | | | | | | | | | |
| **1961** | | | | | X | X | | | | | | |
| **1977** | | | | | | X | | | | X | | X |
| **Northrhine-Westphalia** | | | | | | | | | | | | |
| **1961** | | | X | | X | | | | | | X | |
| **1977** | | X | | X | | | | | | | | |
| **Hesse** | | | | | | | | | | | | |
| **1961** | | | | | X | X | | | | | X | |
| **1977** | | | X | X | X | X | X | | | | | |
| **Bavaria** | | | | | | | | | | | | |
| **1961** | | | X | | X | X | | | | | X | |
| **1977** | | | X | | | X | | | | | | |
| **Schleswig-Holstein** | | | | | | | | | | | | |
| **1961** | | | X | X | | | | | | | | |
| **1977** | X | | | | | | | | | | | |
| **Rhineland-Palatinate** | | | | | | | | | | | | |
| **1961** | | | X | | | | | | | | | |
| **1977** | X | | X | | | | | | | | | |
| **Lower Saxony** | | | | | | | | | | | | |
| **1961** | | | | | X | X | | | | | X | |
| **1977** | | | | | | | X | | | | | |
| **Saarland** | | | | | | | | | | | | |
| **1961** | | | X | | X | | | X | X | | | |
| **1977** | X | | | | X | | | X | X | | | |

SOURCE: Münstermann, E. and H. Becker, *Finanzausgleichsleistungen au Kommunen: Ein Vergleich der Finanzausgsleichssysteme in den Bundesländern*, DST-Beiträge zur Finanzpolitik, Heft 7, Köln 1978.

city, are multiplied by 135%; those of Remscheid by 121.8%. To this population weighted by size groups (*line* 5), the pupils are added in a weighted figure (*line* 6). The deliberate double counting of a small segment of the population is to account for central place functions in that state. The number of pupils is at least a rough approximation of excess burden insofar as they lead to increased costs of schools, transportation, etc. At this point, other

*Table 18*

**CALCULATION OF GENERAL PURPOSE GRANTS IN NORTHRHINE-WESTPHALIA, 1974**

(money figures in deutsche marks—DM)

| Calculation Steps | Dortmund | Remscheid |
|---|---|---|
| I. *Assessment of Tax Need* | | |
| 1. Population, 1972 | 638,288 | 135,547 |
| 2. + Soldiers, Foreign Officials, etc. | 3,162 | 0 |
| 3. Adjusted Population | 641,450 | 135,547 |
| 4. × City Size Adjustment Factor | × 135% | × 121.8% |
| 5. = Population Weighted by Size Group | 865,958 | 165,096 |
| 6. + Multiple Weight for Pupils (Central Place Function) | 187,864 | 37,035 |
| 7. Adjusted Population | 1,053,822 | 202,131 |
| 8. × Hypothetical "Basic Amount" of 393.24 DM in 1974 leads to: Tax Need | 414,404,963DM | 79,485,994DM |
| | (649 DM per capita) | (586 DM per capita) |
| II. *Assessment of Tax Potential* | | |
| 9. Tax Potential | 223,937,612DM | 74,359,863DM |
| | (349 DM per capita)[1] | (549 DM per capita) |
| III. *Calculation of Aid* | | |
| 10. Unadjusted Aid = (Line 8-Line 9)÷2 | 95,233,676DM | 2,563,066DM |
| 11. Additional Aid to Make Tax and Unadjusted Aid Equal to 90% of Tax Need | 53,793,179DM | DM — |
| 12. Adjusted Aid, to Be Paid Out | 149,026,855DM | 2,563,066DM |
| 13. Aid + Tax as Percent of Tax Need | 90% | 96.8% |
| 14. Aid Per Capita | 233.50DM | 18.90 |
| 15. Aid as Percent of Tax Potential | 66.9% | 3.4% |

[1] The figure is lower than in *Table 7* because of slightly different modes of calculation.

SOURCE: Deutscher Städtetag, "Berechnung der Schlüsselzuweisungen," *FAG NW 1974 an Hand von 4 Beispielen*, mimeographed.

adjustments, listed in *Figure 1*, would be expressed in terms of an area-planning improvement factor.

The resulting adjusted population figure in *Table 18* (*line 7*) is then multiplied by a hypothetical "basic amount" in deutsche marks. In 1974 it was DM 393.24. This amount is arrived at by taking the grant pool, i.e., all aid available in the year (Section b1), and by calculating how much per unit of "adjusted population" can be spent after tax potential had been taken into consideration. To show this arithmetically, the total figures of the general purpose grant system in that state would have to be presented. The resulting figure for tax need (*line 8*) is higher per capita in Dortmund (DM 649) than in Remscheid (DM 586).

The grant to be paid out is then calculated in two steps.

First, tax need is compared to tax potential. If potential surpasses need, no grant is given at all. This was the case, for instance, in Düsseldorf, a city not shown in this table. None of this "extra" tax revenue is taken away—which is the main reason for some cities' exceptionally high expenditures (e.g., Frankfurt in *Chapter 2, Table 7*). If tax need surpasses tax potential, half of that difference is made up by grants in this first step (*line 10*).

The second step is paid out only to those cities where unadjusted aid plus tax potential does not equal 90% of the tax need. In the case of Remscheid, the percentage is 96.8%, after step 1 (*line 13*), so it receives only the unadjusted amount—i.e., no second-step payment. Dortmund, however, needs another DM 53,793,197 (*line 11*) to reach the 90% level (*line 13*). Unadjusted and additional aid then constitutes the grant to be paid out (*line 12*), which means per capita amounts in Dortmund of DM 233.50 and only DM 18.90 in Remscheid (*line 14*). The absolute amount of grants to be paid out means 66.9% of tax potential in Dortmund and 3.4% in Remscheid.

In calculating grants, many states define a minimum level which in the calculated example in *Table 18* was 90% of tax need. A similar procedure was discussed for the state level. The example in *Figure 1* applied to two cities which are coterminus with their counties (city-counties). For communities in rural counties, grants have to be split up between those parts of the grant which go directly to the individual community and another part which goes to the county budget. As this does not change the basic approach very much, the specifics are not discussed here further.[25]

## SPECIFIC PURPOSE GRANTS FROM THE STATE

Whereas general purpose grants rather closely follow a pattern across the various states, the rest of the grants system varies widely. In examining the fiscal autonomy of the receiving community, it is important to see whether such a grant is earmarked for specific expenditures or whether it is based on special needs without requiring a particular use of the money.

Again taking the Hessian system as an example,[26] Hesse explicitly distributes several grants which are calculated with regard to specific needs of the community but does not impose strict requirements concerning the money's use. Though the money for each function has to be entered as revenue under the specific function in the budget, a surplus does not lead to repayments to the state but may be applied to the total. In the near future, Hesse expects to provide special equalization (*Sonderlastenausgleich*) for education and welfare burdens. Such special purpose grants, without binding provisions for specific expenditures, are found in several states. Sometimes these grants are grouped together in one system; sometimes they only exist in separate programs.

The second group of specific purpose grants, defined by binding provisions to use the money for specific purposes (or to give it back), is much more difficult to assess empirically. Indeed, even the state itself has difficulties assessing the total number of specific programs, not to speak of their impact.[27]

This type of specific purpose grant has been widely discussed in the context of whether local preferences are unnecessarily distorted under state rules. The spokesmen for the various associations of communities have always argued (1) that, to meet local needs properly, they only need enough money; and (2) that it would be sufficient, therefore, to have state and federal laws provide safeguards against bad local management and for the provision of minimum levels of service in major public functions. Then these binding specific purpose grants which interfere with local self-government could, in their view, be replaced by either more taxes or more general purpose grants.

The states, on their side, contend that statewide or even nationwide norms can only be enforced by means of specific grants—particularly investment grants which ensure similar standards of living (in real terms) throughout the country. Since a great number of federal-local programs have to be added to these state-local grants, the issue is quantitatively important. Because of their high regulatory potential, these grants are also important in qualitative terms.[28]

### SOME FURTHER EQUALIZATION MECHANISMS

In addition to West German states and municipalities, there are some other types of institutions which have to be financed through the states, the local governments, or privately.

Only counties have been mentioned so far. Besides receiving considerable grants from the states, the county budget is financed through contributions of the municipalities. The basis in most counties is the tax potential of the municipalities, in addition to the general purpose grants which the municipalities receive from the states. A certain percentage of the municipal budget is set aside for the county funding, in most cases subject to state government approval.

One problem hardly touched upon so far is disparities within metropolitan areas. This problem has not been solved by extensive municipal consolidation. Therefore, central city and surrounding communities have had to develop other mechanisms. A major effort has been in the field of transportation. Sometimes a big city has formed a transport association with its surrounding communities; for instance, they may have pooled their mass transportation systems, introduced a generalized fare system, and cooperatively financed the deficit. One of the best known unions in a metro region was the Ruhr cities union (*Ruhrsiedlungsverband*),[29] which helped to solve problems in many functional areas in the system of closely interrelated cities in the Ruhr Valley.

Outside the metropolitan areas there are other administrative unions between communities, often aimed at one particular function. The union may have the management of a river as its only purpose—the union consisting of the communities bordering the river.

To judge the equalization effects of all these mechanisms is possible but difficult. Besides, the quantitative outcome would be small in relation to the importance of the division of functions, revenues, and expenditures between federal, state, and local levels. Therefore, this study has not attempted an assessment in quantitative terms.

## Equalization Effects Among Local Governments

Since 10,000 communities cannot be easily compared with respect to the equalization effects of all the mechanisms mentioned before, three "sampling" approaches are used:

- the previous sample of 18 cities is compared with regard to the equalization effects;
- the types of jurisdictions in Hesse are again analyzed; and
- figures on localities by size groups are added to this picture.

To give a total picture of all grants coming from the state and federal level, the 18 selected cities are compared in *Table 19*. Again, they are listed within each size group in the order of their tax potential. Their actual tax revenue (shown in the second column) is one of the reference bases used to illustrate the relative influence of grants from upper levels. The grants are divided into those which are entered in the current budget and those which become part of the capital budget. The grants in the current budget are mostly general purpose grants from the state. All size groups show a definite negative relation between tax revenue and tax potential. With one exception (*Pforzheim*), these grants are considerably lower in the three rich communities than in the three poor communities. The range in per capita grants for the six communities in each size group is rather large; hence the equalization effect is strong.

The capital grants from the federal and state levels, unfortunately, offset much of the equalizing effects. A city like Ludwigshafen re-

*Table 19*

## EFFECTS OF FISCAL EQUALIZATION IN SELECTED LOCAL GOVERNMENTS

| By Size Group | Local Tax Potential, 1971 | Local Tax Revenue, 1975 | Federal and State Grants: Current Budget, 1975 | Capital Budget, 1975 | Total Grants, 1975 | Total Expenditures, 1975 | Grants as Percent of Expenditures, 1975 |
|---|---|---|---|---|---|---|---|
| | (in deutsche marks per capita) | | | | | | |
| **500,000 and Over:** | | | | | | | |
| **Frankfurt** | 730 | 1,509 | 172 | 297 | 469 | 4,271 | 11% |
| **Stuttgart** | 718 | 1,072 | 204 | 147 | 351 | 3,650 | 10 |
| **Düsseldorf** | 710 | 1,040 | 125 | 106 | 231 | 3,007 | 8 |
| **Duisburg** | 500 | 676 | 296 | 230 | 526 | 2,454 | 21 |
| **Essen** | 460 | 706 | 320 | 160 | 480 | 2,234 | 21 |
| **Dortmund** | 389 | 661 | 319 | 179 | 498 | 2,373 | 21 |
| **Range**[1] | (1:1.88) | (1:2.28) | (1:2.56) | (1:2.80) | (1:2.28) | (1:1.91) | |
| **100,000–200,000:** | | | | | | | |
| **Leverkusen** | 915 | 692 | 115 | 91 | 206 | 2,789 | 7 |
| **Ludwigshafen** | 810 | 972 | 16 | 330 | 346 | 3,952 | 9 |
| **Pforzheim** | 678 | 907 | 265 | 149 | 414 | 3,129 | 13 |
| **Trier** | 384 | 559 | 139 | 223 | 362 | 2,559 | 14 |
| **Wilhelmshaven** | 372 | 555 | 275 | 283 | 558 | 2,631 | 21 |
| **Bottrop** | 296 | 471 | 432 | 115 | 547 | 1,712 | 32 |
| **Range**[1] | (1:3.09) | (1:2.06) | (1:27.00) | (1:3.63) | (1:2.71) | (1:2.31) | |
| **20,000–50,000:** | | | | | | | |
| **Bietigheim** | 862 | 679 | 142 | 137 | 279 | 2,751 | 10 |
| **Schwäbisch-Hall** | 807 | 980 | 114 | 272 | 386 | 2,922 | 13 |
| **Neu-Isenburg** | 695 | 895 | 32 | 27 | 59 | 1,553 | 4 |
| **St. Wendel** | 265 | 310 | 254 | 66 | 320 | 1,166 | 27 |
| **Bergkamen** | 243 | 419 | 343 | 339 | 682 | 1,400 | 49 |
| **Osterholz-Sch.** | 203 | 284 | 189 | 30 | 219 | 1,086 | 20 |
| **Range**[1] | (1:4.25) | (1: 3.45) | (1:10.72) | (1:12.56) | (1:11.56) | (1:2.69) | |
| **Federal Government**[2] | | 659 | 227 | 152 | 379 | 1,925 | |

[1] Range in relative terms: the lowest to the highest number.
[2] Average of communities of 20,000 and more inhabitants.

SOURCES:
- Local Tax Potential: *Statistiches Jahrbuch Gemeinden,* 63, 1976, p. 501 ff.
- Local Tax Revenue: *Ibid.,* p. 488 ff.
- Federal and State Grants: *Ibid.,* p. 450 ff.
- Total Expenditures: *Ibid.,* 62, 1975, p. 26 ff.
- Population: *Ibid.,* p. 26 ff.
- Total Grants and Grants as Percent of Expenditures: Author's calculations.

ceives almost no current grants and probably no general purpose grants from the state at all. However, it receives a very high amount of capital grants which brings it to a rather high total. Similar influences can be seen in other cities like Frankfurt or Schwäbisch-Hall.

Therefore, the total amounts of grants received show much less overall equalization than would be expected, particularly when one bears in mind the elaborate system of general purpose grants. Though there still is a tendency to give somewhat more to the poorer cities than to the rich cities, this tendency is rather weak.

Because of the limited overall equalization, total expenditures per capita still vary widely in all three size categories, compared to the range among the states. Initially, the states had smaller disparities and these disparities were evened out to a greater degree. Among communities, the disparities are much greater and not so much reduced. In sum, per capita expenditures vary more among cities within states than among the states themselves.

*Table 20*

## EFFECTS OF FISCAL EQUALIZATION AMONG COMMUNITIES, BY TYPES OF REGIONS IN HESSE

| Type of Region | Local Tax Potential, 1971 | State Grants, 1972–74 Average: General-Purpose[1] | Case of Need[2] | Special Purpose[3] | Grants as Percent of Total Revenues 1970 |
|---|---|---|---|---|---|
| | | (in Deutsche marks per capita) | | | |
| **Hesse** | 280 | 128 | 4 | 145 | 17.8% |
| **Metropolitan Areas** | 365 | 106 | 4 | 146 | 13.6 |
| **Central Cities** | 481 | 76 | 7 | 185 | 10.8 |
| **Suburbs** | 279 | 124 | 3 | 122 | 16.3 |
| **Intermediate** | 215 | 138 | 3 | 136 | 24.7 |
| **Developing** | 178 | 150 | 3 | 121 | 21.5 |

[1] General formula grants and real estate sales tax returned to local governments.
[2] Fund for communities with particularly pressing budgetary needs.
[3] Grants in the field of transportation and roads, health, water supply/sewerage/sanitation, social infrastructure, and other (e.g., police cost).
SOURCE: R. Pauksztat, *Raumordnungspolitische Effekte des kommunalen Finanzausgleichs,* Diss., Marburg, 1976, Europäische Hochschulschriften, 166, Frankfurt 1977, pp. 5, 49, 72, population from Appendix tables 10 ff.

*Table 21*

## GENERAL PURPOSE GRANTS IN TWO STATES, BY SIZE OF COMMUNITIES, 1975

| By Size Group | Hesse | Rhineland-Palatinate |
|---|---|---|
| | (in deutsche marks per capita) | |
| **City-Counties:** | (80) | (58) |
| **200,000 and Over** | 75 | — |
| **100,000–200,000** | 88 | 52 |
| **50,000–100,000** | 124 | 63 |
| **20,000–50,000** | — | 75 |
| **Communities in Rural Counties[1]** | (88) | (93) |
| **50,000–100,000** | 57 | 58 |
| **20,000–50,000** | 54 | 47 |
| **10,000–20,000** | 89 | 60 |
| **5,000–10,000** | 114 | 72 |
| **3,000–5,000** | 101 | 82 |
| **1,000–3,000** | — | 97 |
| **Under 1,000** | 73 | 134 |
| **Rural County Budgets[1]** | 84 | (60) |
| **State** | 148[2] | 126 |

[1] Sums for communities in rural counties and for rural county budgets can be added to show total grants for this type of region.
[2] The figure comparable to that of the Rhineland-Palatinate would be 170; the difference is an amount given to "Landeswohlfahrtsverband" for further distribution.
SOURCES:
Hesse: Direct information from the Hessian statistical office.
Rhineland-Palatinate: *Taschenbuch der Finanzstatistik für Rheinland-Pfalz, 1976,* Bad Ems, 1976, p. 442.

The types of regions in Hesse, discussed before (*Chapter 2, Table 8*), are shown under equalization aspects in *Table 20*, with general purpose grants shown separately. The table shows clearly that the "poorer" regions receive more than the "richer" regions. That is, as local tax potential decreases, from 481 for central cities to 279 for suburbs to 215 for intermediate and 178 for developing regions, general purpose grants increase—from 76 for central cities to 150 for the developing areas. The special purpose grants, however, work in an exactly opposite fashion. The regions are grouped here, too, by size-group (implicitly) and by tax potential. The state special purpose grants favor the regions with higher tax potential in the same way in which combined federal and state grants in the capital budget favored the individual cities with higher tax potential (*Table 19*). When total grants are defined as a percent of total revenues, there is some equalizing effect among central cities, suburban, and intermediate regions; but the developing regions receive less than the intermediate regions.

*Table 21* shows general purpose grants in two states with cities ranked by population size. In both states, general purpose grants increase as the size of city-counties decrease. Among rural communities the same tendency can be detected; but the equalization effect, in regard to city size at least, is less pronounced than (a) among city-counties in both states and (b) among rural communities in Hesse than rural communities in the Rhineland-Palatinate. This seems to be in contradiction to the city size adjustment factor. However, *Table 21* contains the sums as they were paid out, which reflect both—

- higher tax receipts in the bigger communities;[30] and
- higher tax need as expressed, among other factors, through the size group factor.

## FOOTNOTES

[1] Under this aspect of strictly self-sustaining growth, it would be regarded as undesirable to subsidize the well-to-do regions on top of what they receive, for instance, through upper level grants for mass transportation systems.

[2] The argument should actually be expressed in marginal terms and include social costs and benefits.

[3] State and local taxes would probably be less redistributive due to the public good quality of redistribution.

[4] As to the comparison of fiscal equalization and other regionally oriented policies see: Zimmermann, H., *Fiscal Impact on Regional Disparities*.

[5] Redistribution is defined here as an income-elastic ("superior") social good and thus placed on the highest tier of Maslow's hierarchy, with the whole hierarchy being redefined in terms of income elasticity.

[6] Other factors influencing "centralization vs. decentralization" are not discussed here; for instance, increasing economies of scale.

[7] Commission of the European Communities, *Report of the Study Group on the Role of Public Finance in European Integration*, Vol. II, p. 149 ff.

[8] The figures contain double counting because, e.g., grant flows between levels of government may appear twice. The percentages should therefore only be compared between levels of government especially when the reference base is total expenditure and not, as one might expect, total revenues. The reason is that, in German fiscal statistics, current and capital revenues and expenditures are separated from what is called special financing transactions like gross borrowing, debt service, increase of and withdrawal from reserve funds.

[9] *Gesetz über den Finanzausgleich zwischen Bund und Ländern*, August 28, 1969.

[10] *Erste Verordnung zur Durchführung des Gesetzes über den Finanzausgleich zwischen Bund und Ländern im Ausgleichsjahr 1977*, Bundesratsdrucksache, 425/77, September 12, 1977.

[11] This effect could be partly cancelled out by the fact that communities which do levy a payroll tax usually apply lower tax rates for real estate and business taxes, but are also subject to the average or normal tax rates which are applied to calculate tax potential.

[12] See *Erste Verordnung zur Durchführung des Gesetzes über den Finanzausgleich zwischen Bund und Ländern im Ausgleichsjahr*, 1977, p. 4.

[13] This statistic is called "tax need" here because it only refers to taxes. The verbal translation, "equalization indicator" (Ausgleichsmeßzahl), implies much more than that.

[14] The population of the city-states is weighted by 135%.

[15] It should be noted that there exist a few additional regulations. One takes care of those cases in which the equalization procedure leads to less than 95% of the tax-need indicator. Another regulation deals with the special situation of the city-states in this equalization process.

[16] For a few further comments, see Commission of the European Communities, *Report of the Study Group on the Role of Public Finance in European Integration*, *op. cit.*, p. 209 f., where the impossibility of gaining regionalized data is acknowledged.

[17] The legal sources are listed in the bibliography.

[18] *Gesetzentwurf der Landesregierung für ein Gesetz zur Regelung des Finanzausgleiches und zur Änderung anderer Vorschriften*, Landtagsdrucksache, 8/4877, October 11, 1977.

[19] *Ibid.*, p. 25 ff.

[20] *Ibid.*, p. 25.

[21] All states have beside those specific purpose grants, which are included in this more formal allocation pro-

cedure, numerous additional grants dispersed all over the budget.

[22] The author reported on methods of local needs assessment at the Workshop on Measuring Local Government Expenditure Needs prepared by the OECD, Copenhagen, December 1978. The paper will be published as: H. Zimmermann, *Local Expenditure Needs Under Alternative Policy Objectives* in the OECD-volume, forthcoming.

[23] A. Brecht, *Internationaler Vergleich der öffentlichen Ausgaben*, Leipzig-Berlin, 1932, p. 28 ff.

[24] In 1955 only one state and in 1973 the three states mentioned in *Table 18* applied that factor. For further discussion of this issue see, E. Münstermann, *Die Berücksichtigung zentralörtlicher Funktionen im kommunalen Finanzausgleich*, Forschungsberichte des Landes Nordrhein-Westfalen, Nr. 2520, Opladen, 1975.

[25] For discussion see K. Korinsky, *Der kommunale Finanzausgleich in der BRD*, Institut "Finanzen und Steuern," Heft, 97, Bonn, 1971, p. 44 ff.

[26] *Gesetzentwurf der Landesregierung für ein Gesetz zur Regelung des Finanzausgleiches und zur Anderung anderer Vorschriften*, p. 26 ff.

[27] North Rhine-Westphalia, e.g., a number of years ago issued a statement requiring all ministries to provide the state statistical office with data concerning their specific-purpose grants.

[28] For discussion see, e.g., E. Münstermann, *Die Berücksichtigung zentralörtlicher Funktionen im kommunalen Finanzausgleich*; B. Reissert, and B. Hesse, *The Impact of Federal and State Grants on Local Government Investment Expenditures in the Federal Republic of Germany: A Research Design*, mimeographed, Berlin, Jan. 8, 1976.

[29] Cf. A. V. Kneese, *Water Quality Management by Regional Authorities in the Ruhr Area: With Special Emphasis on the Role of Cost Assessment*, Resources for the Future, Inc., Washington, DC, Reprint No. 52, April 1965.

[30] They range, e.g., from DM 2,118 in cities beyond 500,000 inhabitants to DM 1,124 in cities of 20,000 to 50,000 inhabitants (*Statistisches Jahrbuch Deutscher Gemeinden*, 63, 1976, p. 450).

Chapter 4

# Economic Stabilization in a Federal System

## THE IMPORTANCE OF THE STABILIZATION GOAL IN WEST GERMANY

The Federal Republic of Germany is a high income country with a high proportion of foreign trade to GNP. Because of its high income, there is a greater sensitivity to business cycles as consumers have more income available for discretionary purchases (as opposed to necessities). Discretionary purchases, being relatively volatile, may further add to a disequilibrium situation by the investment in new plants and equipment they induce. At the same time, there is heightened political sensitivity to inflation and unemployment.

The need for stabilization policy is increased by the reliance on foreign trade. If a national economy is strongly affected by its foreign trade sector, changes in exchange rates, export and import prices, etc., are of concern. Hence, a broader array of policy instruments is needed to keep the economy on an "even keel."

Aspects of stabilization policy aimed at international trade are more or less exclusively an area for the central government. Subnational governments are only affected if a decrease or increase in foreign trade has a particular geographic impact; but, regardless, these governments have no instruments of stabilization policy available.

The importance of stabilization was emphasized when legislation (*Gestez zur Förderung der Stabilität und des Wachstums der Wirtschaft*) was enacted in 1967. The act contained (1) a brief description of the objectives, (2) a long catalogue of instruments, (3) a set of institutional arrangements, and (4) of special interest here, some discussion of the relation between federal, state, and local governments in achieving economic stabilization.

## INSTITUTIONAL ARRANGEMENTS

The economic stabilization law confirms the fact that the federal government is mainly responsible for business cycle policy. The federal government must issue an annual economic report and formulate its budget to conform with business cycle policy. The law also gives the federal government a number of additional countercyclical tools. At the same time, it explicitly acknowledges that no business cycle policy can be effective without the cooperation of other levels of government.

That cooperation has been achieved in three ways:

1. Article 3 requires the federal government to give benchmarks to the other levels of government, to labor, and to business in order to promote countercyclical behavior by each of these segments of the economy. From this requirement grew a continuous extralegal institution which, in spite of many past failures, has probably become one of the reasons for the relatively good present performance of West German business cycle policy. States' representatives are included in this group and local governments participate through representation by members of the various associations which they have formed (*Kommunale Spitzenverbände*). Though this group has no decisionmaking power, the federal government is able to explain its intentions to the members and consult on what is desirable and feasible. An important role of the group is to agree tacitly to rational discussion on the basis of quantitative data.

2. Article 18 explicitly creates a new institution: the Business Cycle Council (*Konjunkturrat*). Members are:
   - the Federal Ministries of Economic Affairs and of Finances;
   - one representative of each state; and
   - four representatives of local government, as recommended by the associations mentioned before.

   The council does not have decisionmaking power either, and the lack of labor and business representation reduces the influence of its recommendations. The council discusses stabilization instruments and, above all, the question of public borrowing. In this special field its influence has been felt in recent years. The total amount of public borrowing and also the timing and the distribution of a suggested amount among types of government has been determined to a degree through deliberations of the council.

3. The third institution stemmed from Article 9 of the stabilization law which required five-year fiscal planning by the federal government. Another law[1] required creation of a fiscal planning council (*Finanzplanungsrat*) with the following members:
   - the Federal Ministries of Finance and of Economic Affairs;
   - the Ministries of Finance of the states; and
   - four representatives of local government.

   This council's first task was to institute a coordinated system of fiscal planning for all three levels of government.[2] More important for stabilization policies was the provision in the law that the council should determine ways and means of coordinating public budgets at all levels so as to promote stabilization. In this context, cooperation with the Business Cycle Council was explicitly required.

Although these three institutions created no new instruments nor controlled existing instruments, coordination of lower level government budgets has certainly been furthered. Though states and communities may still not be willing to act in a countercyclical way on their own initiative, the federal government is able to urge collective cooperation consistent with its countercyclical programs. State and local governments accounted for two-thirds of total public investments in 1976;[3] and since public investments are still considered one of the major instruments of business cycle policy, federal influence over subnational government investments can increase the effectiveness of its policy remarkably.

## INSTRUMENTS OF MULTILEVEL STABILIZATION POLICIES

### Rules of "Good Conduct"

Articles 1 and 16 of the stabilization law establish something like rules of "good conduct" in business cycle matters. These rules essentially urge all governments to fulfill the objectives of business cycle policy. As the localities depend very much on what the states do, Article 16 also holds that states must induce "good conduct" by localities.

### The Role of the States

One major influence in business cycle policy results from the tax-sharing system. The great amount of shared taxes in the whole tax system means that all levels of government participate in the cyclical variation of taxes even though the cyclical dependence of local governments was reduced somewhat after 1969. However, cyclical variation in shared taxes—rising relative to GNP in boom and falling in recession—is not stabilizing when state and local governments respond with corresponding adjustments in expenditures. Rapid expenditure adjustments produce procyclical rather than countercyclical results because balanced-budget public sector expansion is stimulative in "good times" and restrictive during periods of recession. Therefore, other instruments to influence state and local expenditures had to be found.

Unlike the United States, West German states have always been forced to remit their current surplus to an account with the central bank. In addition, Article 15 of the stabilization law provided that the federal government can, together with the state chamber, force the states to remit part of their revenue to a separate account with the central bank (*Konjunkturausglaischsrücklagen*). The federal government must remit a matched amount. These sums are available for expenditure only after another order of the federal and state chambers releases them. The purpose of this mechanism is, of course, to force a budget surplus in times of economic boom and to release these funds in times of recession—a "rainy day fund."

A third type of instrument also applies to the revenue side. Article 19 of the stabilization law provides that the two chambers can limit the total amount of public borrowing by federal, state, and local government. In order not to put too heavy a limitation on individual local governments, the states can relax the limitations by up to 30% in the aggregate, provided that the relaxed limits for local governments are selective and are justified.

These three instruments at the state level (and partially affecting the local level, too) operate on revenues. Expenditures are too difficult to control directly by intergovernmental means. Hence, only indirect controls on expenditures are used.

### Influencing the Local Level

States are more likely than localities to perceive direct benefits from their own countercyclical fiscal policy and therefore can be expected to cooperate more readily with the business cycle policy of the federal government. Local governments cannot attribute to their own territory the beneficial effects of their own countercyclical budget policy. Countercyclical local policy may be indirectly and slightly induced if the prices of purchased goods and hired personnel are considerably higher in boom periods compared to recession periods. Then there may be some inducement to decrease expenditures in boom periods. However, revenues are high in boom periods so that the short-term budgetary position usually leads to procyclical behavior.

In Germany there is one local expenditure category which by itself tends to respond in a countercyclical manner: welfare payments. As mentioned before, in West Germany welfare law is federal law. Local governments are required to execute that law and to finance this function to a great extent from their own sources. As welfare cases increase during the recession and decrease during the boom, this tends to have a countercyclical effect.

If local expenditures are to contribute to a countercyclical policy, however, it must be under either state or federal guidance. Direct stabilization influences on local expenditures have not yet been tried, though on occasion, such proposals have been made.[4] There has also been some discussion about including localities in the system of keeping current budget surpluses with the central bank, but the plans were dropped.[5]

At the local level, countercyclical instruments are used only on the revenue side and local governments are included in the borrowing limit scheme mentioned before, (though with the exception discussed there). There is an institution which could initiate a statewide policy of adjusting local borrowing to business cycle policy: the state board of control of community affairs (*Kommunalaufsichtsbehörde*). This board of control supervises the orderly budget policy of each locality. Each local government has to submit its budget proposals and the board of control decides whether, for instance, local borrowing is in compliance with legal provisions to ensure long-term, debt servicing capacity. It would be rather easy to have that board also supervise a sophisticated countercyclical system of reducing or expanding net borrowing by local governments.

Local governments depend heavily on grants (*Chapter 5, Table 25*). Therefore, states and/or the federal government could influence local expenditures if they were to vary their grants countercyclically. Such an arrangement could be facilitated by manipulation of tax sharing in combination with the above mentioned remittance system for state tax surplus revenues to the central bank account. When the economy was booming, some portion of shared taxes would have to be remitted and held for release during economic decline. The effect on localities would be indirect, depending on states' responses. To date, little use has been made of tax sharing as a countercyclical device. The legal machinery, however, is in place.

## A COMMENT ON THE EFFECTIVENESS OF INTERGOVERNMENTAL STABILIZATION POLICIES

An assessment of intergovernmental stabilization policies is basically a federal function. At the subnational level, the question can only be how far state and local fiscal flows can be guided in a countercyclical manner. The stabilization law brings together a number of instruments which should be able to achieve coordination. However, the short-term interests of states and communities work against these instruments. High revenues in boom periods offer the chance to spend money for new or expanded programs. Therefore, fiscal restraint in boom periods is difficult to achieve. What remains is the much easier task of spending more money in recession periods. This has been done mainly through federal programs of the same type as are found in all industrial countries: investment programs defined by sectors, regions, etc., sometimes spent directly through the federal government, to a degree spent through the local governments. Since this way of influencing state and local fiscal behavior under stabilization goals poses no great difficulty and is used in many countries, it was not treated explicitly in this chapter.

### FOOTNOTES

[1] For reference, see: *Haushaltsgrundsätzegesetz*, Article 51.

[2] For the system and recent figures for the federal part in it, see, *Finanzbericht 1978*, p. 188 ff.

[3] *Finanzbericht 1978*, p. 229.

[4] See, e.g., D. Dickertmann, and A. Siedenberg, "Konjunkturpolitische Instrumente für Länder und Gemeinden," *Archiv für Kommunalwissenschaften*, 10 1971, p. 284; and Kommission für die Finanzreform, *Gutachten über die Finanzreform in der BRD*, p. 139 ff.

[5] See, e.g., W. Heckt, *Zur Einbeziehung der Gemeinden in die Konjunkturpolitik*, Institut "Finanzen und Steuern," Brief 144, p. 44 ff.

Chapter 5

# Public Sector Growth

## THE PUBLIC SECTOR

The discussion of public sector growth has a long tradition in Germany. About 1880, Adolph Wagner formulated what came to be known as "Wagner's Law." He forecast a relative increase in public functions compared to private functions so that the government share of GNP would increase. From this law, which was not yet formulated in fiscal terms, he derived his "law of increasing fiscal need."[1] When Wagner formulated this law, he always used public expenditures as an indicator of growth. Following that example, the discussion of his law led to extensive data collection on long-term public expenditure.

Unfortunately, the question concerning which level of government was most responsible for this growth was not often asked and long-term data by level of government are almost totally lacking.

Wagner's Law is usually interpreted in terms of public expenditures as a share of either GNP or national income (NI), at factor cost. This method of measuring public sector growth has several shortcomings. *First,* only the expenditure component of public activity is included *(Chapter 1)*: If the federal government widens its domain through extensive regulation, through a change from unconditional grants to conditional grants, or by switching from

*Table 22*

**PUBLIC SECTOR EXPENDITURE AS PERCENT OF GROSS NATIONAL PRODUCT (GNP) AND NATIONAL INCOME (NI), AND TYPE OF PUBLIC EXPENDITURE AS PERCENT OF TOTAL, SELECTED YEARS, 1881–1975**

| | Total Public Sector Expenditures | | Percent of Total Public Sector Expenditures for— | | |
|---|---|---|---|---|---|
| | Percent of GNP | Percent of NI[1] | Defense | Transfers | Investments[2] |
| 1881 | — | 12.6% | 24.7% | 21.7% | 7.3% |
| 1900 | — | 13.9 | 24.4 | 22.1 | 10.7 |
| 1913 | — | 16.5 | 25.2 | 20.8 | 13.2 |
| 1925 | 20.6% | 25.2 | 4.4 | 32.1 | 13.8 |
| 1930 | 24.7 | 30.7 | 3.7 | 43.1 | 11.5 |
| 1935 | 30.1 | 38.7 | 24.3 | 35.1 | 10.2 |
| 1948 | — | — | 24.7 | 24.8 | 11.9 |
| 1950 | 28.6 | 36.5 | 17.1 | 27.8 | 18.1 |
| 1955 | 27.0 | 34.7 | 11.9 | 28.6 | 23.0 |
| 1960 | 27.9 | 35.8 | 12.9 | 23.3 | 22.6 |
| 1965 | 30.5 | 39.6 | 12.5 | 22.3 | 25.6 |
| 1970 | 28.6 | 37.1 | 9.2 | 28.1 | 25.5 |
| 1975[3] | — | 44.3 | 9.1 | — | 22.4 |

[1] National income at factor cost.
[2] Without financial investments.
[3] Expenditures without "special financing transactions."
SOURCE: H.C. Recktenwald, "Umfang und Struktur der öffentlichen Ausgaben in säkularer Entwicklung," *Handbuch der Finanzwissenschaft*, 3rd ed., Tübingen, 1976, pp. 719 and 742 ff.

1975: GNP and NI: *Statistisches Jahrbuch 1977 für die BRD*, p. 500.
Expenditures: *Finanzbericht 1978*, pp. 225, 229 ff.

unmatched grants to matched grants,[2] this relative increase of "federal sector growth" is not reflected. *Second*, while GNP and national income are comprehensive and widely used, they are not perfect measures of output. *Third*, expenditures contain transfers and GNP does not. Thus, it is not a share which is measured but rather a relationship.

In spite of these shortcomings, expenditures as a share of GNP or NI (*Table 22*) are still the "test" used to prove or disprove Wagner's Law. The figures in the table—the only statistics available for the last 100 years—show the 1975 share to be almost four times that of 1881. Since 1930, however, there has not been much of an increase, particularly if business cycles are taken into account. During a recession like 1935 or 1975, GNP and NI decrease and, if countercyclical policies are used, public expenditures increase. Thus, the public sector tends to be larger in recession periods and smaller in boom periods. If 1930 and 1970 are viewed as "normal" years, the comparison reveals an increase over the 40-year period of only 3.9 percentage points in terms of GNP and of 6.4 percentage points in terms of NI.

In the 50 years prior to 1930, however, the government share of national income increased from 12.6% to 30.7%. So Wagner's Law was apparently a good forecast for the first half century after it was formulated. The explanation for the widely different growth of government during the two halves of the century is probably totally different. The background for the big increase has been discussed quite often.[3] The slowdown may be attributed, at least in part, to one of the basic assumptions of optimal budget theory: the additional loss of private income is felt more strongly than the marginal benefit of more public expenditure. This appears especially true in the case of the high marginal tax rates on personal income.

Remarkable changes took place among the different types of expenditure during the nearly 100-year period.[4] Investments increased to three times their original share; transfers on the other hand were practically the same (as a share of total expenditures) in 1965 as in 1881. Defense fell from 24.7% of total expenditures to 9.1%. Though in absolute terms this means much stronger defense forces due to increased GNP, the relative burden on the public budget fell to almost one-third of the previous level. It should be noted that the periods of the two World Wars are not reflected in the figures. The high figures for 1950 and 1955 are caused by expenditures for the Allied Forces, whereas, beginning with 1960, West Germany financed its own defense forces.

The public share of the labor market is shown in *Table 23*. The period from 1881 to 1960 was covered by a long-term study which did not break the figures down by levels of government. Over the last 100 years total public personnel have increased nearly tenfold. It should be noted that after World War II this increase took place within diminished national boundaries and population. If the figures for public employment before 1945 were adjusted to the present smaller national territory and population, the share of public personnel in employment would be considerably higher for those earlier years.

Military personnel in 1881 and in 1976 were almost the same in absolute terms, though there have been wide variations through the years. Again, this does not mean that the relative importance of defense went down as expenditures for equipment per soldier in both monetary and real terms certainly went up.

Although the number of military personnel remained stable, the high figure for nonmilitary personnel in recent years makes it clear that many nonmilitary functions are now being performed with staffs that are growing at a rapid pace. Some increase may be due to additional functions. A major part, however, is certainly caused by the fact that government activity, as in the case of all tertiary activity, is personnel intensive and thus less amenable to productivity gains than the manufacturing sector of an economy.

## THE SHARE OF THE THREE LEVELS OF GOVERNMENT

### Their Share in Personnel and Expenditures

The share of the three levels of government in nonmilitary personnel for the period from 1963 to 1976 is shown in *Table 23*. Even for this relatively short period of 13 years there are marked tendencies. The federal government reduced its share from 12.7 to 11.3%, the local share dropped from 35.0 to 32.1%, with the difference being made up by the increase in state personnel—from 52.3 to 56.6%. Some changes,[5] particularly those between the state and local levels, may be due to the assumption of personnel intensive functions, like police, by the upper level. Also the fact that the state hires the teachers caused an increase in state personnel during a period of rapid growth in school enrollment. This particular tendency, however, should be reversed by 1985 at the latest because fewer pupils are currently entering grade school, and beginning in 1985 student enrollment in universities is also expected to decline.

It would be premature to interpret this relative increase in state personnel as a delayed consequence of the constitutional provision of 1949 (Article 30), which theoretically gave the states the bulk of the power in the federal system. In particular, the regulatory aspect of government activity is not reflected in these figures. [If the federal government increases its activity, for instance in the field of framework legislation *(Chapter 1)*, this additional activity could take place without an increase in personnel; but that would mean a definite increase in federal government "influence" in the federal system as a whole.] It could very well be that the growth at the state level just happens to reflect personnel-intensive functions but that its share in the "public sector" in a broader sense has declined in "real" power terms.

When *Table 24* is compared to *Table 23*, it appears that the federal share in personnel in 1965 does not reflect its share in expenditures, much less the wider "public sector." Even if military personnel are included in *Table 23* and added to federal employment, federal-state-local shares only change to 28.7%: 42.8%:

*Table 23*

## PUBLIC PERSONNEL: NONMILITARY BY LEVEL OF GOVERNMENT, MILITARY, AND PERCENT OF TOTAL EMPLOYMENT, SELECTED YEARS, 1881–1976

| | Nonmilitary Personnel | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | Total[1] | | Percent of Total Nonmilitary | | | Military | | All Public Personnel as Percent of Total Employment |
| | Persons | Percent Change Over Preceding Period | Federal | State | Local | Total Persons | Percent Drafted | |
| **1881** | 297,000 | — | — | — | — | 461,000 | — | 3.8% |
| **1900** | 572,000 | 92.6% | — | — | — | 629,000 | — | 4.7 |
| **1913** | 828,000 | 44.8 | — | — | — | 864,000 | — | 5.5 |
| **1925** | 1,065,000 | 28.6 | — | — | — | 142,000 | — | 3.9 |
| **1930** | 1,132,000 | 6.3 | — | — | — | 145,000 | — | 4.2 |
| **1935** | 1,177,000 | 4.0 | — | — | — | 236,000 | — | 4.7 |
| **1950** | 1,137,000 | −3.4 | — | — | — | 423,000 | — | 7.8 |
| **1955** | 1,372,000 | 20.7 | — | — | — | 303,000 | — | 7.1 |
| **1960** | 1,488,000 | 8.5 | — | — | — | 430,000 | — | 7.3 |
| **1963** | 1,950,315 | — | 12.7% | 52.3% | 35.0% | 443,003 | 39.6% | 8.9 |
| **1965** | 2,050,915 | 5.2 | 13.2 | 52.2 | 34.7 | 446,000 | 36.5 | 9.2 |
| **1967** | 2,140,136 | 4.4 | 13.3 | 52.5 | 34.2 | 477,000 | 41.9 | 10.0 |
| **1969** | 2,196,354 | 2.6 | 13.0 | 53.3 | 33.7 | 456,000 | 44.0 | 10.1 |
| **1971** | 2,349,009 | 7.0 | 12.5 | 54.3 | 33.2 | 479,000 | 45.7 | 10.6 |
| **1973** | 2,500,578 | 6.5 | 12.0 | 55.3 | 32.6 | 473,364 | 43.0 | 11.1 |
| **1974** | 2,551,925 | 2.1 | 11.8 | 55.9 | 32.3 | 489,365 | 45.1 | 11.6 |
| **1975** | 2,614,154 | 2.4 | 11.5 | 55.9 | 32.5 | 488,365 | 45.0 | 12.3 |
| **1976** | 2,640,365 | 1.0 | 11.3 | 56.6 | 32.1 | 488,367 | 45.0 | 12.5 |

[1] Including personnel in dependent agencies (*Wirtschaftsunternehmen ohne besondere Rechtspersönlichkeit*).

SOURCES:

1881–1960: O. Weitzel, *Die Entwicklung der Staatsausgaben in Deutschland*, Diss., Erlangen-Nürnberg, 1967, Appendix Table 8. Definitions vary from those used for figures after 1960.

1960–76:

Nonmilitary: *Finanzbericht 1969*, p. 549; 1973; p. 372; 1978, p. 238.

Military: *Finanzbericht 1965*, p. 438; 1967, p. 492; 1969, p. 507; 1970, p. 308. *Bundeshaushaltsplan 1973*, p. 54; 1974, p. 54; 1975, p. 50; 1976, p. 60.

Employment Base (after 1960): *Statistisches Jahrbuch fur die BRD, 1970*, p. 119; 1975, p. 150; 1977, p. 96; 1978, p. 94.

*Table 24*

**PUBLIC SECTOR EXPENDITURES FOR LEVELS OF GOVERNMENT, SELECTED YEARS, 1913–75**

| Selected Years | Total Expenditures,[1] M/RM/DM[2] (in millions) | Percent of Total Expenditures | | |
|---|---|---|---|---|
| | | Federal | State | Local |
| 1913 | 7,185 M | 32.0% | 28.1% | 39.9% |
| 1925 | 14,484 RM | 35.0 | 26.9 | 38.1 |
| 1928 | 20,791 RM | 38.9 | 23.3 | 37.8 |
| 1932 | 14,492 RM | 32.6 | 25.3 | 42.1 |
| 1936 | 22,312 RM | 59.2 | 14.1 | 26.7 |
| 1950 | 29,108 DM | 50.9 | 27.2 | 21.9 |
| 1955 | 52,242 DM | 44.5 | 30.9 | 24.6 |
| 1960 | 66,553 DM | 43.8 | 31.7 | 24.8 |
| 1965 | 148,075 DM | 42.7 | 29.0 | 28.3 |
| (1970)[3] | (196,330) DM | (46.1) | (33.1) | (20.8) |
| (1975)[3] | (355,119) DM | (45.7) | (33.8) | (20.5) |

[1] Direct expenditures (excludes grants to other budgets of the three levels of governments); without social security fund.
[2] Marks for 1913;
reich marks for the years shown from 1925–36; and
deutsche marks for years shown from 1950–75.
[3] Expenditures without "special financing transactions;" net expenditures.
SOURCES: C. Langheinrich, *Entwicklung und Struktur der Staatsausgaben,* Diss, Bonn, 1970, p. 107, 108.
1970: *Finanzbericht 1975,* p. 230 ff.
1975: *Finanzbericht 1978,* p. 225 ff.

28.5% respectively, whereas the shares in expenditures (*Table 24*) are 42.7%: 29%: 28.3%. The federal government thus has a much higher share in government expenditures than in all public personnel (military and nonmilitary). Federal activity generally is less personnel intensive because it involves income transfers and capital outlays in the defense field.

For the period 1950 to 1965, comparable annual data are available and show that the state share of government expenditures increased slightly, the local share grew considerably, and the federal share thus declined. The figures after 1965 are not exactly comparable with the previous figures. This is due largely to the fact that after 1969 expenditures are shown without "special financing transactions"—mainly debt transactions are excluded. Because the amount of debt-financed expenditures may differ over time and between the levels of government (*Table 25*), the shares in total expenditures are usually also affected.

The long-term development of public expenditures by levels of government in *Table 24*, beginning with 1913, is not easy to interpret. In 1918, in 1933, and in 1948 there were major shifts in the federal pattern of Germany. Although 1913 and 1925 were somewhat "normal" years in two different federal systems, they differ very little in terms of intergovernmental expenditures. The figure for 1936 shows that under the Nazi government there was a strong centralist tendency. However, another type of government would probably have shown similar increases in federal activity for that particular period, because this was a year of heavy countercyclical expenditures which always places the highest burden on the federal level. The Federal Republic of Germany started (1950) with a large share which later declined. In contrast, the states gained during the past 60 years while local governments lost nearly consistently. This local decline would be even more marked if the increase in state mandates were taken into account.

This type of long-term data by levels of government has occasionally been used in Germany to discuss "Popitz' Law," which holds that there is a secular trend toward more centralization in a federal system.[6] The assumption is that the central government attracts more and more functions which also lead to a centralization of expenditures. This tendency is best tested with long-term series of expenditure data within the same federal system. Neither for the period of 1925–32 nor for the period 1950–75 is there any manifest tendency of that kind.[7]

It can be argued, though, that the transition to a new federal system also reflects that tendency if long-term pressures toward more centralization are reflected in a new Constitution. In that sense, the difference between 1913 and 1925 on the one hand and 1932 and 1950 on the other hand (leaving the period 1933–48 out of the picture) might be significant. The federal share is certainly significantly higher than it was in 1913.

### Revenue Structure and Interlevel Dependency

Long-term statistics on public sector revenue systems never generated as much interest in Germany as figures on government expenditures. For this and other reasons, it is difficult to compare the pre and post-1970 periods.

*Table 25* presents a comparison of revenue sources across levels of government for 1970 to 1976. Own-source revenues (excluding those related to "special financing transactions") are classified as either "taxes" or "other," while intergovernmental revenues are shown separately. At the bottom of the table net borrowing figures are expressed as a percentage of total revenues without special financing transaction.

*Table 25* affords the opportunity to compare the extent of dependency on intergovernmental revenues across levels of government. For instance, in 1976, 29.9% of the total revenue came from other governments, compared to only 18.7% for the states. In terms of revenue, localities have a much higher degree of dependency or reliance on other sources—a reliance that would be even higher if upper-level regulations on the total level could be (and were) taken into consideration.

Over the brief time span included in *Table 25*, it appears that only minor changes occurred in the composition of revenue. The total share in intergovernmental revenue remained the same and the change in the federal and state shares was mainly induced by the business cycle. Whereas in 1974 all levels borrowed to about the same degree (as percent of revenue), the federal share had risen to 18.2% in 1976 as the federal government had initiated intensive deficit spending.

## THE ROLE OF GOVERNMENT-OWNED BUSINESS ENTERPRISES

### Problems of Definition

As in many European countries, the diversity of business arrangements in Germany is quite wide, ranging from purely private enterprises on the one hand to public activity, as expressed in public sector budgets on the other. At the federal level, the question is whether the federal railways are to be regarded as a public enterprise or whether this is an activity, like road construction, which is included in the budget. At the local level, utilities may be provided by a totally privately owned enterprise or by some form of public institution.

In addition to these institutions, there is a wide range of nonprofit organizations which operate on a strictly private basis but may also be tied closely to the public sector in terms of meeting public borrowing needs.

### Assessing the Importance of Government Enterprises

The report of the European Association of Public Economy *(Europäische Zentrale der öffentlichen Wirtschaft)* for 1975 noted that in the Federal Republic it is very difficult to assess the importance of the diverse public enterprises as a whole.[8] The usual publications give only partial information and, unless each government level gathers the figures for its sector, only rough estimates are possible.

The report employed a very wide definition of "public enterprise," including the federal railways, the entire postal system, all corporations and banks (including the *Sparkassen*) with public ownership beyond 50%, and two

*Table 25*

## TYPE OF REVENUE, BY LEVEL OF GOVERNMENT, 1970–76

(in millions of deutsche marks—DM)

| | Total Federal-State-Local Revenues | | Federal | | State | | Local | |
|---|---|---|---|---|---|---|---|---|
| | DM | Percent of All Revenues | DM | Percent of All Federal Revenues | DM | Percent of All State Revenues | DM | Percent of All Local Revenues |
| **Revenue From Own Sources[1]:** | | | | | | | | |
| ***Taxes*** | | | | | | | | |
| **1970** | 154,826 | 70.9% | 86,030 | 91.7% | 52,120 | 70.6% | 16,676 | 32.8% |
| **1972** | 195,697 | 70.3 | 103,093 | 92.5 | 69,389 | 70.1 | 23,215 | 34.2 |
| **1974** | 237,124 | 69.3 | 120,723 | 93.2 | 86,793 | 69.5 | 29,608 | 33.8 |
| **1976** | 261,648 | 68.6 | 133,104 | 93.7 | 94,340 | 68.7 | 34,204 | 33.6 |
| ***Other*** | | | | | | | | |
| **1970** | 35,342 | 16.2 | 5,995 | 6.4 | 10,247 | 13.9 | 19,100 | 37.6 |
| **1972** | 43,583 | 15.7 | 6,568 | 5.9 | 12,074 | 12.2 | 24,941 | 36.8 |
| **1974** | 52,947 | 15.5 | 6,836 | 5.3 | 15,005 | 12.0 | 31,106 | 35.5 |
| **1976** | 61,584 | 16.2 | 6,885 | 4.8 | 17,246 | 12.6 | 37,453 | 36.7 |
| **Intergovernmental:** | | | | | | | | |
| **1970** | 28,312 | 13.0 | 1,769 | 1.9 | 11,487 | 15.5 | 15,056 | 29.6 |
| **1972** | 38,953 | 14.0 | 1,805 | 1.6 | 17,480 | 17.7 | 19,668 | 29.0 |
| **1974** | 52,007 | 15.2 | 1,997 | 1.5 | 23,157 | 18.5 | 26,853 | 30.7 |
| **1976** | 57,944 | 15.2 | 1,994 | 1.4 | 25,694 | 18.7 | 30,256 | 29.9 |
| **Total Revenues[2]:** | | | | | | | | |
| **1970** | 218,480 | 100.0 | 93,794 | 100.0 | 73,854 | 100.0 | 50,832 | 100.0 |
| **1972** | 278,233 | 100.0 | 111,466 | 100.0 | 98,943 | 100.0 | 67,824 | 100.0 |
| **1974[3]** | 342,078 | 100.0 | 129,556 | 100.0 | 124,955 | 100.0 | 87,567 | 100.0 |
| **1976** | 381,176 | 100.0 | 141,983 | 100.0 | 137,280 | 100.0 | 101,913 | 100.0 |
| **Net Borrowing:** | | | | | | | | |
| **1970** | 5,698 | 2.6 | 277 | 0.3 | 1,969 | 2.7 | 3,452 | 6.8 |
| **1972** | 16,290 | 5.9 | 4,851 | 4.4 | 3,454 | 3.5 | 7,985 | 11.8 |
| **1974** | 22,456 | 6.6 | 9,049 | 7.0 | 7,738 | 6.2 | 5,669 | 6.5 |
| **1976** | 46,895 | 12.3 | 25,869 | 18.2 | 15,448 | 11.3 | 5,578 | 5.5 |

[1] The "special financing transactions" also contain a few revenues from own sources, for instance, dissolved reserves.
[2] Without "special financing transactions," for instance, without borrowing.
[3] Beginning with 1974, a slightly different calculation method was used.

SOURCE: 1970 and 1972: *Finanzbericht 1974,* p. 294 ff.

Table 26

**THE SHARE OF PUBLIC "ENTERPRISES" IN INVESTMENT AND NET VALUE ADDED, 1970 AND 1973**

(in billions of deutsche marks—DM)

| | 1970 | | 1973 | |
|---|---|---|---|---|
| | **DM** | **Percent** | **DM** | **Percent** |
| **Net Value Added:** | | | | |
| **All Enterprises**[1] | 460.9 | — | 610.8 | — |
| **Public Enterprises**[1,2] | 43.2 | 9.4% | 66.1 | 10.8% |
| **Gross Investments:** | | | | |
| **All Enterprises** | 114.4 | — | 137.9 | — |
| **Public Enterprises**[2] | 19.3 | 16.4 | 29.7 | 21.0 |

[1] Without housing.

[2] Corporations; utilities as dependent agencies; banks (including savings and loan associations) and insurance (if public ownership is beyond 50%); federal railways; mail; Volkswagen and VEBA, though public ownership is below 50%.

SOURCE: Europäische Zentrale der öffentlichen Wirtschaft, *Die Bedeutung der öffentlichen Wirtschaft in der Europäischen Gemeinschaft*, Brussels, 1975, p. 18. ff.

major corporations—Volkswagenwerk and VEBA (even though government ownership is below 50%).[9] For this combination of "enterprises" the estimated share of total net value added is 10.8% and of gross investment 21% in 1973 *(Table 26)*.[10]

A different picture emerges if only the equity capital in market-oriented enterprises held by the federal government and its special funds are considered. The total of 7.283 million DM of federal equity capital in 1976 is less than 5% of all corporate capital[11]—a base which is definitely too small to show all capital invested in private enterprises.

The philosophy concerning the appropriate role of the public sector in private enterprise has changed several times in this century. During the Weimar Republic, several large private corporations experiencing financial difficulties were taken over by government. During the Nazi government, some large new production units under public ownership were created for war production. So the federal government and some states, when they were founded in 1949, confronted an uncoordinated mixture of public and private enterprises. In the following years the major part of the capital of some enterprises was handed back to the private sector.

Public enterprises, as well as nonprofit-making organizations, and major banking systems, are given some preferential treatment under the tax laws. On the other hand, public utility enterprises at the local level have to pay for using the monopoly *(Konzessionsabgabe)*.[12]

At the political level, the growth of the public sector is the subject of discussion between the major parties. The Social Democratic Party presented a platform which called for a 5% increase in the public sector share of GNP in order to finance additional and increased functions.[13] The Christian Democrats, on the other hand, are opposed to such a policy. In general, while there is some uneasiness about the size of the public sector, the issue is usually not a major political bone of contention. Whichever party is in opposition accuses the ruling party of increasing public spending unnecessarily. Both major parties have a long record of expenditure-increasing bills.

During the recession, fiscal pressure (which had hardly been felt during the long boom period after World War II) led to efforts to reduce expenditures in some functions. Several states reduced their payrolls, particularly in the field of education. The rationale was the projected decline in school enrollments in the coming years. Recently a major effort was launched to curb rising health costs, both in the private and public sector; but the results of this effort are as yet unclear.

## FOOTNOTES

[1] A. Wagner, *Finanzwissenschaft*, 3rd ed., Part 1, Leipzig, 1883, p. 76.

[2] This increases the federal influence because matched grants bind funds of the recipient for purposes defined by the federal government.

[3] See, e.g., Shoup, C.S., *Public Finance*, Chicago, 1969, p. 496 f.

[4] The indicator values for 1975 cannot be interpreted as exactly as those for the years before because definitions changed slightly.

[5] These changes cannot be explained by reorganizations between budget-included and budget-excluded public institutions at each level because the personnel in dependent agencies were included.

[6] J. Popitz, "Der Finanzausgleich," *Handbuch der Finanzwissenschaft*, 2, Tubingen, 1927, p. 348 ff.

[7] For further discussion see, e.g., K. H. Hansmeyer, "Das Popitzsche Gesetz von der Anziehungskraft des zentralen Etats," *Beiträge zur Theorie der öffentlichen Ausgaben Schriften des Vereins für Socialpolitik*, H. Timm and H. Haller, eds., N.F., 47, Berling, 1967, p. 197 ff.

[8] Europäische Zentrale der öffentlichen Wirtschaft, *Die Bedeutung der öffentlichen Wirtschaft in der Europäischen Gemeinschaft*, Brussels, 1975, p. 17.

[9] It does not seem to be very useful to include the whole postal system in any type of definition of "public enterprise" and it is debatable whether public utilities at the local level are important for the discussion of how useful and necessary public enterprises are in fulfilling the public role in a market-oriented production or banking enterprise.

[10] Europäische Zentrale der öffentlichen Wirtschaft, pp. 18 ff.

[11] *Finanzbericht*, p. 198 ff; all corporate capital for *Statistisches Jahrbuch 1977 für die BRD*, p. 113.

[12] See, H. Pagenkopf, *Kommunalricht*, 2 Wirtschaftsrecht, 2nd ed., Köln, 1976, p. 105 ff.

[13] Sozialdemokratische Partei Deutschlands, *Entwurf eines ökonomischpolitischen Orientierungsrahmens für die Jahre 1973–1985*, Bonn, 1972; for discussion see, F. Rahmeyer, *Ökonomische und politische Hemmnisse einer Erhöhung der Staatsquote*, Köln, 1975.

Chapter 6

# Federal-State-Local Relations: Selected Aspects

## DIVERSITY AMONG THE STATES IN FISCAL RELATIONS

### Aspects of Fiscal Diversity

Economic and fiscal differences among the states, as well as among communities, have already been reviewed. These differences can also be used to construct indicators of the relative position of a state or a community (*Chapter 2*). A number of fiscal arrangements were reported which affected some states and communities more than others (*Chapter 3*). What remains, then, is the question of whether fiscal arrangements have interacted with differing conditions so as to provide a more uniform pattern of intergovernmental relations or whether great diversities remain.

Great diversity would be expected within a federal system with a constitution that leaves state matters and state-local relations almost entirely at the state's discretion. Since in German history there had always been more or less independent states, this constitutional principle could have opened the possibility for strongly divergent developments in the individual states. Partially, this might have also been expected as a reaction against the previous tendency during the Nazi government towards unification and uniformity. Based on history, diversification might also have taken

*Table 27*

# STATE AND LOCAL EXPENDITURES, BY STATES, 1975

(in deutsche marks—DM)

| Area-States | State and Local Tax Potential (DM per capita[2]) | Gross Domestic Product: DM (millions) | Gross Domestic Product: DM (per capita) | Public Expenditures[1]: State: DM (millions) | Public Expenditures[1]: Local: DM (millions) | Public Expenditures[1]: State-Local: DM (millions) | Public Expenditures[1]: State-Local: Share of GDP (percent) | Public Expenditures[1]: State Share of State-Local (percent) |
|---|---|---|---|---|---|---|---|---|
| **Baden-Wurttemberg** | 1,943 | 157,889 | 17,250 | 15,394.7 | 17,527.4 | 32,922.1 | 20.85% | 46.76% |
| **Northrhine-Westphalia** | 1,880 | 294,454 | 17,189 | 25,473.7 | 32,947.1 | 58,420.8 | 19.84 | 43.60 |
| **Hesse** | 1,870 | 96,507 | 17,389 | 9,999.2 | 10,695.6 | 20,694.8 | 21.44 | 48.32 |
| **Bavaria** | 1,692 | 172,545 | 15,962 | 17,793.8 | 17,750.7 | 35,544.5 | 20.60 | 50.06 |
| **Schleswig-Holstein** | 1,607 | 36,630 | 14,187 | 4,879.8 | 3,733.6 | 8,613.4 | 23.51 | 56.65 |
| **Rhineland-Palatinate** | 1,606 | 57,809 | 15,769 | 6,873.4 | 5,662.1 | 12,535.5 | 21.68 | 54.83 |
| **Lower Saxony** | 1,586 | 103,681 | 14,323 | 12,724.6 | 12,321.4 | 25,046.0 | 24.16 | 50.80 |
| **Saarland** | 1,568 | 16,540 | 15,091 | 2,090.7 | 1,374.0 | 3,464.7 | 20.95 | 60.34 |
| **All Area States** | 1,780 | 936,055 | 16,357 | 96,229.9 | 102,011.9 | 197,241.8 | 21.07 | 48.79 |
| **Range**[3] | (1:1.24) | — | (1:1.23) | — | — | — | (1:1.22) | (1:1.38) |
| **Federal Government** | 1,817[4] | 1,042,160 | 16,906 | 117,525.8 | 102,012.0 | 219,537.8 | 21.07 | 53.53 |

[1] Without "special financing transactions" and state-local transfers, but including shared taxes.
[2] 1976 data.
[3] Range in relative terms: the lowest to the highest number.
[4] Without West Berlin.

SOURCES:

State and Local Tax Potential: *Table 6* of this study.

Gross Domestic Product: *Statistiches Jahrbuch 1976 für die BRD,* pp. 38 ff. and 46 ff.

State and Local Public Expenditures: Statistiches Bundesamt, Fachserie L., *Finanzen und Steuern,* Reihe 1, Haushaltwirtschaft von Bund, Ländern und Gemeinden, III. Vierteljahreszahlen zur Finanzwirtschaft, 4. Vierteljahr und Rechnungsjahr 1975, p. 46 f., and author's calculations. State-local transfers were eliminated by computing state expenditures as the difference of net state-local expenditures minus local expenditures.

place within a framework of regional hegomony exercised by dominant states. Such a general trend toward regional diversification would certainly show now in state-by-state variations in fiscal relations.

Variation might also occur among sizes of the public sector within each state or in different state-local relations. Some differences in state-local relations have been mentioned in *Chapter 3*—especially the variations among the grant systems—but these are relatively minor. This chapter uses more global measures to show to what degree states differ from each other.

## The Size of the Public Sector, by States

In general terms, the size of the public sector has been discussed in *Chapter 5*. The federal level was compared with the state and the local level, but differences between states were not treated there. In *Table 27* public expenditures by states are compared with gross domestic product in the states.[1] The combined state and local expenditures are expressed as a share of state GDP. The range between these shares is 1.22 to 1—almost the same as the range for tax potential.

Combined state and local expenditures as a share of state GDP apparently do not correlate with state and local tax potential or GDP per capita (the indicators for the economic strength of a state). There is only a slight north-south variation insofar as Schleswig-Holstein, Lower Saxony, and Hesse rank higher than Baden-Württemberg and Bavaria. These two southern states are usually ruled by Christian Democrats, whereas the other three states tended to be more a domain of the Social Democrats (in Lower Saxony the parties changed only recently). Therefore, the north-south variation might be expected to reflect different attitudes toward the size of the public sector. On the other hand the Rhineland-Palatinate and Hesse are practically equal, with the former being a domain of the Christian Democrats and the latter having been under Social Democratic rule for decades. Besides, the differences are small, so one should not overinterpret them. In general, the share of state and local government in the state economy is very similar all over West Germany.

The differences are somewhat wider if only the state share in state and local expenditures is looked at. The relative range is 1.38 to 1; and even if the small Saarland, as one extreme, is excluded, the relative range would still be 1.30 to 1. Whether this means a great degree of diversity remains to be put into international perspective.

## Revenue Structure, by States

*Chapter 3* dealt with the equalization mechanisms that try to even out differences in revenues from own sources. It is therefore interesting to see how each state would be situated if it had to live only on its own-source revenue (as defined to *include* shared taxes but *not* other intergovernmental revenue).

In *Table 28*, revenue from own sources is calculated as total revenues (excluding "special financial transactions") on the one hand, minus intergovernmental revenue (excluding shared taxes) on the other.[2] State and local revenues from own sources taken together vary in a range of 1.44 to 1. The differences correlate closely with tax potential, by which states were ranked in this table. The first four states show the higher, the last four states the lower. The Saarland stands out as the state with by far the smallest revenue.

This may at the same time help to explain why in the Saarland the state has by far the highest share in state and local revenues from own sources. The small per capita amount may not be enough to leave money to be handed over to local governments after the state has paid for its own functions. Otherwise the range in the state shares is rather low (from 59 to 65%).

The major reason for the similarity among the states in revenues from own sources is the uniformity of tax devices in the Federal Republic. As described in *Chapter 1*, the Constitution rules that almost all major taxes, including states', are determined by nationwide tax laws. Thus, in practice, tax revenue can only reflect the differences in the tax base.

*Table 29* shows relative reliance on major taxes as percentages of own-source revenue. The major taxes and own-source revenues are

*Table 28*

**STATE AND LOCAL REVENUE FROM OWN SOURCES, BY STATES, 1975**

(in deutsche marks—DM)

| | Revenues (ROS)[1] | | | | |
|---|---|---|---|---|---|
| | State | Local | State-Local | | State Share of |
| Area-States | DM (millions) | DM (millions) | DM (millions) | DM (per capita) | State-Local (in percent) |
| **Baden–Württemberg** | 15,066.1 | 9,822.8 | 24,888.9 | 2,719.2 | 60.53% |
| **Northrhine-Westphalia** | 25,998.2 | 14,083.3 | 40,081.5 | 2,339.8 | 64.86 |
| **Hesse** | 8,910.9 | 6,117.8 | 15,028.7 | 2,707.9 | 59.29 |
| **Bavaria** | 15,848.3 | 9,933.1 | 25,781.4 | 2,385.0 | 61.47 |
| **Schleswig-Holstein** | 3,514.0 | 1,999.7 | 5,513.7 | 2,135.4 | 63.73 |
| **Rhineland-Palatinate** | 5,174.4 | 2,788.7 | 7,963.1 | 2,172.2 | 64.98 |
| **Lower Saxony** | 10,288.0 | 5,494.9 | 15,782.9 | 2,180.3 | 65.18 |
| **Saarland** | 1,625.1 | 449.3 | 2,074.4 | 1,892.7 | 78.34 |
| **All Area-States** | 86,425.0 | 50,689.6 | 137,114.6 | 2,396.0 | 63.03 |
| **Range[2]** | — | — | — | (1:1.44) | (1:1.32) |
| **Federal Government[3]** | 100,640.0 | 50,689.6 | 151,329.6 | 2,454.9 | 66.50 |

[1] Without "special financing transactions" and intergovernmental revenue, but including shared taxes.
[2] Range in relative terms: the lowest to the highest number.
[3] Figures for the federal government are somewhat lower than those shown for 1975 in *Table 26*, due to differences in statistical sources.
SOURCE: Statistiches Bundesamt, Fachserie L., *Finanzen und Steuern*, Reihe 1, Haushaltswirtschaft von Bund, Ländern und Gemeinden, III. Vierteljahreszahlen zur Finanzwirtschaft, 4. Vierteljahr und Rechnungsjahr 1975, p. 50 ff.

shown, by state, combining state and local amounts together. In *Table 29* it is obvious that tax revenue, including shared taxes, is the dominant part of—and therefore primary determinant of—the revenue from own sources.

Across states, the modest variation in reliance on each tax type implies only minor variation in the mix of revenue sources employed. The tax-sharing system has tended to eliminate diversity in this respect. The income and corporation profits taxes are by themselves rather evenly distributed. Net value added tax and business and payroll taxes have a wider range. However, higher reliance on these taxes is inversely related to states' wealth and the result is an evening out of taxing ability between the more and the less wealthy states.

The degree of diversity thus measured is rather low in West Germany. The reasons for this have been discussed in several places in this report. One reason is the basic construction of the Constitution of 1949, which, e.g., introduced some degree of tax sharing. The equalizing effects were increased by the fiscal reform of 1969. In addition to these events, and partly influencing them, is the general tendency to conform to nationwide or parallel rules of taxation. This tendency toward conformity is one of the major trends in the recent history of West German fiscal federalism. Whether or not this trend is welcome depends on whether one advocates fiscal equalization more strongly than other goals which are consistent with a federative constitutional philosophy.

*Table 29*

## MAJOR STATE AND LOCAL TAXES FROM OWN SOURCES AS A PERCENT OF REVENUES (ROS), BY STATES, 1975

(in millions of deutsche marks—DM)

| Area-States | All Tax Revenue: DM (millions) | All Tax Revenue: Share of ROS[4] (percent) | Income and Corporation Profits Tax[1]: DM (millions) | Income and Corporation Profits Tax[1]: Share of ROS[4] (percent) | Net Value Added Tax[2]: DM (millions) | Net Value Added Tax[2]: Share of ROS[4] (percent) | Business and Payroll Tax[3]: DM (millions) | Business and Payroll Tax[3]: Share of ROS[4] (percent) |
|---|---|---|---|---|---|---|---|---|
| **Baden-Württemberg** | 18,197.6 | 73.12% | 10,317.9 | 41.46% | 2,432.1 | 9.77% | 2,762.5 | 11.10% |
| **Northrhine-Westphalia** | 33,130.7 | 82.66 | 18,634.0 | 46.49 | 4,542.5 | 11.33 | 5,214.5 | 13.01 |
| **Hesse** | 11,078.6 | 73.72 | 6,126.8 | 40.77 | 1,471.2 | 9.79 | 1,838.0 | 12.23 |
| **Bavaria** | 18,822.3 | 73.01 | 9,902.8 | 38.41 | 3,007.5 | 11.67 | 2,573.4 | 9.98 |
| **Schleswig-Holstein** | 4,234.8 | 76.81 | 2,411.9 | 43.74 | 717.6 | 13.01 | 499.2 | 9.05 |
| **Rhineland-Palatinate** | 6,038.7 | 75.80 | 3,210.2 | 40.31 | 1,021.3 | 12.83 | 827.9 | 10.40 |
| **Lower Saxony** | 11,892.8 | 75.35 | 6,192.4 | 39.23 | 2,376.4 | 15.06 | 1,561.1 | 9.89 |
| **Saarland** | 1,711.7 | 82.52 | 855.1 | 41.22 | 398.8 | 19.22 | 194.7 | 9.39 |
| **All Area-States** | 105,107.2 | 76.66 | 57,651.1 | 42.05 | 15,967.4 | 11.65 | 15,471.3 | 11.28 |
| **Range[5]** | — | (1:1.13) | — | (1:1.21) | — | (1:1.97) | — | (1:1.44) |
| **Federal Government** | 115,151.7 | 76.09 | 62,900.6 | 41.57 | 17,171.0 | 11.35 | 17,452.7 | 11.53 |

[1] State share and local income tax share.
[2] Without fiscal equalization, i.e., 31.75% of total revenue.
[3] Total revenue minus federal share.
[4] Without "special financing transactions" and intergovernmental revenue, but including shared taxes.
[5] Range in relative terms: the lowest to the highest number.
SOURCES: Statistiches Bundesamt, Fachserie L., *Finanzen und Steuern,* Reihe 2, Steuerhaushalt von Bund, Ländern und Gemeinden, 1975, p. 23 ff. Revenues (ROS) from *Table 29* of this study.

## INTERGOVERNMENTAL COORDINATION BETWEEN THE STATES

Several comments have been made in this study on the similarity of a great many state regulations. Many similarities have come about without much formal coordination, but others are the result of a number of specific institutional arrangements for coordination. Among communities, a number of agreements exist for the provision of services which reach beyond the boundaries of an individual community (*Chapter 3*). Otherwise, coordination among localities is provided by the state. Interlocal coordination has been previously discussed; therefore this section discusses only coordination mechanisms among the states.

### Interstate Agreements

The Commission on Fiscal Reform, whose 1966 report became the basis for the reform of 1969 (*Chapter 1*), noted that "the general tendency towards unification and rationalization which determines modern industrial society" corresponds to an increasing amount of "self-coordination of the states."[3] Without any federal intervention, a great number of formal and less formal agreements were made between the states beginning in 1949. The commission reports that between 1949 and 1960 more than 300 agreements of different types had been made between the states.[4]

The agreements pertain to almost all functions of the states, but especially education—which has always been a major field of interstate agreements. Whereas in federal-state relations such an agreement normally involves bargaining for more or less power, the interstate agreements mostly originate with and cope with outside pressures for uniformity of nationwide regulation. Whether the mutual acknowledgement of university diplomas or the financing of a research institution of more than regional importance is at stake, there seems always to be a rational argument for a reduction of regional diversity and coordination of cross-regional decisions. Though the states do not want to give up their identity, the demands of citizens and business usually force them to adjust their activities in many ways so that citizens and business are not confronted with very different rules in different parts of the Federal Republic.

This activity is difficult to quantify. Counting the agreements does not say much about their importance. It can only be said that the great number of formal agreements over the years has been one of the major sources for the existing nationwide similarity in many fields of public activity.

### Ongoing Interstate Coordination

In almost every field of public activity there are standing commissions of the state ministries. The Commission on Fiscal Reform noted that between 1949 and 1960 the standing conference of the ministries of education alone had passed more than 500 resolutions.[5] If major resolutions have to be passed, the conference of the state prime ministers may have to be consulted. If there are pressing political problems, like short-run demands for additional openings at the universities or renewed terrorist activity, the standing conference of the ministers of education or of the interior will meet outside their schedule to discuss coordinated activity.

Very often the resolutions of these conferences have been the predecessors of interstate agreements. A new field of activity may be covered through resolutions or any other kind of coordinated activity before the need for a formal agreement is felt. As to the functions in which this current coordination takes place, there is practically no state activity which was or is not occasionally discussed in these conferences and possibly covered by a resolution.

### Fiscal Consequences

One of the major reasons for intergovernmental coordination at the state level is fiscal in nature. Unless a function is mainly regulative—like traffic regulations—large sums of money are involved. Whenever coordinated activity of this kind is discussed, compromise is needed among the states. At times, the need for compromise among all the states means a state will undertake a function or spend more money on a function than would otherwise have been the case.

Occasionally, however, resolutions and agreements have had the explicit objective of reducing expenditure. To take an example from the university sector, the state ministries of education agreed long before a pertinent federal law was enacted that the salary increase which a professor could receive if he was offered a chair in another state was to be limited in size. This was an action of collective fiscal self-protection.

There are also state agreements on personnel questions, an area of fiscal significance. For example, bargaining is practically nationwide for public personnel. Though formally the bargaining process starts at the federal level, unions and public authorities in the states and communities usually go along more or less with the federal agreement. As a result, there are practically no regional deviations in public sector salaries in West Germany. Differences which do occur are slight enough so that there is no need to adjust for wage differences, especially when regional cost variations are taken into consideration. Even before there was a nationwide law concerning public personnel, the states had managed to bring about provisions of great uniformity.

## INTERLEVEL PROGRAMS IN WEST GERMANY

This section deals only with federal-state and federal-local programs. Programs between state and local governments were discussed in *Chapter 3*.

### Federal-State Programs

#### CONSTITUTIONAL TYPES OF "COOPERATIVE FEDERALISM"

At several points in this study it has been noted that, as distinct from exclusively federal or state functions, Germany has established a system of federal-state functions. The Commission on Fiscal Reform called it "cooperative federalism" *(Kooperativer Föderalismus)*.[6] The historical perspective in which this type of function developed was explained in *Chapter 1*. Here the present situation and its fiscal aspects are discussed.

The cooperative institutions between federal and state governments are characterized by the fact that neither level of government can act alone to determine what has to be done to fulfill that particular function. Federal and state governments are, e.g., united in planning committees *(Planungsausschuss)* which must make policy decisions by extraordinary majority (which usually has to include the federal vote). For instance, the planning committee on "improvement of regional economic structure" consists of the federal minister of finance and one minister of each state. The votes of the federal representatives together are equal to the votes of all states taken together with each state having one vote. Decisions are reached by this particular committee by a 75% majority. Therefore neither level of government is able to take action unilaterally because a majority requires at least half the votes of the other level.

The Constitution provides two types of institutions of "cooperative federalism": (1) common tasks under Article 91a, and (2) agreements under Article 91b. In Article 91a three common tasks are defined: university construction, regional economic policy, and agricultural policy (including seacoast improvement). University construction had been a state function but the tremendous additional need for universities went beyond the fiscal means of the states. In the field of regional economic policy there had been federal and state programs long before the creation of the present German federation. Agricultural policy had been primarily a federal program but the states had also financed some agricultural programs of their own.

The fiscal provisions for the three common tasks are similar. For university construction and regional economic policy, the federal government finances 50%; for agricultural programs, 60%; and for seacoast improvements, 70%. All three programs are managed by a planning committee, as mentioned before.

In addition to these common tasks, Article 91b of the Constitution provides for two special agreements between federal and state level—one concerning educational planning, the other, research promotion. Educational planning is a function requiring little expenditure. This agreement was a response to the expansion of the educational sector since about 1965. The Federal-State Commission for Educational

*Table 30*

**FEDERAL SHARE IN COMMON TASKS AND AGREEMENTS, 1972, 1974, AND 1977**

(in millions of deutsche marks—DM)

| | 1972[1] | | 1974[1] | | 1977[2] | |
|---|---|---|---|---|---|---|
| | DM | Percent | DM | Percent | DM | Percent |
| **Common Tasks:** | | | | | | |
| **University Construction** | 1,569 | 41.5% | 1,464 | 39.6% | 850 | 35.5% |
| **Regional Economic Policy** | 313 | 8.3 | 228 | 6.2 | 334 | 14.0 |
| **Agricultural Policy[3]** | 1,282 | 33.9 | 1,219 | 33.0 | 1,210 | 50.5 |
| **Agreements Under Article 91b:** | | | | | | |
| **Educational Planning** | 67 | 1.8 | 98 | 26.5 | — | — |
| **Research Promotion** | 554 | 14.6 | 686 | 18.6 | — | — |
| **Total Federal Share** | 3,785 | 100.0 | 3,695 | 100.0 | — | — |

[1] Actual expenditures.
[2] Budget estimates.
[3] Includes seacoast improvement.
SOURCES:
1972 and 1974: Enquête-Kommission Verfassungsreform des Deutschen Bundestages, *Beratungen und Empfehlungen zur Verfassungsreform,* Part II: Bund und Länder, Presse- und Informations-zentrum des Deutschen Bundestages, Ed., Bonn., 1977, p. 104 ff.
1977: *Finanzbericht 1978, op. cit.,* p. 112 ff.

Planning has established medium-term plans for the educational system, including plans to deal with the unemployment of young people.

Research promotion, on the other hand, requires considerable expenditure. The main purpose of the agreement of 1975 was the financing of major research organizations. The most important of them are *Deutsche Forschungsgemeinschaft* and *Max-Planck-Gesellschaft. Deutsche Forschungsgemeinschaft* is mainly a research-promoting agency, whereas *Max-Planck-Gesellschaft* both does research and finances a great number of other institutions as well, with the federal share ranging from 50% to 90%.[7]

Figures for the federal share for programs of cooperative federalism are listed in *Table 30.* Although figures for "agreements" were not available for 1977, like other figures they probably have not changed much from prior years. The importance for federal and state budgets is not very great. Compared to shared taxes *(Chapter 1)*, the federal-state share of common functions as a fraction of federal-state outlay is very small. In *Table 1 (Chapter 1)* the expenditure figures for federal and state governments in 1976 are shown. Even if it is assumed that the combined federal and state amounts are double the federal amounts shown in *Table 30,* the result would be little more than 2% of total federal-state expenditures.

On the other hand, the importance of such a relatively new constitutional provision cannot be assessed solely in terms of expenditures over only eight years. Once this institution was established, a framework was created that can accommodate additional functions and more financing if more cooperative federalist programs are desired.

## ADDITIONAL FEDERAL-STATE PROGRAMS

For the fiscal year 1965, the report of the Commission for Fiscal Reform listed 216 items of the federal budget that constituted financing activities of the federal government within the domain of the states (or, in some cases, of local governments). All of the "unregulated" federal activity carried on informally or under separate agreements should, according to the commission, either be organized under the recommended common tasks framework or by formal agreement.[8]

Since it is difficult to assess the fiscal relevance of numerous current formal agreements, only one estimate—combined for local and state level—is given below.

## Federal-Local Programs

Fiscal flows are only part, and in some cases not even the most important part, of intergovernmental relations. Local governments are creatures of the states, as they are in the U.S.A. The states, therefore, have sought to prevent the federal government from directly interfering with local affairs. Under Article 104a, the federal government is allowed to give the states grants for particularly important investments of (state and) local governments. When the federal government tried to attach conditions to a grant for urban renewal, the Supreme Court ruled, in March 1975, that the federal government could define the purpose of the grants broadly but that the specifics of the program are a state matter. This ruling clarified the scope of federal regulatory authority over local governments in connection with functional grants.

Three major programs are currently affected—transportation, urban renewal, and hospitals. Communities receive a large percentage of the growing revenue from the tax on oil for the purpose of improving their transportation systems (including both streets and public transit). The federal government has begun to help finance urban renewal and urban development. The federal money goes mainly to urban areas but some part gets to smaller growth centers. Certain small cities with, for instance, medieval structures of importance receive considerable amounts of money in relation to their regional economic base. Federal funds have been made available to local communities to help cover the cost of hospital construction. Hospital operational costs are recovered through user charges.

## The Quantitative Importance of "Cooperative Federalism"

About half of the 1974 expenditures for intergovernmental programs was for the three "common tasks"—university construction, regional development, and rural development (*Table 31*). In the aggregate, these programs represent not much more than 4% of the combined federal and state budgets. Obviously, the amount of cooperative expenditure activity is relatively low.

The states received varying per capita amounts of the "common task" and other program funds. There is no obvious pattern of fund distribution because some programs favor the poorer, rural regions, and others favor heavily populated regions. Recent university construction programs seem to have accrued more to wealthy states, whereas regional and agricultural policy funds flowed in somewhat greater volume to the less wealthy states.

In one sense, any direct transfer of funds from the federal government to a particular institution or locality is an interference with state functions. If the states asserted their authority under Article 30 of the Constitution they might be able to stop these flows. However, this is not in their short-run interest because they might have to replace the amount from their own budgets. In the long run they may be better off retaining the functions and fighting for more money. These block grants provide some states with more fiscal relief than others, and a distribution of tax revenue of the same size as these programs would differ substantially from the way the funds are now distributed.[9] A shift to the tax-sharing approach would give more decisionmaking power to the states and lessen nationwide rules in the functional areas. For the most part, decentralization of decisionmaking is not yet a very prominent issue. Reactions by the states show that it may yet surface in some functional areas.

## Tendencies in Vertical Relations

### THE INTENSITY OF INTERLEVEL RELATIONS

This section traces the recent history of fiscal federalism in West Germany.

The first federal fiscal system, the Reich, began before 1918 and generally was marked by net flows from the states to the central government. In 1912, the states paid 234.8 million marks and received back 182.8 million marks. In other years such as 1895–98, the states re-

*Table 31*

## FEDERAL SHARE IN FEDERAL-STATE AND FEDERAL-LOCAL PROGRAMS, BY STATE, 1974

(in deutsche marks—DM

| States | State + Local Tax Potential DM per capita[1]) | All Programs | | Individual Programs (in Deutsche marks per capita) | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | DM (millions) | DM (per capita) | University Construction | Regional Policy | Agriculture | Local Transportation | Urban Renewal | Housing | Hospitals | Article 91b[2] |
| **Area-States** | | | | | | | | | | | |
| Baden-Württemberg | 1,943 | 1,012 | 110 | 26 | 1 | 18 | 25 | 2 | 11 | 14 | 13 |
| Northrhine-Westphalia | 1,880 | 1,939 | 113 | 31 | 0 | 9 | 31 | 2 | 12 | 15 | 13 |
| Hesse | 1,870 | 607 | 109 | 18 | 4 | 13 | 31 | 2 | 13 | 15 | 13 |
| Bavaria | 1,692 | 1,290 | 119 | 18 | 5 | 25 | 32 | 1 | 11 | 14 | 13 |
| Schleswig-Holstein | 1,607 | 409 | 158 | 9 | 14 | 59 | 34 | 3 | 13 | 13 | 13 |
| Rhineland-Palatinate | 1,606 | 372 | 102 | 9 | 4 | 25 | 22 | 3 | 10 | 16 | 13 |
| Lower Saxony | 1,586 | 1,071 | 148 | 24 | 7 | 37 | 28 | 2 | 22 | 15 | 13 |
| Saarland | 1,568 | 116 | 104 | 7 | 30 | 7 | 19 | 1 | 11 | 16 | 13 |
| Range [3] | (1:1.24) | — | (1:1.55) | (1:4.43) | (1:30.0) | (1:8.43) | (1:1.79) | (1:3.0) | (1:2.20) | (1:1.23) | (1:1) |
| **City-States** | | | | | | | | | | | |
| Hamburg | 2,853 | 202 | 116 | 34 | — | 8 | 28 | 1 | 10 | 23 | 13 |
| Bremen | 2,240 | 126 | 174 | 66 | 1 | 10 | 30 | 7 | 13 | 35 | 13 |
| West Berlin | — | 280 | 138 | 21 | — | 1 | 47 | 8 | 17 | 33 | 13 |
| **All States** | 1,817 | 7,424 | 122 | 24 | 4 | 20 | 30 | 2 | 13 | 16 | 13 |

[1] 1976 data.
[2] Educational planning and research promotion. Since sums could not be allocated directly, equal per capita amounts were assumed.
[3] Range in relative terms: the lowest to the highest number.

SOURCES: Enquête-Kommission Verfassungsreform des Deutschen Bundestages, *Beratungen und Empfehlungen zur Verfassungsreform,* Part II: Bund und Länder, Bonn, 1977, p. 102 ff.

Population 1974: *Statistiches Jahrbuch 1975 für die BRD,* p. 38 ff.

State and Local Tax Potential: *Table 6* of this study.

*Table 32*

**INTERLEVEL FLOWS, 1975**

| Spending Level | Receiving Level | Flows[1] (in millions of DM) Total | Current | Capital |
|---|---|---|---|---|
| **Federal**[2] | State[3] | 20,553 | 12,679[3] | 7,874 |
| | Local | 1,880 | 1,494 | 386 |
| **State** | Federal | 329 | 267 | 62 |
| | Local | 27,494 | 17,355 | 10,139 |
| **Local** | Federal | — | — | — |
| | State | — | — | — |
| **Total Flows** | | 50,256 | 31,795 | 18,461 |

[1] Repayment of loans and payment of interest on loans from lower to upper levels of government are not included, nor are loan proceeds from loans extended by upper levels to lower levels.
[2] Federal level without Fund for Equalization of Burdens and European Recovery Program Fund. City-states are included in the state level.
[3] Without federal grants from the net value added tax.
SOURCE: Statistisches Bundesamt, Fachserie L., *Finanzen und Steuern,* Reihe 1, Haushaltswirtschaft von Bund, Ländern und Gemeinden III. Vierteljahreszahlen zur Finanzwirtschaft, 4. Vierteljahr und Rechungsjahr 1975, p. 40 ff. The calculation deviates slightly from that in *Table 25* of this study due to the difference in the statistical basis.

ceived more than they gave, but this was more often the exception than the rule.[10]

By 1975, the flows of funds were definitely from upper to lower level governments (*Table 32*). Federal funds flow mainly to the states. State funds flow mainly to the local level. The flows themselves fail to reflect the degree of outside financial and budget control over local governments.

Moreover, transfers from the federal to the local level are underreported by the amount of the reimbursements to local governments for executing federal laws. If this flow were added to the amount shown in *Table 32*, the federal to local flow would be several times as high as it is. It is not possible to provide an estimate of this transfer because it is money passed from the federal level through states to localities.

It is difficult to judge the effect federal fund flows have on local fiscal discretion in the German setting. There are those who would argue that federal-local flows have had little appreciable effect on the structure and quality of local expenditures. Moreover, some would contend that, since federal money for urban renewal can only be given to the lower level without conditions attached, states and/or localities largely determine functional spending priorities. Origin and destination of intergovernmental transfers do not reveal the extent of centralized or decentralized authority. In some federal systems transfers can be a powerful instrument of extending one level's political influence. In other federal systems, financial transfers can help the recipient to widen its sphere of political influence. The latter characteristic seems to apply to the German federal system.

## Federal-State Relations

### THE CENTRALIZATION ISSUE: POLITICAL ASPECTS

At the heart of the centralization issue is the question of whether the tendency toward nationwide regulations is going to decrease or increase. It can be argued that the strong bias toward decentralization of political and fiscal authority in the Constitution of 1949 reflected only a short-term reaction against the extreme centralization of such power during the Nazi government. But the concentration of authority in the national government had a longer history in Germany. During much of the 19th Century the development of government in Germany reflected a longing for national unity and sought to capitalize on the feeling that the differences in states—their historical background, language, and other traits—were much smaller than their similarities.

Before the Nazi government, major reports concerned with fiscal federalism all had a strong bias toward either direct centralization or at least nationwide rule for state and local governments. The report of Popitz in 1932 called for strengthening central authority.[11] The central government and the states were depicted as victims of excessive local government authority.[12] Popitz has been called therefore a "fullhearted centralist."[13] He drew up a preliminary constitution in the event of an overturn of Hitler's government. In this draft he practically abolished the state level so that the division of functions and revenues was only a matter between central government and the local level.[14]

More recently, organizations and scholars have shown a healthy suspicion about excessive zeal to centralize or decentralize authority. The Commission on Fiscal Reform, though it expressed a desire for more nationally uniform standards for state and local programs, did not advocate a direct centralization of functions and/or revenues. Nor was its proposal to tie functions and funding together intended as a barrier to centralization. As a practical matter the concept of common tasks does not represent an urge to decentralize authority. Indeed, cooperative activity in certain functional areas did not lead to the participation of lower-level governments in previously exclusively upper-level functions. Moreover, one important analyst of joint political decisionmaking has cautioned about "tendencies of decentralization to create problems."[15]

In the report of both the Commission for Fiscal Reform and the Commission of Inquiry there are passages referring to the degree of decentralization intended under the Constitution of 1949.[16] Both reports acknowledged, however, that developments since 1949 have increased the need for nationwide standards in certain functional areas[17] and suggested reform proposals to adjust the Constitution to this apparent change in reality. It remains to be seen whether tendencies to ward off centralization of authority will remain in healthy tension with the idea that a considerable degree of decentralization decisionmaking power has allocative advantages.

## THE CENTRALIZATION ISSUE: ECONOMIC ASPECTS

The Federal Republic's strong dependence on foreign trade exercises a pressure to centralize tax policy determination. The federal government regularly argues that the distribution of revenues between state and federal government diminishes its capacity to cope with international issues.[18]

Because economic stability is harder to achieve in a country with high dependency on foreign trade, and coping with the business-cycle policy is almost an exclusive federal responsibility, there is also pressure to increase the central government's fiscal power. The federal government turned to deficit spending in the recession of 1974 and increased its share of net borrowing to total revenues from own sources more than the states or the communities did. Federal borrowing rose as a percent of total revenue from 7.0% to 18.2% between 1974 and 1976; state borrowing rose from 6.2% to 11.3%; local borrowing declined from 16.5% to 5.5% in the same period. Only four years earlier, the local level had financed 11.8% from net borrowing compared with the federal government's 4.4% and the state government's 3.5% (*Table 25*).

Federal and state governments, in addition to being entitled to short-term borrowing during the fiscal year, can remit to and withdraw from their countercyclical accounts with the central bank. Local governments have no similar access to the central bank. The quantitative importance of this bank credit, however, has not been great. Since 1971 the highest amount, made up of several programs and figured for both levels of governments together, has never been higher than 10 billion DM—a small amount compared with total revenue and expenditures.[19] (*Table 3* in *Chapter 1*.)

It is difficult to assess whether the rather strong German tradition of keeping deficits low will hold in the near future. As in many other countries, the business cycle changes are difficult to distinguish from essential structural changes. It is, therefore, not certain what the long-run effects of the recent recession will be. If a rate of unemployment which is considered high for West Germany continues for a number of years, there will always be political pressure to keep net borrowing at a high level. Under the present institutional arrangements this will mean more federal (and, to a degree, state) spending. The local level has not been included in this process of raising revenues countercyclically (*Chapter* 4), although it has been the instrument for increased federal spending in the course of business cycle-oriented federal programs.

## MORE "COOPERATIVE FEDERALISM?"

The initial enthusiasm about the institutions of "cooperative federalism" has subsided to a degree. The federal government and state governments (irrespective of which party controls a state) have voiced concern over their reduced freedom of action. In criticizing the "tremendous financing hodge podge,"[20] Minister of Finance Apel noted that mixed financing leads first to mixed responsibility for the function and its financing and then to a lack of accountability and lags in action. He warned against introducing new joint functions if they go along with joint financing and advocated a review of the existing cooperative functions with the objective of reducing them as far as possible.

Because cooperative financing has mostly meant federal cofinancing of more functions which had been state responsibilities, the views of a federal minister of finance may reflect a certain bias. Others outside the federal government, however, share this opinion. When the federal government initiated a cooperative program to save energy in 1977, two states opposed the venture. Among other arguments, spokesmen for the states took the view that additional mixed financing reduces the financing possibilities of the states for their own functions in an intolerable way.[21] The cooperative regional development effort has led to a discussion in several states about whether they should further participate in this program. The individual state, it is argued, can no longer claim credit for its own achievements in this field and thereby cannot justify further expenditure.

The possibility of expansion in other program areas of cooperative functions can be explained partly by the existing tax-sharing arrangements. Tax sharing as currently operating in Germany allows a shift of power between federal and state levels. Yearly negotiations about the division of the net value added tax receipts can lead to gradual shifts in functions between federal and state governments. If there were no shared functions, the tax-sharing agreement would only follow the actual development of the expenditures associated with the functions. If functions are "cooperative," tax sharing can work the opposite way: If one level has fought successfully for a higher share in revenues, it can accept a higher share in the financing of a common function; and this usually goes along with a stronger influence on the determination of size and structure of that function. Since 1949 the federal government has offered financing in previously totally state functions like constructing new universities. The process may have started with concurrence of some needy states. This then led to an agreement between all states and the federal government and eventually ended up in one of the constitutional provisions of 1969. In this way the federal government has assumed a larger role in shaping certain programs. Examples of growing state influence in previously purely federal functions are difficult to find.

Local governments have no strong countervailing influence in this aspect of fiscal federalism. They are heavily dependent on state governments and, through states, on the federal government. They cannot check federal power. Instead, local governments appear to be quite willing to accept whatever federal money is handed over to them. In regional development they are an object of joint state and federal policy, to the extent that they receive money to improve local infrastructure and attract business. Because federal interests are backed by grants, local governments willingly acquiesce in federal and state policy determination even though that sometimes entails sanctions in the field of area planning. Federal and state policymakers decide which local government will be a growth center, and therefore which locality shall have more or less opportunity to offer space for housing and commercial buildings. It is understandable that associations of local government periodically grumble about federal and state decisions and control over local planning.[22]

A reduction in cooperative federalism would probably result in a reduction of the federal government's share in total revenue relative to the state share, because the federal share is currently committed heavily to support functions which in the framework of the Constitution of 1949 are state responsibilities.

## The Unpredictability of State-Local Relations

State-local fiscal relations are matters worked out exclusively within each state. The variety of state-local arrangements makes it exceedingly difficult to mount a popular movement for more local control of finances or functions.

The likelihood of enlisting federal government support for greater local control is slim. Party affiliations of German politicians are strong. Each state is governed either by the Social Democrats or by the Christian Democrats. In general, each state finds itself cooperating with or opposing federal policies. While state and federal authorities of the same party may disagree on some issues, it is highly improbable that officials of different parties from different states could agree among themselves to introduce at the federal level a program to strengthen local government.

## FOOTNOTES

1 As in previous comparisons, state gross domestic product is used instead of personal income. Besides the fact that such income figures by states were not available for 1975 and that income figures derived from national income statistics cause methodological problems, reference to gross domestic product makes for easier comparisons with national and foreign country public sector sizes.

2 Figures for the Federal Republic are somewhat lower than they would show for 1975 in *Table 25* (*Chapter 5*), due to differences in statistical sources.

3 Kommission für die Finanzreform, *Gutachten über die Finanzreform in der BRD*, p. 12 ff.

4 *Ibid.*, p. 13.

5 *Ibid.*, p. 13.

6 *Ibid.*, p. 19 f.

7 *Finanzbericht*, 1978, p. 134 f.

8 Compare W. Heckt, *Die Entwicklung des bundesstaatlichen Finanzausgleichs in der Bundesrepublik Deutschland*, Institut "Finanzen und Steuern," Heft 103, Bonn, 1973, p. 50.

9 The Commission of Inquiry compared the distribution of reimbursements for these federal functions with the distribution of an increase in the state share of the net value added tax. The differences were rather large and the introduction of such a system would have started a new discussion of all implicit and explicit equalization mechanisms.

10 W. Gerloff, *Die Finanz- und Zollpolitik des deutschen Reiches*, Jena, 1913, p. 522.

11 J. Popitz, *Der künftige Finanzausgleich zwischen Reich, Ländern und Gemeinden*, Berlin, 1932.

12 *Ibid.*, p. 5.

13 G. Schmölders, *Finanzpolitik*, 3rd ed., Berlin-Heidelberg-New York, 1970, p. 152.

14 *Ibid.*, p. 152.

15 W. Scharpf, *Politikverflechtung*, heading to *Chapter 2*, p. 22.

16 Kommission für die Finanzreform, *Gutachten über die Finanzreform in der Bundesrepublik Deutschland*, p. 10 f.; Enquête-Kommission Verfassungsreform des Deutschen Bundestages, *Bertungen und Empfehlungen zur Verfassungs-reform*, p. 47.

17 Explicitly, "Bedürfnis nach einheitlichen Regelungen im Bundesgebiet," in Enquête-Kommission, p. 47.

18 *Compare, e.g., the statement of Minister of Finance Apel, reported in Frankfurter Allgemeine Zeitung*, July 7, 1977.

19 *Monatsberichte der deutschen Bundesbank*, 30 Year, No. 1, January 1978, Appendix p. 8; the figures include some more business cycle programs.

20 H. Apel, "Wie lange soll Bonn die Zeche zahlen?," in *Die Zeit*, July 8, 1977.

21 *Frankfurter Allgemeine Zeitung*, January 9, 1978.

22 See, e.g., *Frankfurter Allgemeine Zeitung*, December 31, 1977, where a statement of the Bavarian Association of Cities was referred to.

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