

Revenue sharing in the Federal Republic of Germany

J.S.H. Hunter

Centre for Research on
Federal Financial Relations
The Australian National
University, Canberra

RESEARCH MONOGRAPH NO.2



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REVENUE SHARING IN THE FEDERAL REPUBLIC OF GERMANY

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J.S.H. Hunter

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Centre for Research on Federal Financial Relations

The Australian National University: Canberra

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The Centre was established by the Australian National University in 1972, with financial support from the Australian Government, for the purpose of undertaking studies in the field of federal financial relations. The role of the Centre is to generate ideas in relation to problems of federal finance and to extend the reliability and range of information and analysis. In particular, the work of the Centre will have regard to expenditure responsibilities, financial powers (with respect to both taxation and loan finance), grants arrangements and the scope for intergovernmental co-operation.

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Publications

Books

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R.L. Mathews (Ed.), *Intergovernmental Relations in Australia*, Angus and Robertson, Sydney, 1973 (forthcoming).

Research Monographs

No. 1 J.E. Richardson, *Patterns of Australian Federalism*, Distributed by ANU Press, Canberra, 1973, pp. x + 142 (\$4.00).

No. 2 J.S.H. Hunter, *Revenue Sharing in the Federal Republic of Germany*, Distributed by ANU Press, Canberra, 1973, pp. xi + 116 (\$3.00).

No. 3 B.S. Grewal, *Fiscal Federalism in India*, Distributed by ANU Press, Canberra, 1974 (forthcoming).

No. 4 R.L. Mathews (Ed.), *Fiscal Equalization in a Federal System*, Distributed by ANU Press, Canberra, 1974 (forthcoming).

Reprint Series

No. 1 R.L. Mathews, "The Future of Government Finance", *Public Administration* (Sydney), Vol. XXXII, No. 2, June, 1973.

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The University of New England
March, 1973

J.S.H. Hunter

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The Australian National University
October, 1973

R.L. Mathews

REVENUE SHARING IN THE FEDERAL REPUBLIC OF GERMANY

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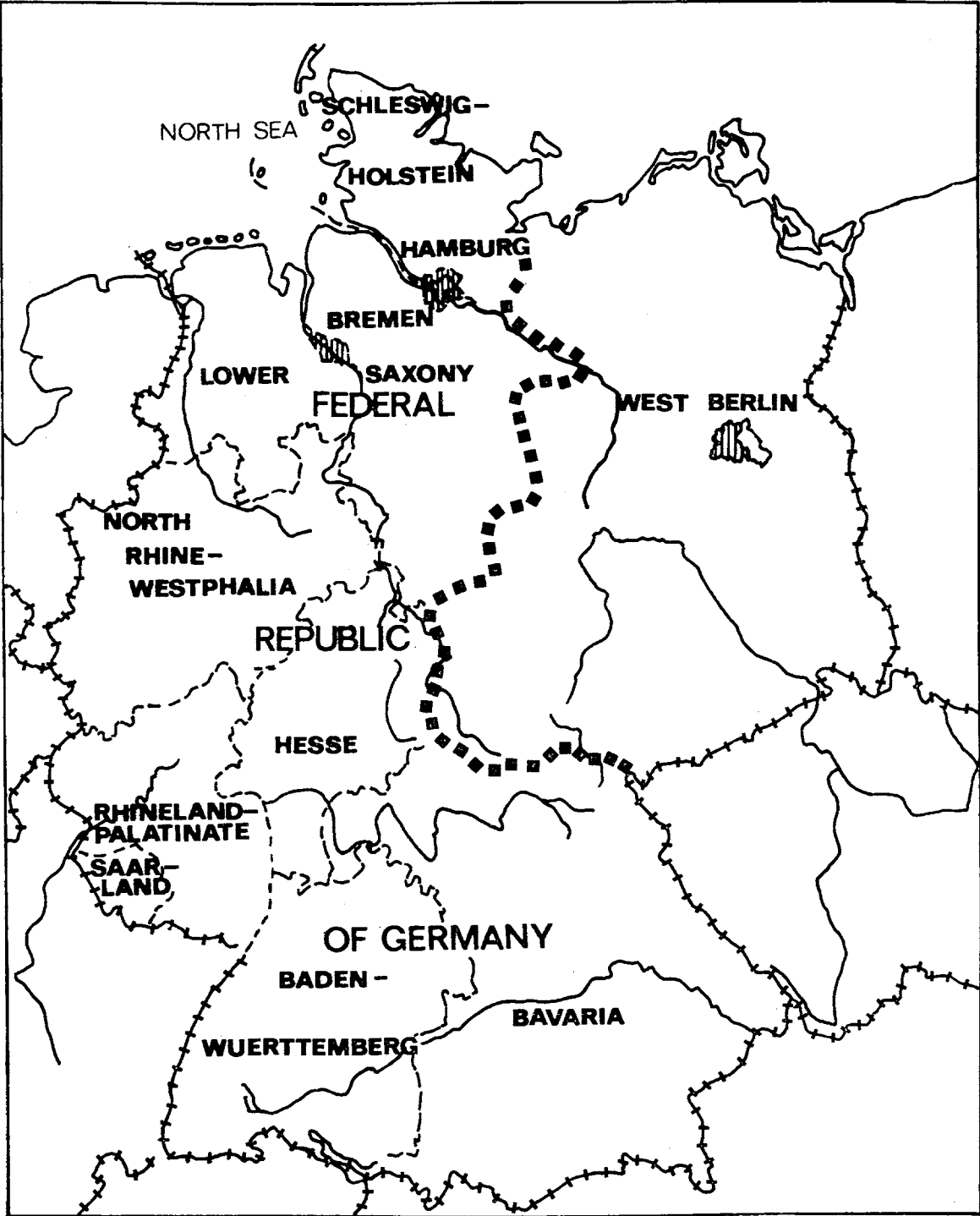
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STATES OF THE FEDERAL REPUBLIC OF GERMANY



I: PURPOSE AND SCOPE OF STUDY

This study is designed to give the reader a clear insight into the arrangements for revenue sharing in the Federal Republic of Germany.

The study covers both the vertical (Federal - State) and horizontal (inter-State) financial settlements in considerable detail - the former being dealt with in Chapter III and the latter in Chapter IV.

Chapter II, by providing a suitable economic and constitutional background, is designed to put the whole study in a true perspective.

Special attention is given throughout to the recent finance reform measures which bear closely on revenue sharing. The main emphasis is on Federal-State financial relations, but it has not been possible to overlook the important role of local authorities, especially as a major part of finance reform was concerned with an improvement in municipal financing via participation in income tax receipts.

II: THE ECONOMIC BACKGROUND AND THE FEDERAL CONSTITUTION

II (1): The Economic Structure and Recent Developments

The population of the Federal Republic of Germany stands at approximately 62 million. The country has an area of 96,000 square miles - not much greater than the size of Victoria. The Federation embraces eleven States (including the City States of Hamburg, Bremen and West Berlin). The four States which make up three-quarters of the total Federal area - Bayern (Bavaria), Niedersachsen (Lower Saxony), Baden-Württemberg and Nordrhein-Westfalen (North Rhine-Westphalia) - account for almost 72 per cent of the total population. This is, of course, in marked contrast to the pattern in Australia where we find that three States which have 80 per cent of the population (N.S.W., Victoria and Queensland) account for only 44 per cent of the Federal area.

In West Germany where the area is relatively small, growth forces have been strong. Economic growth has been geared to manufacturing industry, and especially foreign trade and investment. In recent years the value of exports has averaged over 18 per cent of gross national product at market prices (compared with 14 per cent in Australia).

In world trade the Federal Republic occupies a position of importance second only to the United States. In third place is Japan, followed by the United Kingdom, France and Canada. Exports from Germany in 1971 accounted for 12.4 per cent of total world exports.¹ The branches which are especially export-oriented are the electrical industry, mechanical engineering, motor vehicle production, iron and ironware, the chemical industry, precision instruments and the optical industry. On the import

¹ See International Monetary Fund: *International Financial Statistics*, Vol. XXV, No. 10, October 1972, p. 36.

side the most important items are food products, oil, textiles and clothing, machines, non-ferrous metals and iron and steel products.² Nearly half of the German exports go to the enlarged European Economic Community. After that come the developing countries, the United States and Canada, followed by countries of the Eastern Bloc. Imports follow a similar pattern. France is the most important trading partner in both exports and imports.³

In the last five years or so West Germany has emerged as a major capital exporting country in response to mounting current account surpluses, pressure from deficit countries, and the increased world demand for capital. Despite this, or because of it (opinions differ) the Deutsche Mark ranks as one of the strongest currencies. Although the mark has been upvalued on several occasions (in 1969, 1971 and 1973), the central bank has been obliged repeatedly to intervene in foreign exchange markets to prevent the mark from rising in relation to other currencies.

The rapid and sustained rate of economic growth in the Federal Republic is well known although the reasons for this growth are not fully comprehended. In the early years of the new Republic repeated references were made to the economic miracle (*Wirtschaftswunder*) under Chancellors Adenauer and Erhard. The economic success was, however, a many-sided affair. It is misleading to refer to it as a "miracle" since the main-springs of this growth (superimposed on a relatively modest endowment of natural resources) included sound economic management, hard work and industry of the people, the flair and opportunity for innovation, the US foreign aid program in the late 1940's and early 1950's, and membership

² Data from Statistisches Bundesamt: *Statistisches Jahrbuch* 1971, Kohlhammer, p. 295.

³ *Ibid.*, pp. 301-2.

of the EEC since 1957. The advent of the EEC meant, *inter alia*, a widening economic area free of trade barriers and with increasing opportunities for a high degree of mobility with respect to capital, labour and enterprise.

For these and other reasons West Germany emerged from the chaos of World War II as one of the leading industrial nations of the world. Apart from heavy industry, the nation is now prominent in the production of chemicals, drugs, fertilizers, synthetics, automobiles, machine tools, precision instruments, paper, optical goods and textiles.

In Germany the manufacturing sector occupies a central position. More than 40 per cent of GNP at factor cost is accounted for by that sector (Australia, 28 per cent), while primary production, mining and power absorb less than 8 per cent (Australia, 15 per cent). This concentration of economic activity in manufacturing also finds expression in the pattern of employment because nearly 40 per cent of the work force is engaged in manufacturing of one sort or another.⁴

With the exception of the recession year 1966-67, the growth of the economy in real terms (GNP at constant prices) has been impressive. In a ten year period to the end of 1971, the average annual growth rate worked out at 4.6 per cent. With the population gaining over the period at an average annual rate of 0.9 per cent, there was left a substantial gain in terms of material well-being.⁵

⁴ See *Statistisches Jahrbuch* 1971, pp. 125; 505-6.

⁵ Statistics on GNP at 1962 prices are from *Statistisches Jahrbuch* 1971, p. 504, and Report of the *Deutsche Bundesbank* for the year 1971, p. 3. Statistics on population are from IMF: *International Financial Statistics*.

Acute labour shortages marked the period 1961-65; and looking at more recent developments we find that, since the recession of 1966-67, the economy has been operating at or very near to its full production potential. In fact, there is still evidence of over-full employment in the labour market. The number unemployed has for some time been around 0.5 per cent of the work force and there are now about 800,000 jobs vacant, or five jobs to every one person unemployed. In recent years the increased demand for labour has been partially satisfied by the inflow of foreign workers. There are at present more than 2 million foreign workers in the country. In fact, every tenth worker in Germany is now a foreigner.⁶ About half the population increase on the average is derived from immigration.

Increasing demand for labour, itself a function of the underlying growth impulses (*e.g.*, in the last 3 years spending on new plant and equipment rose at an average annual rate of 17.6 per cent) has, of course, accentuated inflationary pressures; but in Germany these pressures have, at least until quite recently, been constrained by virtue of substantial productivity gains. Output per man hour rose by 4 per cent in 1970 and 3.5 per cent in 1971. A further rise of about 4 per cent was expected in 1972.⁷

If the rate of increase in consumer prices can be taken as a broad index of inflationary pressure, we see from Table 1 that in 1969 and 1970 West Germany experienced about the same degree of inflation as Australia, but much less than the United Kingdom, the United States or Japan. In 1971 the rate of price increase accelerated in Germany,

⁶ See Report of the *Deutsche Bundesbank* 1971, p. 3.

⁷ *Ibid.*, pp. 5, 26.

Australia and the United Kingdom, but tapered off in the United States. In 1972 there were signs that inflation had diminished slightly in all these countries with the exception of the United Kingdom and Germany. In view of the fact that, in contrast to many other countries, the West German economy has been operating for some time with very little, if any, margin of excess capacity, it is not unreasonable to suppose that price inflation in the Federal Republic would have been greater in the absence of large productivity gains and successive revaluations of the Deutsche Mark in 1969 and 1971. Revaluation had a significant effect in reducing import prices and made it more difficult for German exporters to raise the prices of exportable goods in terms of local currency.

Table 1

Percentage Increases in Consumer Prices (Selected Countries) 1962-72

	<u>Annual Average 1962-1968</u>	<u>1969</u>	<u>1970</u>	<u>1971</u>	<u>1972 Annual Rates</u>
West Germany	2.6	2.7	3.8	5.2	7.0 (a)
Australia	2.2	2.8	3.9	6.0	4.5 (b)
Japan	5.5	5.3	7.9	6.2	4.7 (a)
United Kingdom	3.5	5.4	6.4	9.4	8.6 (c)
United States	2.4	5.4	5.9	4.3	3.8 (c)

(a) January to November

(b) January to September

(c) January to October

Source: IMF: *International Financial Statistics*

II (2): Role of Government

The Federal Republic of Germany has a strong central government which is able to exercise a decisive influence on fiscal and monetary

affairs. Expenditure by the public sector, comprising the activities of the three levels of government (Federal, State and local), accounts for well over one-quarter, and nearer to one-third, of gross national product.

Although the crude statistics would suggest that the public sector in Germany is slightly less important than in several other federations (Australia and Canada, for example), there are grounds for believing that the recent development of economic planning techniques and machinery for combating economic fluctuations has placed the central government in a very strong position.⁸ The available statistics nonetheless provide ample evidence as to the key importance of government in the economy. In 1971 government consumption increased at a faster rate than any other component of national expenditure. The importance of government in recent years can be gleaned from Table 2.

Table 2

Selected National Accounting Aggregates (Average Annual
Rate of Increase) 1967-71

	%
Private Consumption	10.0
Government Consumption	12.4
Gross Fixed Capital Formation	15.5
Exports	11.7

Source: Report of the *Deutsche Bundesbank* for 1971, p. 7.

The most recent yearly statistics (1971) show that the Federal Government absorbs 46 per cent of total public sector outlay in Germany,

⁸ This point is expanded in section (6) dealing with the "Economic Stability and Growth Law".

compared with 48 per cent in Australia. In Germany the local authorities are, however, much more important than in Australia, where the States and their semi-governmental authorities perform many of the functions which in Germany are undertaken by municipalities or municipal corporations. Examples are: adult education;⁹ extension of water, gas and electric mains; development of local bus and tram services; road building; hospitals; housing; cultural affairs (e.g., municipal theatres and museums); and local welfare. These activities are partially dependent on financial allocations from the States and are subject to the overall supervision of the States.¹⁰

Local authorities in West Germany account for 20 per cent of public sector outlay (8 per cent in Australia) and about two-thirds of fixed investment in the public sector.¹¹ The local authorities, however, have a relatively less important role in Germany than they do in either the United States or Canada, as shown in Table 3.

In the 'sixties municipal expenditures increased at a faster rate on the average (10.1 per cent p.a.) than was the case for expenditures undertaken by the Federal Government and the States. They also increased faster than the gross national product.¹² Looking ahead ten years it is

⁹ General education and university education are the responsibility of the States. However, since 1964, the Federal Government and the States have undertaken the joint financing of the extension and improvement of universities and other institutions of higher learning.

¹⁰ See H. Arntz: *Facts About Germany*, Press & Information Office of the Federal Government, 7th ed., 1968, pp. 60-2.

¹¹ See Raske: "Die Kommunalen Investitionen in der Bundesrepublik", *Schriftenreihe des Vereins fuer Kommunalwissenschaften*, Band 30, Stuttgart 1971, p. 43; and H. Koschnick: "Ursachen und Loesung der Kommunalen Finanzkrise", *Kommunalpolitik*, Wirtschaftsdienst 1972/II p. 73.

¹² *Ibid.*, pp. 71-2.

Table 3

Distribution of Public Sector Outlays by Level of Government (a)

(Per Cent)

	<u>Federal</u>	<u>State</u>	<u>Local</u>
West Germany (1971)	46	34	20
Australia (1970-71)	48	44	8
Canada (1971)	37	29	34 (b)
United States (1969)	60	14	26

(a) excludes intergovernmental transfers

(b) includes hospitals and pension plans, which account for 8 per cent of the total.

Sources:West Germany: *Finanzbericht* 1972, BMF, Table 7, p. 25.Australia: *Treasury Information Bulletin, Supplement on National Accounting Estimates of Public Authority Receipts & Expenditures*, December 1971, Tables 3, 5 & 7; also *National Income & Expenditure White Paper* 1970-71, Tables 10-15.Canada: "The National Finances, 1972-73", *Canadian Tax Foundation*, Table 2-1, p. 9.

U.S.A.: W. Prest, "Fiscal Adjustment in the Australian Federation - Vertical Balance", Paper presented to a Seminar on Intergovernmental Relations, Academy of the Social Sciences in Australia and the Australian National University, Canberra, 5-8 November 1971, p. 3.

clear that in task areas such as kindergartens, traffic, hospitals, public utilities and sporting facilities the demand for services will be stepped up even further. It was the recognition of the important role of municipalities in the structure of government that led the *Troeger Commission*¹³

¹³ The *Troeger Commission* conducted a comprehensive enquiry into various aspects of Federal-State-Municipal finance. The Commission was appointed in 1964 and its *Report* was released in 1968. The new finance reform law, based on the Commission's recommendations, was approved in April 1969. See *Gutachten ueber die Finanzreform in der Bundesrepublik Deutschland*, Kommission fuer die Finanzreform, Kohlhammer, 1966.

to make the reform of municipal financing one of its foremost aims. The latter is covered fully in Chapter III (8).

II (3) Organs of Government and Special Importance of the Council of States (Bundesrat)

The Constitutional Assembly (known as the "Parliamentary Council") met in Bonn on 1st September 1948, and worked out a Constitution (or *Basic Law*) which was approved by a two-thirds majority of the parliaments of the participating States and came into force on 23rd May 1949.¹⁴ The Constitution¹⁵ decrees that the general rules of international law form part of the Federal Law. Executive power is vested in the States unless the Constitution prescribes or permits otherwise.

The Organs of the Federal Republic are:- (i) the Lower House (*Bundestag*) elected for a term of four years; (ii) the Council of States (*Bundesrat*) consisting of members of the governments of the States; and (iii) the Federal President (*Bundespraesident*) elected by the Federal Assembly for a 5 year term. The Federal Assembly consists of the members of the Federal Lower House and an equal number of members elected by the popular representative bodies of the States according to a particular system of semi-proportional representation.¹⁶

The Federal Executive Government consists of the Federal Chancellor, elected by the Lower House on the proposal of the Federal President, and his Cabinet, *i.e.* the Federal Ministers, who are appointed and dismissed by the Federal President upon the proposal of the Chancellor. Federal

¹⁴ *The Statesman's Year Book*, 1967-68, S.H. Steinberg ed., Macmillan, N.Y., 1967, p. 1049.

¹⁵ The main fiscal clauses of the Federal Constitution (*Grundgesetz*) are set out in the Appendix.

¹⁶ *Ibid.*

laws are passed by the Lower House and then submitted to the Council of States, which has a limited veto. The Constitution may be amended if approved by two-thirds of the members of both Chambers.

Unlike the Weimar Constitution, the Constitution of the Federal Republic clearly contemplates a parliamentary system of government, and not a government of divided powers as in the United States. The functions of the Federal President are largely formal and representative. As Head of State, he represents the Federal Republic in dealing with other nations and appoints federal judges and other federal officials. The President is obliged to appoint and dismiss the Federal Chancellor upon the direction of Parliament, and to appoint and dismiss federal ministers upon the request of the Chancellor.

In Bismarck's Reich of 1871 the States held a strong position. In the Weimar Republic, by contrast, the Federal Government held a dominant position in financial matters. In 1934 the National Socialists stripped the States of their sovereign rights and made them into administrative regions of the central government. With the collapse of Germany in 1945 the Allies proceeded to restore the fiscal sovereignty of the States.

The conflict between unitarians and federalists had been intense ever since 1918; and controversy was revived when the Constitution of the Federal Republic was being drafted in 1948. However, on that occasion the balance of opinion swung decisively in favour of the federalists. The Council of States (*Bundesrat*) again became a permanent conference of State Ministers. It was not merely an Upper House or House of Review after the British, American or Swiss pattern; and its influence in the field of federal legislation and administration is very much greater than that of

the Reichsrat of the First Republic.¹⁷ The federal structure of the country is much more marked than in the Weimar Constitution.

Under the 1949 Constitution the Council has not only established itself as an integral part of the federal legislature (reviewing legislation passed in the Lower House and, on occasion, initiating legislation itself). In addition, it has assumed another role, that of a States House - a role which, from the standpoint of the present study, is of the utmost importance.

The Council serves, in effect, as a connecting link between the Federal Administration and the States.

The Council is, in accordance with *Article 51* of the Constitution, a true States House since its representation is, in fact, composed of State Ministers (or their nominees) who are subject to the directives of their respective governments.¹⁸ In the Council, unlike the Lower House (*Bundestag*), members act in accordance with the decision of State governments and not necessarily in accordance with their political ideologies. The views of Council members - or a majority of members - may or may not be identical with the prevailing view of the Federal Government majority in the Lower House.

The Council of States currently has 45 members. State

¹⁷ H.J. Gumpel: *Taxation in the Federal Republic of Germany*, Harvard Law School World Tax Series, 2nd ed., 1969, p. 316.

¹⁸ The members of the Bundesrat are appointed by the State governments and recalled by them. The appointments are made in an informal way on the basis of agreement. Only Berlin and Rheinland-Pfalz have special rules for the appointment of delegates to the Bundesrat. See H. Laufer *Der Bundesrat*, Bundeszentrale fuer Politische Bildung, Bonn, 1972, pp. 6, 8.

representation in that Chamber is geared to population.¹⁹ Each State has at least three votes. States with more than 2 million people have four votes while States with more than 6 million people have five votes.

Baden-Württemberg, Bayern (Bavaria), Niedersachsen (Lower Saxony) and Nordrhein-Westfalen (North Rhine-Westphalia) each has five votes; Hessen, Rheinland-Pfalz and Schleswig-Holstein each has four votes; and Bremen, Hamburg and the Saarland each has three votes. There are four delegates from Berlin but they are not normally entitled to vote.

The influence of the Council of States has proved to be far-reaching in taxation and related fields, and also in other matters. For example, it was mainly because of pressure brought to bear in the Council of States that the Federal Government acquired the power to accumulate excess governmental funds in frozen accounts with the central bank to fend off a boom and to release funds from these accounts to combat recession.²⁰

In the field of taxation and public finance, the consent of the Council of States is required with respect to: (a) laws regulating taxes where the proceeds accrue entirely or in part to the States; (b) federal statutes altering the distribution of income tax revenues between the Federal Government and the States; (c) federal laws on fiscal equalization payments between the States; and (d) federal laws regulating the administration of federal taxes by the fiscal authorities of the States.

¹⁹ See A. Pfitzer: *Der Bundesrat*, 21st ed., Bonn, April 1972, p. 22; and J.F. Golay: *The Founding of the Federal Republic of Germany*, University of Chicago Press, 1958, p. 53. When the Federal Republic was formed there were twelve States. In 1952 the number was reduced to ten with the consolidation of Baden, Württemberg-Baden and Württemberg-Hohenzollern into one State called Baden-Württemberg. In 1957 the Saarland became the eleventh State of the Federal Republic.

²⁰ Pfitzer, *op.cit.*, p. 41. This decision constituted an important part of the Economic Stability and Growth Law. See II (6) below.

The Council of States has extended its influence over a wide area to embrace such matters as protection of the environment, city development, education, culture, health, transport, foreign affairs, agriculture and the European Economic Community. Changes in the Constitution require Council of States approval and it can initiate legislation. Its influence is, however, most apparent where the interests of States and the functioning of the Federal system are at stake. The Council of States appears to have been very successful in specifying and defending State interests and in securing appropriate compromise decisions when the interests of various States diverge or when some States have put forward proposals which have the necessary support in the Lower House. The Council of States has been able, in large measure, to counter the tendencies towards centralism which are inherent in most modern federations. As we shall see shortly, the decisive achievement has been in the direction of formulating machinery for Federal-State co-operation over a wide canvas, in respect of revenue-sharing in particular, but also in a sphere which will be shown to be closely related, namely the joint planning and financing of important segments of public authority expenditures.

The State representatives who comprise the Council meet in Bonn, on the average about every three weeks. Special conferences of State Ministers are not necessary since the Council is, in fact, a permanent conference of State Ministers and can convene in Committee²¹ to discuss and act upon any particular issue which bears on the rights and responsibilities of the States.

²¹ Decisions are prepared in Committees of which there are fourteen. The most important Committee is the Finance Committee.

It should be noted that the committees of the Council of States are usually composed of Ministers' nominees, in the form of senior State civil servants whose influence in their respective cabinets is apparently quite marked. In short, the Federal bureaucracy has an effective counterforce in the bureaucracy of the States as manifested in the various Council committees.²²

The Ministers or the delegates who form the Council do not start from a weak bargaining position; they do not come begging for money. There is no need for them to do so because the Federal Government is not able, by virtue of its majority in the Lower House, to pass and implement new legislation in any matter where State revenues are involved without the matter being thrashed out by the Council. Laws which bear on State interests cannot be promulgated without the consent of the Council of States. *Articles 105-7* of the Federal Constitution relate to tax matters, including the distribution of revenue between the Federal Government and the States and horizontal fiscal equalization at the State level. All laws in these categories require Council approval.

The relatively strong position of the States is evidenced by the fact that in the early life of the Federal Republic the Federal Minister of Finance was obliged to seek Council approval for an increasing share of income tax revenue. The Federal requests were invariably granted but it is clear that the composition and authority of the Council of States is such that Federal Cabinet cannot proceed to a decision without taking careful account of the effect which such a decision might have, for

²² See Laufer, *op.cit.*, pp. 16-17.

example on the ability of the States to finance expenditures which lie within their field of competence. An interesting situation occurred in 1962 when the States agreed to pay the Federal Government a "once for all" subsidy of DM 1,050 million. According to one expert, the payment was "without precedent in financial history".²³ Such payment, which was an alternative to an increase in the Federal share of income tax revenues, can be justified in the light of special circumstances - in this case the Berlin Crisis. Unexpected events of this nature cannot be taken into account by any formula governing the distribution of revenues between differing levels of government. A piecemeal approach is then clearly justified.

II (4): The Responsibilities of the Federal Government and the States

The exclusive legislative jurisdiction of the Federal Government extends, *inter alia*, to the following matters: foreign affairs and defence, citizenship, immigration and emigration, extradition, foreign commerce and customs, railroad and air transportation, minting and currency, mail and other media of communications, patents and copyrights.

Concurrent Federal and State legislation covers a great variety of fields, including aliens, public welfare, regulation of industry, commerce and insurance, promotion of scientific research, real property, public roads and shipping.

On the face of it, the West German Federation is strongly biased towards the centre. In the field of concurrent legislation the States can

²³ K. Stadler "Der Finanzausgleich zwischen Bund und Laendern", *Vortrag anlaesslich der Fachwissenschaftlichen Tagung Finanz und Haushaltswesen*, 5-7 December 1962, p. 122.

legislate only if the central government decides not to do so.²⁴ In fact the central government has made wide use of its concurrent legislative powers, especially in the tax field. What needs to be stressed is that the Federal Government cannot act in an arbitrary fashion - it must be able to demonstrate that there is a need for federal legislation in an area in which the States have legislative competence under the Constitution. This places the *Federal Constitutional Court* in a position of key importance since the Court has to be convinced that federal legislation in a particular field is in the public interest. The Court is able, therefore, to decide what activities should, in fact, be reserved for the States. Its decisions to reserve education and culture for the States²⁵ provide good examples of how the Court is able to act as a buffer against centralizing tendencies. In 1961 the Court made it clear that the development of radio and television was a matter for the States and not the Federal Government.

The point should be made that whether or not the Federal Government has exclusive or competing legislative powers and whether, in the latter case, it chooses to exercise them, would seem to be of less importance in West Germany than in most other federations. This follows from the position of influence which the Bundesrat - the Council of States - has acquired in the Federal Republic, as noted in the previous Section. Even if the Federal Government is able to legislate in one of the concurrent fields, any actual legislation which emerges will, in most instances, need

²⁴ The States retain the right to legislate unless and until the Federal Government pre-empts that right - and to do this the need for Federal legislation must be clearly established. Gumpel *op.cit.*, pp. 311, 422-3.

²⁵ G. Sawyer, *Modern Federalism*, C.H. Watts, London 1969, p. 101.

to gain the approval of the Council of States in which the political balance of power at the national level (as manifested in the composition of the Lower House) is not of decisive importance. States may not, therefore, be too unhappy with an extension of federal legislation in areas which overlap with their own prime spheres of influence. The 'joint tasks' concept discussed in III (6) and III (7) below is an excellent example, although the motivation goes deeper.²⁶ On the other hand, particular States (with Bavaria prominent) have resisted this trend and the Federal Constitutional Court has demonstrated its ability to do likewise.

II (5): Federal Tax Power and the Distribution of Tax Revenues

The West German Federation, with the advantage of hindsight, did not follow the American practice of giving both the Federal Government and the States legislative authority over taxes. The Constitutional Assembly saw distinct advantages in having uniform tax rates and structures throughout the whole federation. They also wished to avoid the need for piecemeal "patching-up" subsidies which appeared to be the inevitable result of competition between rival taxing authorities.²⁷ The importance of regulating the vertical intergovernmental fiscal imbalance through appropriate revenue-sharing arrangements, as set forth in the Constitution, seems to have been recognized right from the beginning.

The Constitution gives the Federal Government and the States *concurrent* legislative powers in most taxes; but once the Federal Government has pre-empted a tax field - and it has been quick to do this - the

²⁶ See *infra*, pp. 50, 53-7.

²⁷ Golay, *op.cit.*, p. 77.

powers of the States are at an end. Despite initial opposition from the Allied authorities, it was decided to opt for fiscal uniformity. It was also decided (*Article 106*) that the yields from certain specified taxes were to be earmarked for each level of government while the yields from other specified taxes would be shared between the Federal Government and the States. The latter are the *shared taxes* which comprised initially the income taxes paid by persons and corporations, but more recently include the value-added tax as well. In arriving at a decision as to the proportion of revenues to be received by each level of government, certain basic principles have to be observed:

(a) the Federal Government and the States have equal claim on current income to meet necessary expenditures;

(b) the latter are viewed within the context of financial planning stretching over several years;

(c) the financial needs of each level of government have to be balanced so that an excessive burden on tax-payers is avoided and the uniformity of living conditions in the Federal Republic is maintained.²⁸

Federal supremacy in tax legislation was therefore firmly established from the outset. In short, the Federal Government (with the approval of the Council of States) determines the rates and principles of assessment for non-Federal taxes (as well as for Federal taxes) where uniformity is considered desirable. Under the amended version of *Article 105* (passed in 1969), legislative power over taxation is given more extensively than previously to the Federal Government. The Federal Government has the competing legislative powers for all taxes if it receives income either

²⁸ See G. Obert, 'Die Finanzreform 1969', Sonderdruck aus dem *Bulletin* des Presse und Informationsamtes der Bundesregierung, Nr. 65, Bonn, 21/5/69, p. 19.

wholly or in part from those taxes or if Federal laws are necessary in the interest of uniform living standards.²⁹ This power does not infringe on the right of municipalities, with the consent of their State, to fix their own surtaxes or surcharges (*Hebesaetze*) to determine the effective yield from taxes on property, business and payrolls. However, to conform with the principle of fiscal uniformity, these tax rates (*i.e.*, the bases to which the surcharges are applied) are fixed by Federal law.³⁰

The financial provisions of the Constitution can be seen therefore as a compromise between the desire for a strong central government and for fiscal uniformity on the one hand and the importance attached to adequate machinery, which will protect the financial autonomy of the States, on the other hand. There is no necessary contradiction between these objectives. In order to secure State fiscal autonomy it is sufficient first that the States have a strong voice in decisions which affect their vital interests, and secondly that they have access to finance commensurate with their expenditure responsibilities. Despite strong opposition from the Allied authorities, the right was conceded to the Federal Government to enact uniform tax rates for the whole federation but in return it was agreed that all legislation on taxes relating to States and municipalities must have the approval of the Council, whose important role has been noted. The only major concession to the Allied

²⁹ *Ibid.*, p. 12; and H. Ruhe "Die Finanzreform", *Deutsche Steuerzeitung*, Nr. 12, 15/6/69, pp. 179-180.

³⁰ The municipalities have virtually no legislative power in the tax field. Statutes reserving the proceeds of certain taxes to the municipalities (*e.g.*, part of income and trade taxes) are Federal laws. The distribution of revenue among the municipalities within a State-horizontal fiscal equalization at the local level-is regulated by State law. See Gumpel, *loc.cit.*, p. 422.

point of view was that the actual assessment and collection of taxes³¹ (with the exception of local taxes) were left to the States.

Of particular importance for subsequent discussion were the arrangements for tax-sharing within the framework of fiscal uniformity. By specifying what taxes were to be assigned to each level of government and what taxes were to be shared between each level (and on what basis), the Constitutional Assembly sought to avoid the problems associated with large grants from the centre - problems which had clearly emerged in federations which had failed to make flexible and meaningful arrangements for revenue-sharing.

What seems to be especially significant in the Federal Republic is that the clear advantages of fiscal uniformity have been combined with machinery (under the Economic Stability and Growth Law) which ensures ample protection to State autonomy, coupled with a method of sharing the proceeds of income and other taxes which serves to correct for vertical intergovernmental fiscal imbalance.

II (6): The Economic Stability and Growth Law

In order to comprehend fully the system of revenue-sharing which has evolved in the Federal Republic of Germany, it is important to refer briefly to the passage of the *Economic Stability and Growth Law*³² in June 1967. This Law was in a sense the first instalment of the greater finance reform which was carried through in 1969-71 and which is discussed in some

³¹ Golay, *loc.cit.*, pp. 86, 108.

³² *Gesetz zur Förderung der Stabilität und des Wachstums der Wirtschaft*, Bundesministerium fuer Wirtschaft, Bonn, 3rd ed., May 1970.

detail below.

The Economic Stability and Growth Law can be seen as a means of redressing the imbalance between the use of fiscal and monetary policy. According to an OECD Report³³ the Federal Government in the late 1950's and early 1960's had tended to place too much reliance on monetary policy and had been reluctant, for constitutional and other reasons, to use fiscal policy for purposes of demand management. The Federal authorities were not unaware of this imbalance and the matter came to a head as a result of the inflationary boom of the mid-1960's, and the subsequent recession. After debate the authorities decided (and initiatives taken by the Council of States were important) to amend *Article 109* of the Federal Constitution. This was the fifteenth law to change the Constitution and its purpose was to strengthen, per medium of fiscal policy, the ability of the national government to combat economic fluctuations and to ensure a high and sustained growth rate. However, great care was exercised, in framing the law, to see that the rights and responsibilities of the States and municipalities in the Federal system were not jeopardized.

Whilst preserving the right of the *Bund* (the Federal Government) and the *Laender* (the States) to be independent in their budgeting, *Article 109* was extended as follows:

- (a) both the Federal Government and States must, in their budgeting, consider the requirements of the "total economic equilibrium";
- (b) each level of government must plan several years ahead; and
- (c) for purposes of trade cycle control, the Federal Government may

³³ W.W. Heller: *Fiscal Policy for a Balanced Economy: Experience, Problems and Prospects*, OECD, Paris, 1968, paras. 30, 65 & 67.

issue regulations with regard to government borrowing and the "freezing" or "unfreezing" of governmental funds held with the central bank.

With the granting of these new powers, the Federal Government then proceeded, through the Economic Stability and Growth Law, to specify the major policy goals and to establish machinery to enable each tier of government, in a spirit of co-operation, to work towards the attainment of these goals.

The Law is important in several respects, and particularly as it represents a decisive move towards co-operative federalism. In view of the growth of the public sector and the ability of the States and municipalities to influence both the pace and pattern of that growth, the Federal Government perceived the need for a more effective control (initiated from the centre) in the interests of economic management. But it did not want this to be done in a way which would undermine the financial independence of the States. A solution was therefore sought in terms of erecting machinery which would make economic planning and business cycle control the concern of *both* the Federal Government and the States.

According to *Paragraph 1* of the Law, each level of government (Federal and State), in formulating its budgets, must consider the requirements of total economic equilibrium. This means that account must be taken of price stability, high-level employment, external equilibrium and steady growth. Should these broad aims appear at any time to be threatened, the Federal Government is required (under *Paragraph 3*) to make available orientation data for concerted action by governmental units, business and trade unions so as to restore equilibrium. The Federal Government must plan forward for five years and report annually to both

Houses of Parliament (*paras. 2 and 9*). The 5 year economic plan is adjusted annually to take account of changing circumstances.

The Law sets down:

(a) the procedures which govern the use of excess funds of the Federal Government and the States for purposes of anti-cyclical control (*paras. 5, 8 and 15*);

(b) limitations to be placed on governmental borrowing to prevent undue strain developing in the capital market (*paras. 19-25*); and

(c) the possibility that rates of income taxes and the investment bonus can be changed, within certain limits, to counter any impending disturbance to economic equilibrium (*paras. 26-27*).

Decisions on these matters do, however, require approval of the Council of the States and can only apply for a year at a time. Moreover, additional government funds which are immobilized at the central bank in any year are not permitted to exceed 3 per cent of tax revenues raised by the Federal Government and the States in the previous year.

To help streamline decision-making and to provide the necessary intergovernmental co-operation, two bodies were set up under this law. First there was the Trade Cycle Council (*Konjunkturrat*) which is concerned with business cycle control and which advises, *inter alia*, on the re-activation of the frozen anti-cyclical funds, limitations on government borrowing and desired rates of spending by each level of government. Second there was the Financial Planning Council (*Finanzplanungsrat*) which co-ordinates medium-range financial planning of each level of government. The membership of each Council is similar - two Federal representatives, one from each of the eleven States (usually the Finance Ministers) and four

municipal representatives.

It seems clear that the Economic Stability and Growth Law has enabled the Federal Government to intensify its control over the economy, but without weakening the fabric of federalism. Fears that the law would destroy the federal structure have not been borne out. Since the States have full representation on the two advisory Councils they are more inclined to reject the notion that their interests are necessarily in conflict with those of the Federal Government.

This lessening of conflict between the two levels of government would not, however, have been possible if the States had not been able to gain access to the financial resources necessary to discharge their functions and if techniques had not been developed to ensure a more equitable distribution of revenues between States. As we shall see shortly, a willingness by the Federal Government to come to grips with both issues (vertical and horizontal imbalance) has greatly lessened the tensions which we might otherwise expect to find in federations at a time when national governments are prone to widen their sphere of influence.

In order to explain this easing of tensions special mention must be made of the role of the Council of States (*Bundesrat*) in effectively serving as a buffer against the inherent centralizing tendencies. However, the vital point is that the States are protected from arbitrary action by the Federal Government, not only by virtue of the authority of the Council of States, but because the *States actually participate in policy formulation* through their membership of the Trade Cycle Council and the various planning boards. Although the main initiatives must necessarily come from the Federal Government, the States are not placed in the invidious position of having decisions (which affect their interests as

sovereign States) thrust upon them by the Federal Government. The essence of federalism, as conceived in Germany, is *joint decision-making*, and this is something that the parties have consciously sought after and which now has a firm legal basis.

In order to arrive at an appropriate tax distribution between the Federal Government and the States, which is always a contentious issue, it is especially important that the financial planning of each level of government be brought into greater harmony. This is the task of the Financial Planning Council.³⁴

II (7): Main Features of the 1969 Finance Reform

The main *purposes* of finance reform in the Federal Republic of Germany were as follows:

- (a) to strengthen the ability of the Federal Government to control total expenditures but without destroying the Federal structure of government;
- (b) to improve the method of distributing the proceeds of tax revenues between each level of government;
- (c) to clarify the responsibilities of the Federal Government on the one hand and of the State governments on the other; and
- (d) to provide municipalities with a more elastic source of revenue so that less reliance would be placed on trade and property taxes and to enable local authorities more easily to finance expenditures in areas such as education and transport.

³⁴ Obert, *loc.cit.*, p. 10.

As we have seen, the Finance Reform measures followed closely on the recommendations of the *Troeger Commission*, a body of five members (with Dr Troeger as Chairman) appointed by the Federal Government in 1964 to conduct a full-scale enquiry into intergovernmental financial relations in the Federal Republic. The Commission's recommendations, approved in April 1969, came into effect in 1970 and included the following:

(a) The establishment of an Institute for Joint Tasks (*Institut der Gemeinschaftsaufgaben*) to enable the joint planning and financing by the Federal Government and the States of certain public tasks associated with higher education, scientific research, the regional economic structure, agriculture and coastal protection. An amendment to the Constitution [Articles 91 (a) and (b)] was required.

(b) Provision for Federal financial aid to States and municipalities to fend off economic recession and/or to promote uniform economic development. This change also required Constitutional amendment [Article 104 (a)].

(c) A decision to extend or widen the *Steuerverbund* (taxes shared between various levels of government) to incorporate the value-added tax and to make changes in the latter (*i.e.*, changes in the percentage share received by the States) the prime vehicle for regulating the vertical financial settlement (for details, see Chapter III and for relevant Constitutional amendment, see Appendix).

(d) Direct participation for the first time by municipalities in the proceeds from the wage and assessed income tax (initially 14 per cent), distribution to be on a local collection basis. As a partial offset municipalities agreed to channel 40 per cent of the yield from their trade taxes to the Federal Government and the States.

(e) An intensification of horizontal financial equalization at the

State level so that the adjusted tax capacity of each State would be raised to at least 95 per cent of the ten-State average (West Berlin excluded) on a per capita basis. The previous minimum was 91 per cent. The financial settlement transfers would, moreover, be smaller in view of the decision to distribute 75 per cent of the State share of value-added tax on a population basis and to use the remaining 25 per cent of that share to assist financially weak States.

(f) An amended version of *Article 105* of the Federal Constitution to strengthen the Federal Government's tax powers. The Federal Government can legislate on taxes from which it derives revenue or it can legislate on other taxes (*e.g.*, property taxes) in the interest of uniform living conditions.

II (8): The Equalization Law

Horizontal fiscal equalization at the State level is covered in *Article 107* of the Federal Constitution (Basic Law). The purpose of this Article is to ensure that the differential financial capacity of the States is appropriately offset. This follows recognition that the distribution of tax revenues on a derivation (or local collection) basis will favour States with high taxable capacities (usually the heavily industrialized ones).

Article 107 leaves the details to a special State financial equalization law (*Laenderfinanzausgleichsgesetz*), which is administered by the Federal Ministry of Finance in Bonn and which is designed to effect a redistribution of tax revenues among the States. In determining the amount of the horizontal equalization transfers, some weight must be given to the financial strength and financial needs of municipalities [*Article 107 (2)*].

Perhaps the most interesting aspect of horizontal fiscal equalization in Germany is that, unlike other federations, there is a "brotherly" rather than a "fatherly" financial settlement.³⁵ The more affluent States transfer revenue to the less affluent States in accordance with criteria established by the Federal Government (with *Bundesrat* approval). The settlement is *between* the States instead of through direct allocations from the Federal budget to the financially weak States.

Article 107 does allow for Federal supplementary payments to States in need³⁶ but these payments are small in relation to the equalization transfers. Since 1969 the financial settlement has also been influenced by rules governing the inter-State distribution of the State share of value-added tax revenues. The way in which the latter has reduced the need for financial settlement transfers, and the methods by which the financial strength or weakness of particular States is measured, will be covered fully in Chapter IV.

II (9): Summary

The foregoing should provide the reader with the background information necessary to appraise the importance of revenue sharing in the Federal Republic of Germany. Attention was directed first at the structure of the economy, its rapid growth and the recent tendency towards inflation. This was followed by reference to the role of government and to the

³⁵ K. Stadler, "Der Finanzausgleich zwischen Bund und Laendern", *loc.cit.*, p. 118.

³⁶ The relevant clause operates mainly in favour of West Berlin which does not participate in the inter-State financial settlement.

constitutional provisions governing the division of functions and tax powers in the West German federation.

To see revenue sharing in its true perspective, the following points need emphasis:

(a) The Federal Government has been able to secure virtually unlimited control over the tax system, partly for purposes of fiscal uniformity and partly to assist in overall economic management.

(b) This situation may give the appearance of a federation with strong centralizing tendencies, especially as the authorities have put considerable stress on the need for fairly uniform living conditions throughout the country. These tendencies are, however, greatly moderated by virtue of the special position and authority of the Council of States (Bundesrat) which is a permanent conference of State Ministers. All legislation which affects the distribution of tax revenues to States (vertical or horizontal settlement) must have the approval of the Council. The Federal Constitutional Court can, in the event of conflict, also rule that certain functions come within the State jurisdiction.

(c) A further protection to State autonomy has been built into the Economic Stability and Growth Law. This Law was designed to give the Federal Government wider powers to control economic fluctuations and to plan expenditure programs several years in advance. Although the main initiatives can be expected to come from the centre, the machinery erected under this law ensures that *both* the Federal Government and the States participate in such planning. Decisions on the distribution of the joint tax revenues (income and value-added taxes) logically follow efforts to harmonize medium-range financial planning at both levels of government.

(d) It was recognized right from the start that State fiscal autonomy could only endure and be meaningful if the States had access to revenues sufficient to match their spending commitments. Control of tax rates and structures was not considered to be a necessary part of such autonomy.³⁷

(e) It would therefore seem that the Constitution of the Federal Republic was framed and subsequently amended so that the advantages of federalism - unity at the national level and diversity at the regional level - could be preserved. In order to secure the necessary degree of co-operation between the central and regional governments, it is clear that each level has been willing to surrender some degree of sovereignty. Had that not been the case, co-operative federalism could not have become a reality in West Germany.

³⁷ The Rowell-Sirois Commission in Canada argued in similar vein. The Commission rejected the notion that Provincial autonomy is genuine only if the Provinces have exclusive access to the more lucrative fields of direct taxation. See D.V. Smiley, "The Rowell-Sirois Report, Provincial Autonomy and Post-War Canadian Federalism", reprinted in *Canadian Federalism : Myth or Reality*, J.P. Meekison (Ed.), Methuen, 1968, p. 67.

III: THE VERTICAL FINANCIAL SETTLEMENT

III (1): Meaning and the Alternative: A Statement of Principles

The expression "financial settlement" was, according to one writer,³⁸ imported from Switzerland and has been used in Germany since 1920. Its aim is to bring the receipts of each level of government (national and regional) into harmony with its respective tasks, and hence expenditures. The sharing of revenues, by which the vertical financial settlement is secured, therefore has *two facets* which stand out as the basic conditions for every federation: (a) the demarcation of responsibilities between the Federal Government and the States; and (b) the allocation of funds to make it possible for each level of government to discharge its constitutional responsibilities. If one partner is able to obtain more funds than it needs, the other partner may be unable to perform its tasks adequately or effectively. If this discrepancy persists and if it is the Federal Government which is able to obtain funds at the expense of the States, the trend towards a unitary form of government will be accelerated.

One alternative to a properly regulated financial settlement between the Federal Government and the States is, of course, an unregulated system in which each level of government is able to tax at will and decide what funds it wishes to raise. This alternative has been rejected in the Federal Republic of Germany for the following reasons:

- (a) The desire for fiscal uniformity and uniform living standards.

³⁸ Stadler, *op.cit.*, p. 113.

(b) The desire to avoid tax competition and what is seen as the inevitable consequence (for example, in the United States) - the need for large federal subsidies or grants to particular States.

(c) A realization, on the one hand, that the tax capacity of the economy is not unlimited coupled with recognition, on the other hand, that large financial needs of the public sector require relatively high tax rates. In short, to ensure a reconciliation and an appropriate balance between competing demands for resources on the part of the private and public sectors, these financial needs have to be considered in relation to the total amount of taxes and other funds which can be raised without impeding the overall objectives of economic policy. The central government is in the best position to perceive what that total amount should be and what growth can reasonably be contemplated for the public sector as a whole.

(d) A belief, and now a reality, that planning of public sector expenditures should not be carried out in a haphazard fashion but should be conducted within the framework of machinery for co-operation between the Federal Government and the States. The extent to which each level of government should *share* in tax developments can then be seen as a logical end-result of the planning techniques. Since taxes comprise about 80 per cent of total government receipts in West Germany, any major miscalculation with respect to estimated tax proceeds and/or the appropriate distribution between the Federal Government and the States to secure the vertical financial settlement would mean that certain plans are not realized. This would subject the federal structure to strains, particularly if it should be the States which obtain an insufficient share of tax revenues; for it is likely to be more difficult and costly for the States to make good the

deficiency through borrowing.

It is the financial settlement which gives the federal state its special character; and in Germany this settlement acquires its special significance within the framework of co-operative federalism - a type of federalism which recognizes *both* the special responsibilities of the national government for economic management and the need to protect the financial autonomy of the States. The financial settlement is the mirrored reflection of the division of powers between each level of government. In a federal state the two major tiers of government - federal and state - compete with each other for responsibilities and positions of influence. There is nothing peculiar about this state of affairs. In West Germany the central government has the controlling influence in finance (in the interests of fiscal uniformity and economic management), but this financial power is combined with a system of tax-sharing designed to enable each level of government to act responsibly and responsively in relation to its expenditure needs. These needs must, of course, be reassessed periodically in the light of changing circumstances.

III (2): Features of Revenue Sharing in the Federal Republic of Germany

There are several interesting points to note about the West German method of revenue sharing:

(a) It is a "mixed" system. Some taxes are specifically earmarked to either the Federal Government or the States, while other taxes are shared. The important distinction is between the *Trennsystem* (taxes assigned to particular levels of government) and the *Verbundsystem* (taxes shared between each level of government).

(b) The methods of tax sharing are specified in the Constitution.

(c) The high yielding or 'growth' taxes - the income taxes and, to a lesser extent, the value-added tax - are now included in the tax sharing system (*Verbundsystem*). These taxes are 'joint' in that revenue is shared between two, or in some cases three, levels of government.³⁹

(d) The vertical financial settlement has been regulated by changing the percentage share of the joint taxes which accrue to each level of government. With the enlargement of the tax pool (*Steuerverbund*) in 1970 to incorporate the value-added tax (excluding the tax on imports), the latter has become the sole movable portion of the tax distribution by which the vertical financial settlement is regulated. The participation ratio (between the Federal Government and the States) can be changed every two years by Federal law, with the approval of the Council of States.

(e) A clear separation is accomplished between the vertical (Federal-State) financial settlement and the horizontal financial settlement at the State level. The vertical financial settlement is regulated by changing the participation ratio in accordance with the *Revisionsklausel* of Article 106 (4) of the Constitution, while the horizontal financial settlement is regulated under Article 107 through the use of criteria which determine the inter-State distribution of whatever the State portion of the value-added tax revenue (excluding imports) happens to be and through special arrangements designed to take account of inter-State differences in tax capacity and financial need.⁴⁰

³⁹ Since 1969, municipalities have received 14 per cent of the yield from the wage and assessed income tax, and now retain only 60 per cent of the trade tax. See Table 5, p. 43.

⁴⁰ For details, see Chapter IV.

III (3): The Distribution of Taxes

Article 106 of the Federal Constitution (Basic Law) sets out the taxes which are assigned to each level of government (Federal and State) and the taxes which are shared between the two levels of government.

Article 106 (2) gives the States revenue from taxes on wealth, beer, motor vehicles, inheritance, and on various types of transactions (such as gambling, share turnover and insurance). Apart from customs and excise duties (excluding beer) the Federal Government derives revenue from the turnover tax (now value-added tax), equalization of burdens,⁴¹ and a surcharge which it can levy on personal and corporate income taxes.

Article 106 (3) specifies that income taxes (apart from the surcharge) are to be *shared* between the Federal and State governments. In terms of the recent finance reform measures, based on the recommendations of the *Troeger Commission*, the sharing arrangements have, as noted, been extended to embrace the value-added tax and to provide for a direct transfer of portion of income tax revenue to local authorities in return for part of their trade tax receipts (traditionally the principal source of revenue for local authorities).⁴² Revenues from property and payroll taxes are reserved for the municipalities. Of minor significance, in terms of revenue, is a variety of taxes imposed by local authorities on amusements, beverages, bars and cabarets, dogs and hunting privileges. In all, there are more than 40 different Federal, State and local taxes in the Federal Republic.

⁴¹ These are capital levies, computed from the date of the 1948 Currency Reform, which are designed to equalize burdens as a result of differential war damage. The levies continue until 1979. See Gumpel, *op.cit.*, pp. 578-81 and *The Statesman's Year-Book*, 1972-73, J. Paxton ed., Macmillan 1972, New York, p. 970.

⁴² For details, see *infra*, III (8).

The revenue derived by each level of government from various taxes in 1971 is set out in *Table 4*. The joint taxes account for approximately 70 per cent of tax receipts of the Federal Government and the States and 73 per cent of tax receipts of all three levels of government.

III (4): State Financial Autonomy

The close "correspondence" of revenue resources and expenditure commitments at each level of government (Federal and State) in Germany⁴³ is mainly a product of the arrangements for revenue sharing.

There may be a temptation to argue that this "correspondence" is more apparent than real and that the financial independence of the States is far from complete since they do not have the power to vary income tax rates or the tax structure.

There are, however, three comments which seem appropriate in this connection:

(a) State financial autonomy can never be absolute because the Federal Government has the ultimate responsibility for economic management.

(b) There are clear-cut advantages in having the major taxes uniform throughout the Federation.

(c) To secure and maintain a significant measure of State fiscal autonomy it is less important for the States to be able to change tax rates and structures than it is for them to have a guaranteed source of revenue, the growth of which bears a close relation to the tempo of

⁴³ See *Table 6* at the end of section III (5).

Table 4

Tax Receipts in 1971 by Level of Government

	<u>DM billion</u>
<u>Federal Taxes</u>	
Petroleum Tax	12.4
Tobacco Tax	6.9
Other Excise Duties (excl. beer)	4.1
Customs Duties	3.1
Income Tax Surcharge	1.1
Road Haulage Tax	0.5
Other	2.0
	<u>30.1</u>
<u>Federal Share of Joint Taxes</u>	
Wage and Assessed Income Tax	26.4
Other Income Taxes	4.6
Value-added Tax	30.1
Trade Tax	2.5
	<u>63.6</u>
<u>Total Federal Tax Revenue</u>	<u>93.7</u>
<u>State Taxes</u>	
Beer Tax	1.2
Motor Vehicle Tax	4.1
Wealth Tax	3.0
Other	1.8
	<u>10.1</u>
<u>State Share of Joint Taxes</u>	
Wage and Assessed Income Tax	26.4
Other Income Taxes	4.6
Value-added Tax	12.9
Trade Tax	2.5
	<u>46.4</u>
<u>Total State Tax Revenue*</u>	<u>56.5</u>
Total Federal and State Tax Revenue	<u>150.2</u>
<u>Local Taxes</u>	
Property Tax	2.8
Payroll Tax	1.8
Other Taxes	0.9
	<u>5.5</u>
<u>Local Share of Joint Taxes</u>	
Income Tax	8.4
Trade Tax	7.2
	<u>15.6</u>
<u>Total Tax Revenue of Local Authorities^φ</u>	<u>21.1</u>
Total Federal, State and Local Tax Revenue	<u>171.3</u>

* Excludes municipal taxes of the City States (Berlin, Hamburg and Bremen)

φ Includes municipal taxes of the City States (Berlin, Hamburg and Bremen)

Sources: Federal Ministry of Finance, *Finanzbericht*, 1972, pp. 44-5; and "Monthly Report of Deutsche Bundesbank", Vol. 24, No. 10, October 1972, pp. 56-7.

business activity (and hence income generation) within the borders of each State. At least this is one way, and perhaps the most sensible way, of looking at State tax sovereignty.

If condition (c) is satisfied (and it should soon be apparent that in Germany it is), the volume of '*ad hoc*' financial assistance from the centre will be greatly lessened; and it then becomes possible to focus on Federal assistance to promote national objectives and facilitate horizontal fiscal equalization.⁴⁴

III (5): Regulating the Distribution of Joint Tax Revenues

While the tax-sharing arrangements are a prominent feature of Federal - State finance in West Germany and the principles governing the vertical financial settlement are clearly specified in the Constitution, in practice the correspondence between revenue sources and expenditure needs of each level of government cannot be perfect. Estimates can be made and a close correspondence can be achieved; but the difficulties facing this task should not be underestimated. There are problems which arise from overlapping functions, new tasks, unanticipated changes in tax yields and, of course, the real difficulty in projecting forward and comparing the expenditure needs of each level of government. For the latter no objective criteria are possible (*e.g.*, how to compare the need for Federal expenditure on autobahns against the need for State expenditure on clinics; or the need for Federal expenditure on Embassy buildings against the need for State expenditure on flood water prevention); in the final analysis a political judgment has to be made, and in Germany this

⁴⁴ The techniques used for re-distributing tax revenues between States are covered fully in Chapter IV.

emerges as a compromise between the interests of the two parties since any change in the distribution of joint taxes requires the approval of the Council of States (*Bundesrat*).⁴⁵

The key to the regulation of the vertical intergovernmental financial imbalance is found in the Constitutional provision relating to the distribution of income tax revenue and, more recently, value-added tax revenue. These taxes are *joint* in the sense that the revenue is shared between the Federal and State governments.⁴⁶ The ratio is set out in the Constitution but can be varied by Federal Statute (with *Bundesrat* approval) "*in the event that the relationship between Federal revenue and expenditure on the one hand, and State revenue and expenditure on the other, should become so unbalanced that a substantial deficit developed on either the Federal or the State level*".⁴⁷

The participation ratio can be changed every two years by Federal law, according to the *Revisionsklausel* [Article 106 (4)] but, as noted, any change requires the approval of the Council of States. The States can use their power in the Council to defeat any proposed change

⁴⁵ J. Seeger, "Der Grosse Steuerverbund", *Finanzpolitik*, Wirtschaftsdienst 1969/I, p. 6.

⁴⁶ A recent Committee on Tax Reform, which released its Report early in 1972, has recommended that the municipalities also share in the proceeds from the value-added tax. See *Gutachten der Steuerreformkommission* 1971, Band III, Abschnitt XII, pp. 52-4. Since 1970 the municipalities have received 14 per cent of the proceeds of the wage and assessed income tax. The amount received from this source accounts for about 40 per cent of total municipal tax revenue (*Table 4*).

⁴⁷ Gumpel, *loc.cit.*, p. 425. Since 1970 only the shares of the value-added tax have been adjusted (see *infra*, p. 43).

in the ratios of income or value-added taxes should the change appear to be to their disadvantage. On the other hand, should the Federal Government already be in a superior position, the Lower House (*Bundestag*) can block any proposal by the States for a change in the ratios.⁴⁸

This system appears to have worked efficiently. Large deficits have not persisted at either the Federal or State level; and when large unplanned deficits have developed, discussions between Federal and State officials have been arranged to see what steps might be needed to counter-act the trend. One approach is through intergovernmental agreement in the Planning and Trade Cycle Councils [see Chapter II (6)] to slow down or accelerate expenditures.⁴⁹ Another possibility is to secure agreement on a new basis of sharing tax revenues. If both levels of government show a tendency toward persistent deficit or surplus which is not considered to be in the interest of total economic equilibrium, the solution is likely to lie in resort to fiscal techniques such as changes in tax rates, the 'freezing' or 'unfreezing' of government funds and/or direct intervention to curb or accelerate public spending projects. If, however, the trends diverge - if the States are threatened with deficits and the Federal Government with a surplus (or vice versa) - there is then a *prima facie* case for a change in the participation ratios (*i.e.*, in the percentage

⁴⁸ Seeger, *op.cit.*, p. 3.

⁴⁹ As an example, the Federal Government in 1971 adopted a domestic economic stabilization programme, approved by both the Medium Range Planning Council and the Trade Cycle Council, aimed at a DM 2 billion cut in the expenditures of Federal and State governments (Bund and Laender). Under *Article 19* of the Economic Stability and Growth Law borrowing limits were also reduced. In addition, to limit the scope for expenditure increases, it was decided to 'freeze' an additional DM 1.7 billion in the anti-cyclical reserve funds at the central bank. See *Report of the Deutsche Bundesbank* for the year 1971, pp. 76-7.

share of joint tax revenues which accrue to each level of government). The interesting point is that agreement between the Federal Government and the States has been reached on several occasions to change the ratios.

From the information to hand, it would seem that these changes have been implemented without much delay, although as one State financial report put it '*not without extremely difficult deliberations*'.⁵⁰ The consultative machinery can work quickly when the occasion demands it.

The Federal share of income tax was 35 per cent between 1958 and 1963, 38 per cent in 1963, 39 per cent from 1964 to 1966, 37 per cent in 1967 and 1968, and 35 per cent in 1969. The Finance Reform which became effective in 1970 increased the Federal ratio to 43 per cent for the wage and assessed income tax and 50 per cent for other income taxes, but provided (for the first time) that 30 per cent of the revenue collected from the value-added tax (other than tax on imports) was to be transferred to the States. The percentage distribution of joint taxes between the three levels of government - before and after finance reform - is shown in *Table 5*. The State share of value-added tax revenue has recently (1972) been raised in two steps, from 30 to 33 per cent and then to 35 per cent of total collections (excluding the tax on imports) in order to meet an increase in State deficits.⁵¹

⁵⁰ Senator fuer Finanzen: 'Die Entwicklung und Reorganisation der Oeffentlichen Finanzwirtschaft', Excerpt from *Finanzbericht 1971*, Bremen, p. 82.

⁵¹ See *Monthly Report of the Deutsche Bundesbank*, Vol. 23, No. 12, December 1971, p. 25; and Federal Ministry of Finance *Die Steuern des Bundes und der Laender*, Bonn, May 1972, p. 6. The new 35 per cent participation ratio for the States will remain in force until the end of 1973.

Table 5

Tax Distribution (Joint Taxes) Before and After Finance Reform

(Per cent)

	<u>Before Finance Reform</u>			<u>After Finance Reform</u>		
	(1969)			(1970 - 1971)		
	<u>Federal</u>	<u>States</u>	<u>Munic.</u>	<u>Federal</u>	<u>States</u>	<u>Munic.</u>
Wage and Assessed Income Tax	35	65*	-	43	43*	14
Non-assessed Tax on Yields	35	65*	-	50	50*	-
Corporation Income Tax	35	65*	-	50	50*	-
Turnover (Value-added Tax)	100	-	-	70	30 ^ø	-
Trade Tax	-	-	100	20	20	60

* Municipalities receive a certain percentage share of these taxes (and other revenues of the States) as laid down in State legislation.

ø State share is calculated on the turnover/value-added tax excluding the tax on imports.

Since the finance reform measures began to take effect in 1970, the distribution of revenue from the value-added tax has become the adjustable (or movable) part of the tax distribution whereby the vertical intergovernmental financial settlement is reached. This point is made explicit in the Constitution. *Article 106 (4)* states that the proportional share of the value-added tax between the Federal and State governments can be adjusted every two years to take account of differential trends in revenues and expenditures of each level of government.⁵² Moreover, under the amended version of *Article 107*, the distribution of the State share among the various States is made on a population basis⁵³ - unlike the

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Federal Ministry of Finance, *Finanzbericht* 1970, Bonn, p. 167.

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Ibid., p. 170.

inter-State distribution of income tax revenue which continues, for the most part, to be on a 'derivation' basis (*i.e.*, on the basis of actual tax moneys collected in each State).⁵⁴

What emerges from the foregoing is that the machinery for revenue sharing has been firmly established in the Federal Republic, within an appropriate legal setting and with due recognition to the rights of both levels of government (Bund and Laender) to participate in decision-making. In fact, the so-called *Steuerverbund* (taxes to be distributed among various levels of government) has recently been enlarged to embrace the value-added tax, and the State participation ratio has been increased in sympathy with larger State deficits.

These arrangements seem eminently sensible and represent an essential part of co-operative federalism, with its mixture of Federal initiatives in the major policy areas and the ability of the States to exert pressure to strengthen their autonomy and to secure a share of revenues commensurate with expenditure commitments. This system is, as we have seen, a direct outcome of the particular form of government which is found in West Germany, with the Council of States (*Bundesrat*) serving a vital function as a permanent conference of State ministers. In short, neither party has overriding power to force the issue with respect to any change in revenue-sharing arrangements; and yet the Federal Government has proved that it is still able to take the necessary initiatives to promote major policy objectives.

This type of system has clear-cut advantages and should have appeal both to the ardent federalist and to those who attach importance to

⁵⁴ See *infra* Chapter IV (3).

the use of fiscal policy.

The existence of what appear to be flexible arrangements for responding to changes in revenue/expenditure patterns at each level of government does not, however, ensure by some magic that the compromise agreement reached in Committee will automatically provide the solution to divergent trends in Federal and State finances. Some of the practical problems have been adverted to earlier in this section. To reach a decision on what is an appropriate tax-sharing arrangement for the ensuing period (usually 2 - 3 years) requires a careful analysis of revenue and expenditure trends at each level of government. This in turn demands, *inter alia*, a complete review of expenditure needs, decisions on priorities, estimates of trends in the economy (and the likely effect on tax yields) and allowance for new tasks, including joint financing by Federal and State governments.

The critical importance of the machinery for intergovernmental planning and control of expenditures should be immediately evident since any decision on revenue sharing is clearly bound up with the expenditure trends anticipated for each level of government. In Germany taxes cover more than 80 per cent of public expenditure needs and more than 70 per cent of tax revenues are distributed between the three levels of government. As noted in Chapter II (6), it is regarded as essential in Germany, in arriving at an appropriate tax distribution, that the financial planning of the Federal Government and of the States be brought into

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harmony.

⁵⁵ The planning techniques have already been mentioned in the context of the Economic Stability and Growth Law. The recent trend towards joint financing is discussed in III (7), *infra*.

There would appear to be some force in the argument that the recent enlargement of the *Steuerverbund*⁵⁶ and the decision to correct any vertical intergovernmental fiscal imbalance via adjustments to the participation ratio for the value-added tax have materially weakened the position of the States *vis-à-vis* the Federal Government. The percentage share of value-added tax revenue which accrues to the States has recently been revised upwards in order to meet actual and projected State deficits. However, during the period in which the percentage share is unchanged, the States may be placed at a disadvantage, especially in a boom period, since income tax yields increase faster in response to income changes than is the case with the value-added tax (the latter tends to show a linear relationship with income).⁵⁷ The 1969 Finance Reform has shifted the balance of power to the Federal Government in the sense that the latter now receives a larger proportion of the yield from income taxes (see *Table 5*). The States will, however, soon catch up because any decision to change the participation ratio for the value-added tax will presumably take these differing relationships into account.

The new system does, therefore, point up the need for speedy decision-making and a larger change in the value-added tax ratio than was necessary when any vertical imbalance could be corrected via changes in the income tax ratios. Those seeking a simple solution in this area are bound to be disappointed. A further complication stems from the extension of joint Federal and State financing into fields which constitutionally rest with the States and local authorities (examples are hospitals;

⁵⁶ Taxes for distribution among various levels of government.

⁵⁷ Seeger, *op.cit.*, p. 10.

education; road building, other than autobahns; city development; and traffic control).⁵⁸ In so far as this trend lessens State deficits it will reduce the extent of changes required in the participation ratio for the value-added tax. *Table 6* records government revenue and expenditure between 1962 and 1971.

Table 6

Revenue and Expenditure Pattern of Federal and State Governments
(Bund and Laender)^(c) 1962-71

Year	<u>Total Expenditure (a)</u>			<u>Total Income (b)</u>		
	Bund	Laender	Laender proportion	Bund	Laender	Laender proportion
	(DM billion)		%	(DM billion)		%
1962	49.9	42.4	45.9	49.3	42.6	46.4
1963	54.4	45.8	45.7	52.0	45.0	46.4
1964	57.8	50.0	46.4	57.2	48.2	45.7
1965	64.2	54.3	45.8	62.4	50.2	44.6
1966	67.4	57.6	46.1	65.6	53.8	45.1
1967	76.0	59.5	43.9	67.1	56.0	45.5
1968	75.4	62.5	45.3	70.6	61.3	46.5
1969	81.6	66.9	45.1	83.2	68.1	45.0
1970	87.3	76.4	46.7	88.3	73.4	45.4
1971	98.4	85.6	46.5	96.7	81.3	45.7

(a) Excluding allocations to reserves and debt repayment.

(b) Excluding drawing from reserves and borrowing.

(c) Bund = Federal Government; Laender = State governments.

Source: Various issues of '*Finanzbericht*', Federal Ministry of Finance.

⁵⁸ A thorough-going analysis of the development of the joint tasks concept, while a fascinating study in itself, is outside the scope of this paper. But as an integral part of federal financial assistance to the States it is, of course, relevant to revenue sharing and hence to the vertical financial settlement. (See III (7), *infra*.) We may in passing note that while this method may appear to involve the States in some loss of sovereignty, it also means that they are better able to cope with the financing of large-scale projects and, through the Institute of Joint Tasks described below, to participate fully in the decision-making process.

III (6): Importance of Joint Taxes to the States

In the period 1966 to 1970, the financial position of the States as a whole showed a marked improvement. This improvement was to an important extent a direct consequence of rising receipts from the State share of the joint taxes. The Finance Reform, instituted in 1969 and having a major impact in 1970, has also enabled the States to shoulder vastly increased expenditure commitments without undue strain. The improvement in State finances is illustrated in *Table 7*, which presents the economic (*i.e.* revenue and expenditure) account of the States in an abridged form for the period 1966 to 1972. Adjustments on the revenue side have enabled the States to step up the rate of expenditure in real terms without incurring large deficits. In real terms, spending rose from an average annual rate of approximately 3 per cent between 1966 and 1969 to almost 15 per cent in 1970 and about 8 per cent since.

State revenue from the joint taxes accounted for just on 50 per cent of total State income between 1966 and 1968. However, since then the joint taxes have become even more important and now account for 57 per cent of total State income (see *Table 8*). This trend provides the key to the way in which the vertical financial settlement has been regulated in West Germany. By contrast, financial transfers (grants and loans) from the Federal Government have fallen from 19 to 14 per cent of total State income over the last seven years.

The year 1970 marked a decisive turning point in relation to the financial settlement between the three levels of government. In that year (and subsequently) the revised tax-sharing arrangements referred to above - in combination with an extension of intergovernmental planning and

Table 7

Economic (Revenue and Expenditure) Account of the States 1966-72

DM billion

	<u>1966</u>	<u>1967</u>	<u>1968</u>	<u>1969</u>	<u>1970</u>	<u>1971</u>	<u>1972 (e)</u>
Share of Joint Taxes (a)	27.0	27.6	30.5	36.8	41.0	46.4	56.0
State Taxes (b)	9.3	10.0	10.4	11.5	11.2	12.1	13.3
Total Tax Revenue	36.3	37.6	40.9	48.3	52.2	58.5	69.3
Federal Grants and Loans	10.0	9.7	11.1	9.9	10.7	12.1	14.4
Other Receipts (c)	7.5	8.7	9.3	9.9	10.5	12.6	14.3
TOTAL INCOME	53.8	56.0	61.3	68.1	73.4	83.2	98.0
Transfers to Local Authorities (Net)	6.0	6.1	6.0	6.8	8.1	9.2	10.7
Other Current Expenditure	34.6	36.7	40.0	42.7)	66.1	77.2	86.7
Investment Expenditure	15.3	14.9	14.6	15.3)			
Other Payments	1.7	1.8	1.9	2.1	2.2	2.4	2.5
TOTAL OUTLAY (d)	57.6	59.5	62.5	66.9	76.4	88.8	99.9
Deficit (-) or Surplus (+)	-3.8	-3.5	-1.2	+1.2	-3.0	-5.6	-1.9
	<u>per cent</u>						
Deficit/Surplus as % of Total Outlay	-6.6	-5.9	-1.9	+1.8	-3.9	-6.3	-1.9

- (a) Embraces share of personal and corporation income taxes up to 1969 and thereafter includes share of value-added tax and trade tax.
- (b) Includes local taxes of the City States. State taxes are headed in terms of revenue by taxes on motor vehicles, wealth and inheritance, beer, gambling and land acquisition. Several 'bagatelle' taxes (on insurance, securities, company incorporation and share turnover) were transferred to the Federal Government in 1970 following a recommendation by the *Troeger Commission*. The annual cost to State revenues of this transfer, to be set against the gain from the 'new' tax distribution of the 'joint' taxes, was estimated at DM 1.3 billion.
- (c) Includes fees, interest and other non-tax revenue and also capital receipts such as the sale of assets and loan repayments, but excludes drawing on reserves and borrowing in credit markets.
- (d) Excludes additions to reserves and debt repayments.
- (e) Partly estimated.

Source: *Finanzbericht 1971* (Table 2, p. 167 and Table 5, p. 170); *Finanzbericht 1972*, Table 9, p. 29; and *Finanzbericht 1973*, pp. 47-8, 65.

Table 8

Economic Account of the States
Major Income Sources as Per Cent of Total 1966-72

	<u>1966</u>	<u>1967</u>	<u>1968</u>	<u>1969</u>	<u>1970</u>	<u>1971</u>	<u>1972</u> (Estimate)
Share of Joint Taxes	50.2	49.3	49.8	54.0	55.9	55.7	57.2
State Taxes	17.3	17.9	17.0	16.9	15.3	14.7	13.6
Total Tax Revenue	67.5	67.2	66.8	70.9	71.2	70.4	70.8
Federal Grants and Loans	18.6	17.3	18.1	14.5	14.6	14.4	14.7
Other Receipts	13.9	15.5	15.1	14.6	14.2	15.2	14.5
Total Income	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: *Table 7.*

the provision of federal finance to assist projects categorized as 'joint tasks' - have enabled both States and local authorities to respond to expanding demands for public services (such as education, highways, public utilities, hospitals and city development) without undue strain on their respective budgets.

In 1971 the Federal Government received DM 63.6 billion in revenue from the joint taxes. This was made up of 43 per cent of the wage and assessed income tax, 50 per cent of other income taxes, 70 per cent of the value-added tax (other than the tax on imports) and 20 per cent of the trade tax. As the figures in *Table 9* clearly show, the revenue received by the Federal Government from the joint taxes grew at a much faster rate in 1970 than the revenue received by the States and municipalities. However, when all tax revenues are included and comparisons are made over several years, the position of the States and their

Table 9

Tax Revenue of Federal, State and Local GovernmentsPercentage Change from Previous Year 1967-72

	<u>1967</u>	<u>1968</u>	<u>1969</u>	<u>1970</u>	<u>1971</u>	<u>1972</u> (Estimate)
<u>Federal</u>						
Joint Taxes	-6.0	+10.4	+10.6	+21.9 ^(a)	+13.0	+10.5
Total Tax Revenue	+1.3	+5.1	+18.6	+6.8	+11.3	+9.3
<u>States</u>						
Joint Taxes	+2.2	+10.5	+20.7	+11.4 ^(b)	+13.2	+20.9
Total Tax Revenue	+3.6	+8.8	+18.1	+8.1	+12.1	+18.3
<u>Local Authorities</u>						
Joint Taxes	-	-	-	(c)	+16.2	+21.3
Total Tax Revenue	+0.7	+5.0	+27.0	-1.6	+15.2	+18.6

- (a) Comparison is with income tax revenue and turnover tax revenue (excluding tax on imports) actually received in 1969.
- (b) Comparison is only with income tax revenue received in 1969 as the States did not share in the turnover tax until 1970.
- (c) In 1970, municipalities received for the first time a direct share of income tax revenue (see text).

Source: Calculations based on data taken from *Finanzbericht 1973* (and earlier issues).

municipalities is seen in a more favourable light. Indeed, in 1971 and 1972 the States and local authorities gained tax revenues, especially revenue from the 'joint' taxes, at a faster rate than the Federal Government. Nevertheless, because of rising expenditure commitments, the deficits of the States and local authorities have been increasing in recent years. This trend has been more pronounced for the local

authorities whose deficits⁵⁹ in the aggregate in 1971 and 1972 were estimated at nearly 9 per cent of total outlays. By contrast, State deficits relative to total State outlays did not increase in 1972 and were, in fact, considerably lower than in 1966 and 1967 (see *Table 7*).

A close examination of relevant statistical data lends support to the view that recent adjustments to the distribution of 'joint' taxes (implemented as part of the Finance Reform) have greatly strengthened the financial position of the States as a whole.⁶⁰ State own tax revenues (that is, revenues from taxes assigned exclusively to the States) now account for less than 20 per cent of total State tax revenues (compared with about 26 per cent in 1966).

III (7): Federal Financial Aid and Debt Financing

A proper appreciation of the significance of revenue-sharing arrangements requires a brief reference to Federal financial aid and debt financing since one of the main purposes of a comprehensive scheme of revenue sharing is to reduce State and local dependence on Federal aid and debt financing.

From *Table 8* it can be seen that Federal grants and loans comprised less than 15 per cent of State income in the past four years. In Australia, by contrast, more than 60 per cent of State revenues is now

⁵⁹ The deficits of the municipalities are financed mainly by longer-term borrowing under State supervision; and a large part of this borrowing takes the form of credits through city savings banks. See *Deutsche Bundesbank, Monthly Bulletin*, VII, Dec. 1970, p. 56.

⁶⁰ There was, however, some loss of State revenues by virtue of the transfer to the Federal Government of several 'bagatelle' taxes. See footnote (b), *Table 7*.

derived from Federal grants. Moreover, in West Germany the annual increase in State indebtedness in the five years from 1966 to 1970 averaged 3.3 per cent of total State outlays compared with 15 per cent in Australia.⁶¹

When local authorities are brought into the reckoning, the contrast between the two countries is also quite striking, as shown in *Table 10* (which also gives comparative figures for Canada).

Open-ended general revenue grants are rare in Germany.⁶² Grants are mainly of the specific purpose variety and fall into two main categories:

(a) assistance for 'joint tasks';

(b) assistance to combat recession and for structural and other long term purposes.

Unlike Australia, there are no unconditional grants in Germany to correct for vertical intergovernmental fiscal imbalance. As noted, this correction is accomplished mainly through revenue-sharing arrangements with respect to income and value-added taxes. The main thrust of federal financial assistance is now concentrated on assistance for joint tasks. The joint tasks concept gained prominence in discussions surrounding finance reform about four years ago. The central idea was to clarify the

⁶¹ For Germany, statistics on State outlays have been obtained from the *Finanzbericht*, 1971 and 1972 while the data on State indebtedness appear in the *Monthly Report of the Deutsche Bundesbank* Vol. 22, No. 8, August 1970, p. 15 and Vol. 23, No. 12, Dec. 1971 (Table VII, p. 56). For Australia, statistics on State debt have been taken from *Government Securities on Issue*, 30th June 1971, White Paper presented with 1971-72 Budget (Table 8, p. 25), while the data on State outlays appear in 'National Accounting Estimates of Public Authority Receipts and Expenditure', *Supplement to the Treasury Information Bulletin*, Dec. 1971, p. 3.

⁶² Federal supplementary payments are, however, made to particular States and in special circumstances in connection with the horizontal financial settlement. These payments, though small, are unconditional (see Chapter IV).

Table 10

Net Increase in Indebtedness of State and Local Authorities as a
Percentage of Total Outlay: Australia, Canada and West Germany

(Per cent)

	<u>Australia</u> (a)	<u>Canada</u>	<u>West Germany</u>
1966	22.7	12.4	6.7
1967	23.0	14.2	6.4
1968	23.1	11.5	4.1
1969	22.1	9.6	1.8
1970	19.6	9.3	4.3
1971	19.1	n.a.	8.8
Average 1966-71	21.6	11.4 (b)	5.4

(a) Financial years, 1965-66 to 1970-71. For comparability, the debt and outlays of semi-governmental authorities are included.

(b) Average, 1966-70.

Sources:

Australia: Commonwealth Bureau of Census and Statistics, *Public Authority Finance* (1969-70) and White Paper on *National Income and Expenditure* (1970-71).

Canada: *Bank of Canada Review*, December 1971 (Tables 29-30), and Department of Finance *News Release*, Ottawa 16/11/71, Statement by E.J. Benson on Federal - Provincial Taxation Arrangements (Table 2).

Germany: *Finanzbericht* 1971 and 1972; also *Monthly Report of Deutsche Bundesbank*; Vol. 22, No. 8, August 1970 (p. 15); Vol. 23, No. 12, December 1971 (Table VII, p. 56); and Vol. 24, No. 10, October 1972.

nature of those tasks which the Federal Government and the States should jointly plan and finance; and for this purpose the Constitution was amended (*Article 91a*) to provide for the establishment of an *Institute for Joint Tasks*. The tasks which Federal and State governments jointly plan and finance relate to:

- (a) extension and construction of institutes of higher education, including the university clinics;
- (b) improvement of the regional economic structure; and
- (c) improvement of the agricultural structure and of coastal protection.

The term 'joint tasks' was coined by the Fiscal Reform Commission (*Troeger Kommission*), whose recommendations formed the basis of subsequent reform measures. These are tasks which were hitherto the responsibility of the States but which, under Federal law, have now been declared to be 'joint' because of their national importance and because they require joint long term planning.

It should be pointed out that, even before the recent finance reform, certain tasks (*e.g.*, home-building, higher education and agriculture) had been jointly financed by Federal and State governments. The new laws were, however, designed to ensure that, in future, arrangements would proceed in a more systematic manner. For this purpose two amending clauses⁶³ in the Constitution were necessary - *Article 91 (a)* which applied to planning under the auspices of the Institute for Joint Tasks and *Article 91 (b)* which envisaged co-operation between the Federal and

⁶³ G. Obert, 'Die Finanzreform 1969', *loc.cit.*, p. 6. Prior to these amendments the Constitution made no mention of the fulfilment of joint tasks. It recognized only Federal and State responsibilities. See Ruhe, *loc.cit.*, p. 177.

State governments in educational planning and in the promotion of scientific research on the basis of simple administrative agreements. Thus, by virtue of *Article 91 (b)*, agreements for the joint financing of the Max-Planck Foundation and the German Research Foundation were given a clear constitutional basis.⁶⁴

Under *Article 91 (a)*, several planning boards have been set up for the various fields of expenditure, and in this connection the following points are worth noting:

(a) Before a project can be incorporated in a plan it must have the approval of the State in whose area the project will be initiated.

(b) There are two Federal representatives and one representative from each of the eleven States on each board, making a total of thirteen representatives. States are usually represented by their Finance Ministers. Both the Federal Government and the States have 50 per cent of the voting power.

(c) Before any project can be approved, a 75 per cent majority of votes is required. This means that if the Federal Government approves, it needs to gain the support of six of the eleven States (each of which commands approximately 4.5 per cent of voting power) before the seal of approval can be granted and the necessary funds set aside in the respective budgets.

(d) Once agreement is reached for the inclusion of particular projects in framework plans, the Federal Government provides at least half the necessary finance. In some categories - coastal protection, for

⁶⁴ K. Stadler, 'Die Neue Finanzverfassung', *Bayerische Verwaltungsblätter*, September 1969, p. 298.

example - the Federal Government provides 70 per cent of the total finance required.⁶⁵

(e) The Federal Parliament and the relevant State parliaments must, of course, approve the budget allocations for the planned expenditures put forward by the planning boards.⁶⁶

(f) The Federal Government is concerned with planning in a broad sense and is not involved in the details of the planning.⁶⁷

Apart from the framework plans for joint financing of approved projects, the new finance reform provided for a Constitutional amendment [Article 104 (a) (2-4)] relating to Federal financial assistance, either to fend off a disturbance to economic equilibrium (the measures to stimulate economic activity in the 1967 recession are relevant in this context) or to support especially important investments of the States or municipalities in the interests of uniform economic development.⁶⁸

Financial aid under this amendment can be secured either in terms of a Federal law (which needs the approval of the Council of States) or by means of an administrative agreement between the Federal Government and one or several States (when, in the Federal budgetary law, an authorization for the administrative agreement has been provided).⁶⁹

This is an important amendment for at least three reasons:

⁶⁵ See, for example, *Finanzbericht* 1972, pp. 179-81.

⁶⁶ Ruhe, *loc.cit.*, p. 178.

⁶⁷ Stadler, *op.cit.*, p. 299.

⁶⁸ *Ibid.*, p. 301; Obert *loc.cit.*, p. 7; *Finanzbericht* 1971, pp. 163-4 and 1972, pp. 181-3.

⁶⁹ Ruhe, *loc.cit.*, p. 179.

- (a) it can be used to assist recovery from a recession;
- (b) it aims at the preservation of uniform living conditions throughout the Federation; and
- (c) it leaves unquestioned the right of the Federal Government to provide financial assistance direct to local authorities for specific purposes.

With regard to Federal assistance to local authorities, plans have been formulated to 1975 providing for aid for such purposes as improvements in traffic conditions,⁷⁰ housing, city development and hospitals. For the latter it is envisaged that 85 per cent of the total assistance will be distributed to the States on a population basis with the balance being controlled at the discretion of the relevant Federal Minister in accordance with extra-regional needs.⁷¹

III (8): Reform of Municipal Financing

The tendency for municipal expenditures to grow faster than expenditures of the Federal Government (Bund) and the States (Laender), and the expectation that in future the same trend would continue, prompted the *Troeger Commission* to give special attention to the question of municipal financing.

Since there seemed little scope for pruning expenditures, the reform decided upon involved: (a) augmenting municipal tax revenues in total; (b) changing the composition of that total; and (c) stepping up

⁷⁰ Such improvements will continue to be financed in part from Federal petrol tax receipts. See next section.

⁷¹ *Finanzbericht* 1972, p. 182.

allocations from both Federal and State budgets. As a result, the municipalities gained additional revenue of DM 2.3 billion in 1970 and DM 3.3 billion in 1971.⁷² An even larger increase was anticipated for 1972, as shown in *Table 9*. In percentage terms the local authorities have, in fact, fared better than Bund or Laender, but nevertheless, with their expenditures rising at an even faster rate, reliance on borrowing has not been lessened. About 10.5 per cent of all income is obtained through new borrowing, about 44 per cent from taxes, fees etc., 27.5 per cent from Bund/Laender allocations and 17.5 per cent from other sources (such as interest, rents, sale of assets and loan repayments).⁷³

The substance of finance reform as it relates to municipalities is contained in *Article 106 (5) to (8)*. The really decisive change relates to the decision, effective in 1970, to channel 14 per cent of the yield from the wage and assessed income tax direct to municipalities. This revenue is passed on by the States to their municipalities on the basis of the income tax payments of their citizens. The main purposes of this move were to give the local authorities a more flexible revenue base and to lessen their reliance on the trade tax. The municipalities agreed to return 40 per cent of the proceeds of the trade tax to the Federal Government and the States (20 per cent to each) as a partial offset against their participation in income tax receipts.⁷⁴

⁷² Koschnick, *loc.cit.*, p. 72.

⁷³ *Ibid.*

⁷⁴ The Federal Government has already moved to phase out the trade tax which is regarded as having several drawbacks on grounds of equity, resource use and administration. Prior to finance reform the municipalities derived about 80 per cent of their tax revenues from this source. For detail on the nature and impact of this tax, see H. Kolms, *Finanzwissenschaft III Besondere Steuerlehre* 2nd ed., Berlin, 1966, pp. 83-6; Noell v.d. Nahmer, *Lehrbuch der Finanzwissenschaft II*, Koeln & Opladen, 1964, pp. 94-8; Gumpel, *loc.cit.*, Chap. 15; and G. Spangemacher, *Gewerbesteuer*, Steuerbeamten Verlag Duesseldorf, Vol. 5, 3rd ed., 1971.

As a result of this reform, the municipal tax system has now attained a better balance as between three bases: enterprises, population and real estate. In 1971 the municipalities derived 41 per cent of their tax revenues from trade and payroll taxes, 41 per cent from income tax, 14 per cent from property taxes and 4 per cent from other municipal taxes.

Municipalities have also benefited through larger financial allocations from Federal and State governments. According to *Article 106 (6)* local authorities should receive a certain percentage of the State share of joint taxes as determined by State law.⁷⁵ The importance of the new version of *Article 104* in making it possible for the Federal Government to provide financial assistance direct to municipalities was noted in the previous section. Under the Constitution, revenue from the petrol tax (in common with all excise taxes, except beer) is assigned to the Federal Government. Revenue from this source has grown rapidly in recent years (rising from DM 6.1 billion in 1964 to approximately DM 13 billion in 1972). Under an agreement in force since 1967 the Federal Government contributes from its petrol tax revenues about 50 per cent of the cost of approved projects for road building in municipalities. In 1971 the municipalities received approximately DM 1 billion in revenue from the petrol tax, or 8.3 per cent of the total yield from the tax.

⁷⁵ Under the Constitution, States are required to provide their municipalities with 'adequate' finance, and State allocations to local authorities (as indicated by *Table 7*) have in fact steadily increased in recent years. However, the actual percentage of State revenues to be transferred to municipalities is regulated by State laws, and these laws differ from State to State. Information obtained from the Federal Finance Ministry suggests that the range is from 16 to 22 per cent.

The reform measures introduced so far have not, however, satisfied the critics. Increasing municipal debts attract adverse comment in the press. The planning bodies are also active in stressing the need for a re-structuring of municipal financing. The Commission on Tax Reform (not to be confused with the Troeger Commission), which released its Report early in 1972, has proposed a reduction by two-thirds in the current revenue which local authorities derive from the trade tax.⁷⁶ The Commission has also come out in favour of increasing the municipal quota of the income tax (currently 14 per cent)⁷⁷ and, more importantly, of allowing municipalities to share directly in the proceeds from the value-added tax.

These proposals have not been implemented at time of writing but the clear intention is to more than compensate the municipalities, in terms of revenue, for further reductions in receipts from the trade tax. These changes therefore herald a further extension of tax sharing (the *Verbundsystem*) in a way which should strengthen the financial position of the municipalities as a whole. In the current planning period to 1975, the tax revenues of municipalities are expected to rise at an average of 10 per cent p.a. compared with an average annual rate of increase for all levels of government of 8 per cent. In addition the Financial Planning Council has repeatedly stressed the need for the States to increase their allocations to local authorities in line with an

⁷⁶ 'Gutachten der Steuerreformkommission ...' *loc.cit.*, p. 51.

⁷⁷ *Ibid.*, p. 52. The increase in the municipal quota is designed to ensure that local authorities are not disadvantaged by the tax reform proposals which, if implemented, could be expected to cause a considerable reduction in income tax receipts.

increase in the budget resources of the States.⁷⁸

To sum up, the municipalities do not appear to be badly off when compared with other Federal systems. In the Finance Reform they made significant gains and further gains seem likely. Many writers express grave concern at the increase in municipal debt. It is true that the debt of municipalities in absolute terms is larger than either State or Federal debt; but that is hardly surprising when it is recalled that local authorities are responsible for about two-thirds of all investment in the public sector. In fact what is really surprising is that municipalities derive only 10 per cent of their income from borrowings. This seems to be quite a low dependence on borrowing and is certainly no cause for alarm. The change of greatest significance is that the municipalities will in future have a revenue source - namely personal income tax - which grows faster than gross national product. In the current planning period to 1975 they will also receive special consideration from the Federal Government in terms of *Article 104* allocations.

III (9): Summary and Conclusions

It is now time to draw the threads of Chapter III together.

With Federal grants and loans comprising less than 15 per cent of State income, it is clear that the tax-sharing arrangements have been

⁷⁸ The Tax Reform Commission is also on record as favouring an increase in open-ended grants by States to local authorities, because this would leave greater scope for freedom of action by local authorities as to the way in which additional funds are spent. See *ibid.*, Band III, Abschnitt VIII, pp. 8-10.

of decisive importance in regulating the vertical intergovernmental financial imbalance in the Federal Republic of Germany.

The close correspondence between revenues and expenditures at each level of government (Federal and State) can be seen from *Table 6*. In the ten years up to and including 1971, the State proportion of total expenditure (Federal and State) averaged 45.7 per cent and the State proportion of total income (Federal and State) averaged 45.6 per cent. If we take the last five years, the respective proportions are 45.5 and 45.6, and for the last three years they are 46.1 and 45.4. These figures suggest that the correspondence was remarkably close.

The tendency for State deficits to rise somewhat in the last two years has been met by increasing the State share of value-added tax revenues. The impact is not immediate but there is absolutely no evidence of a chronic imbalance as between Federal and State finances as a whole (some States have, of course, fared better than others, but this is dealt with by the horizontal financial settlement, which is discussed in Chapter IV).

In terms of conventional measurement, the vertical fiscal imbalance in Germany, by comparison with Australia for example, is of minor dimension. This has not occurred by accident but springs directly from provisions of the Federal Constitution relating to tax sharing and to subsequent adjustments worked out by Federal and State legislators. As a consequence we find, in marked contrast to the situation in Australia, that the States are not heavily dependent on Federal grants or excessively burdened with debt. In Australia, Federal Cabinet and Commonwealth public servants exercise a dominating influence in making

adjustments to financial assistance and other grants in order to correct for vertical intergovernmental financial imbalance. In Germany, by contrast, the percentage of the 'shared' or 'joint' taxes which goes to the States is regulated in a way which gives the States a much greater opportunity to have the decisive influence. The main reason is found, as noted earlier, in the pervasive influence of the Council of States (*Bundesrat*). The end result is always a compromise agreement in which neither partner has overriding power nor authority.

The financial provisions of the Constitution (*Grundgesetz*) were framed, *inter alia*, with a view to avoiding tax competition between States (which has been a source of friction in the American federal experience) and at the same time ensuring that each tier of government would have access to revenue deemed adequate in the light of the expenditure functions specified in the Constitution, and as modified by mutual agreement, legal interpretation, or changing economic conditions.

While the Federal Government of West Germany exercises a tight control over the whole economy and has a range of functions comparable with those assigned to national governments in other federations such as the United States, Canada or Australia, it has managed to evolve a financial settlement which has several distinctive characteristics.

This vertical financial settlement, which has been surveyed at some length, has been combined with a system of financial transfers from the Federal Government to the States and local authorities. This system of financial transfers also has distinctive characteristics since it is planned several years ahead on the basis of economic and social criteria agreed upon by each level of government in joint consultation.

Machinery for intergovernmental financial co-ordination in Germany is designed to ensure that grants from the centre are determined largely as a consequence of, and have a firm basis in, cost-benefit calculations with respect to specific projects which are examined by the various planning boards. The finance reform measures of 1969 leave no scope for general financial aid paid in an *ad hoc* fashion to particular States. The financing of 'joint tasks' is regulated either in the Constitution itself [Articles 91a (4) and 104 (3)] or through administrative agreement [Articles 91b and 104 (4)]. Outside the joint financing arrangements, the Federal Government can extend aid only according to the conditions and procedures set out in Article 104 or as supplementary allocations in terms of Article 107 (2).⁷⁹

What the West German authorities have achieved in a relatively short space of time can be summed up as follows: tight overall economic control, flexible arrangements for revenue sharing, an apparatus of joint decision-making, and the absence of massive intergovernmental transfers or heavy financial burdens pressing on the States. The critical importance of the tax-sharing arrangements in regulating the vertical financial settlement should by now be only too apparent.

The major advantage claimed for the tax-sharing system is that the Federal Government and the States (and, since 1969, the local authorities) share in tax developments, and both benefit as the economy expands. In view of the large and growing expenditure commitments of the States and the desire to avoid excessive State borrowing and/or piecemeal

⁷⁹ Stadler, *op.cit.*, p. 302.

Federal subsidies to States and local authorities on an *ad hoc* basis, the *Troeger Commission* rejected the argument that, because of Federal responsibilities for economic stability and growth, all income tax revenue should go to the Federal Government.⁸⁰ It has already been observed that the Commission carried tax sharing a stage further by its recommendation (subsequently adopted) that value-added tax revenue should also be shared between the central and regional governments.⁸¹

The West German system of revenue sharing for purposes of regulating vertical fiscal imbalance has the prime advantage of simplicity, both from the legal and administrative standpoints. It is also regulated in a way which gives each party a voice in decision making and it would appear that the latter permits a fairly quick response to changes in economic conditions and/or in the revenue/expenditure patterns of each level of government. In short, competition between rival taxing authorities is avoided, massive grants from the centre are not needed, and the important influence of the Council of States ensures that a handful of Federal officials are unable to impose their will on the States. State financial autonomy is not undermined and State bargaining for short-term political advantage is kept to a minimum.

In West Germany horizontal fiscal equalization at the State level is explicit and is not mixed up with the vertical financial settlement (although both are regulated by Federal law). The separation is accomplished by a stipulation that the State share of income taxes is to

⁸⁰ Report of Troeger Commission, *loc.cit.*, para. 229, p. 58 and para. 425, p. 110.

⁸¹ *Ibid.*, para. 532, p. 151.

be distributed between the States on a 'derivation' basis, in accordance with the income tax receipts actually collected in each State.⁸² Although on the surface this separation has been blurred somewhat by the recent decision to have the State share of the value-added tax distributed among the States on a population basis (with provision for 25 per cent of this amount to be distributed beforehand to financially weak States), the basis of the separation is clear and the amount of horizontal fiscal equalization at the State level can be readily ascertained. Thus, the intermingling of Federal grants for purposes of the vertical (Federal - State) settlement and horizontal (inter-State) settlement, which has emerged as one of the less satisfactory features of the financial settlement in Australia, has so far been avoided in West Germany.⁸³

⁸² This rule has been modified somewhat since 1970. See Chapter IV *infra.*, p. 81.

⁸³ A clear separation is also accomplished in Canada. See, for example, D.H. Clark, 'Fiscal Need and Revenue Equalization Grants', *Canadian Tax Papers* No. 49, September 1969, Canadian Tax Foundation, Toronto, pp. 3-6, 35, 38-9.

IV: HORIZONTAL FINANCIAL SETTLEMENT AT THE STATE LEVEL

As well as providing machinery to regulate vertical financial imbalance, the need was perceived by the framers of the Constitution to secure an appropriate distribution of tax revenues as *among the States*.⁸⁴ The rule which prescribes the division of State taxes (including their share of 'joint' taxes) among the States on a 'derivation' or local collection basis 'is one of expediency which weights the scales heavily in favour of the industrialized and densely populated States. In order to correct this imbalance, *Article 107 (2)* of the Basic Law calls for a Federal Statute through which an equitable distribution of revenue among the various States shall be attained.'⁸⁵

Inter-State fiscal equalization is best thought of in terms of preferred fiscal treatment to regions whose per capita incomes are below the national average or below some composite figure representative of economic performance in high or above-average income States. Such 'equalization' is accomplished by the transfer of funds to areas in the low income category. These transfers are, ideally, of a 'balancing' nature in that the amounts to be transferred are calculated *after* the impact of all other governmental transfers have been taken into account.

This chapter deals, in turn, with:

- (1) the rationale for horizontal equalization transfers;

⁸⁴ In Germany most States assist their municipalities with below-average tax capacities and greater revenue needs. While important, horizontal fiscal equalization at the municipal level is beyond the scope of this paper.

⁸⁵ Gumpel, *loc.cit.*, p. 426. The Basic Law is the Constitution.

- (2) the financial settlement among the States in West Germany;
- (3) the 1969 finance reform;
- (4) the impact of horizontal fiscal equalization;
- (5) special features of the West German approach to inter-State fiscal equalization which may be of interest to the reader in Australia.

IV (1): The Rationale for Horizontal Equalization Transfers

Horizontal equalization transfers are designed to narrow differences in State taxable capacities and financial needs. In order to justify these transfers it has to be demonstrated that there is a net benefit to the nation as a whole from a re-distribution of tax revenues from financially strong to financially weak States. The benefits can be part economic, part social and part political in terms of resource allocation, financial need, greater uniformity in living standards and perhaps the opportunity for low income States to support certain minimum standards of public services.

Although governments have with few exceptions moved to assist low income regions to attain higher standards of public services, it has proved to be a difficult assignment to demonstrate that this action will necessarily result in a net benefit to the nation as a whole.

The benefits, especially the economic ones, can be more imaginary than real. Inter-State fiscal transfers may, for example, distort the resource pattern and cause real output for the nation as a whole to be lower than it would be in the absence of the transfers.⁸⁶ Resource

⁸⁶ See A.D. Scott, 'A Note on Grants in Federal Countries', *Economica* Vol. 17, November 1950, p. 419.

wastage is surely involved to the extent that funds are transferred from an area of high development potential to an area of low development potential.

The desirability of a move towards greater uniformity in the provision of public services over the entire Federal area seems to be widely accepted - at least among those responsible for making the actual decisions. The idea is very firmly embedded in West Germany. But even here, one has to tread cautiously. The proposition that States, just like people, should be made more 'equal' seems in this age to have great emotive appeal. It is a proposition which may not, however, stand up to close analysis. A note of caution seems necessary at this juncture, even though it is not the prime purpose of this paper to argue either for or against Federal intervention to secure inter-State fiscal equalization.

Financial need is an elusive concept and it is therefore gratifying to see that, in Germany at least (and this is also true of Canada), the main emphasis is on differential tax capacities, with very little, if any, scope for subjective judgments about inter-State differences in financial 'need'. The broad aim is to narrow the inter-State tax differentials without any attempt to influence the pattern of State expenditures.⁸⁷ For example, the recipient States in Germany can spend the additional amounts as they wish or, as a broad alternative, they can use the funds to augment cash reserves or pay off debt (but *not* to reduce taxes).

In the Federal Republic of Germany an adjustment is made in

⁸⁷ This statement applies only to the horizontal financial settlement. As shown in Chapter III, State spending patterns are greatly influenced by Federal aid programmes.

favour of States which face especially large (above-average) expenditures in fields which are considered important enough to warrant special consideration (*e.g.*, the port of Hamburg serves national as well as regional and local interests). But in Germany there is no attempt at a comprehensive measure of financial need. Instead, certain facets of financial need which are easily identifiable and on which there is widespread agreement are taken into account (along with the tax capacity differences) in arriving at an appropriate financial settlement between States.

If inter-State income differences are large, the political pressures for equalization transfers will undoubtedly be strong. Such transfers may not, of course, succeed in significantly narrowing these income differences since the latter may, for example, be largely a function of differing resource endowments. However, evidence of substantial inter-State income differences is likely to put the equalization machinery in motion; and this provides us with a convenient starting point.

On the face of it inter-State income differences are much greater in Germany than in Australia. However, if one excludes the City States of Hamburg and Bremen, whose per capita incomes are much higher than in the other States,⁸⁸ the order of difference between Germany and Australia is not particularly significant. Thus, in relation to the national average, the per capita income of Hessen in 1970 stood at 106.5,

⁸⁸ For political reasons West Berlin has a special significance. Although designated as a State in the Constitution, West Berlin has had a special status from the time of the joint occupation in 1945. It is therefore the subject of special financial arrangements per medium of Federal subsidies and loans from the Federal budget. This contrasts with the financial settlement transfers between the ten States which involve no direct budgetary commitment on the part of the Federal Government.

Bayern (Bavaria) at 93.5 and Schleswig-Holstein at 81.8. In Australia, New South Wales and Victoria top the scale at 105, Western Australia stands in the middle of the spectrum at 95.7 while Tasmania is at the lower end of the scale at 85.8. Inter-State income differences in Canada and the United States are much more marked than in Australia or Germany.

Professor J.M. Buchanan has argued that there should be equal treatment for equals irrespective of geographical location, but this view was opposed by Professor A.D. Scott on the basis of the adverse effects⁸⁹ which such a policy might have on economic efficiency.

It is not proposed to discuss the Buchanan-Scott controversy in this paper, especially since Buchanan's fiscal equity principle does not seem to have great relevance to the Federal Republic of Germany, where horizontal fiscal equalization is worked out largely on the basis of differing tax capacities and where State tax rates are uniform. It is, in any event, the 'non-economic' arguments that have been used by governments to justify equalization transfers. These arguments, briefly stated, are as follows:

(a) The central government will feel a responsibility to see that all States are placed in a financial position that will make it possible for them to provide public services up to a level regarded as adequate in the light of standards established in the more affluent States.

⁸⁹ J.M. Buchanan, 'Federalism and Fiscal Equity', *American Economic Review*, September 1950; and A.D. Scott, *op.cit.*, 'The Economic Goals of Federal Finance', *Public Finance* Vol. 19, No. 3, 1964 and 'Federal Grants and Resource Allocation', *Journal of Political Economy*, Vol. 60, December 1952.

(b) It is desirable, for political and social reasons, that public services should be fairly uniform throughout the country.⁹⁰

The objection against (a) is that, since equalization transfers are usually unconditional, they will not necessarily achieve an acceptable minimum level of public services in the low income States.⁹¹

The objection to (b) is that it may be thought by some to amount to a negation of federal principles. Thus, Professor Musgrave refers to the '*multi-unit bias of fiscal location theory*' which stresses inter-regional diversity and the need to allow a matching of spending decisions at the regional level with preferences exerted by citizens at that level. If preferences for particular services (*e.g.*, education) differ as between States then it may be better to let each State determine its own education system.⁹² (Such diversity would, of course, need to be tempered to ensure an adequate State investment in services where spillover benefits are significant.)

As noted in Chapters II and III, the philosophy of federalism in West Germany has stressed the need for uniform tax burdens and living conditions over the whole federal area; and the recent finance reform made

⁹⁰ Article 106 (3) 2 of the West German Constitution provides that the financial needs of the Federal Government and the States must be adjusted so that an overburdening of taxes is avoided and the uniformity of living conditions over the Federal area is preserved.

⁹¹ McLure argues convincingly that unconditional grants are an extremely clumsy method of achieving minimum service standards. See C.E. McLure, 'Revenue-Sharing: Alternative to Rational Fiscal Federalism?' and Comment by J.A. Maxwell, *Public Policy*, Vol. XIX, No. 3, Summer 1971, p. 475 and Vol. XX, No. 1, Winter 1972, pp. 155-162. See also: A.D. Scott, 'The Economic Goals of Federal Finance', *op.cit.*, p. 254 and R.A. Musgrave, 'Theories of Fiscal Federalism', *Public Finance* Vol. 24, No. 4, 1969, p. 527.

⁹² *Ibid.*, p. 526.

it clear that federal intervention was justified in the interest of uniform economic development. Nevertheless the particular structure of government in the Federal Republic is such as to protect State autonomy, with respect to both the source of finance and participation in the planning of public authority expenditures.

In considering the justification for equalization grants, certain inherent conflicts in a federation become readily apparent. On the one hand, there are the centralizing tendencies, especially the political and social pressures for uniformity. On the other hand, there is the proposition that States should be free to make decisions on taxes, and on the allocation of funds between competing uses, in line with their own particular assessment of needs and priorities.⁹³ It would seem to the author that a suitable compromise would be to allow equalization grants to be largely unconditional but with some machinery at the federal level to ensure that each region does, in fact, use the additional funds to raise the standard of essential public services - at least to certain stipulated minima, preferably based on 'average' experience in the nation as a whole.

IV (2): Financial Settlement Among the States

The almost complete financial autarky of the States before the Federal Republic was established had led to considerable differences amongst the States, since they were unequally burdened with war damages

⁹³ Thus according to Eapen, 'the very fact that a number of States decide to form a federal polity ... implies that the people of these States want to retain a fair measure of freedom to determine their social choices more or less independently of one another.' A.T. Eapen, 'Federalism and Fiscal Equity Reconsidered', *National Tax Journal*, Vol. 19, No. 3, September 1966, p. 327.

and social costs and there were large differences in taxable capacities. As from April 1950, the war damage and social cost burdens were transferred to the Federal Government and at the same time the consumer taxes (with the exception of beer), which had previously gone to the States, were given to the Federal Government. The turnover tax and the transport tax were also given to the Federal Government. These changes led to some improvement in the position of the financially weak States.

The financial settlement among the States was first regulated by law in March 1951. From 1950 to 1954 the financial settlement comprised, apart from offsetting tax capacity differences, the offsetting of certain burdens relating to refugees, unemployment, interest on loans, higher education, and harbour maintenance.

The first reform of the Constitution, and of the State financial settlement in particular, occurred in 1955. In December 1955, *Article 107* of the Constitution provided that the revenue from State taxes (*i.e.*, taxes assigned specifically to the States) should be distributed among the States according to amounts collected in each State. The principle of distribution of taxes according to local receipts was also applied to the State share of income taxes.⁹⁴ The resulting tax capacity differences were then to be evened out, in accordance with *Article 107*, by an appropriate financial settlement between financially strong and financially weak States. This Article also envisaged supplementary allocations from the Federal Government to financially weak States.

Since 1955, the State financial settlement has been designed to

⁹⁴ Seeger, *loc.cit.*, p. 7.

offset differences in taxable capacities, but with some allowance for special burdens (*Sonderbelastungen*) facing particular States.⁹⁵

The actual settlement is worked out as follows: First, the *tax capacity yardstick* of each State is calculated by the addition of revenue from (a) State taxes, (b) the State's share of the joint taxes according to local yields, and (c) half of the property and trade taxes of the municipalities, also according to local yields and worked out on the basis of uniform surcharges (*Hebesaetze*).⁹⁶ Deductions are then made for any special burdens (extraordinary expenditures) facing a particular State. In this way the *adjusted tax capacity* of each State is determined.

Comparison of the adjusted tax capacity for each State is then made with the average tax capacity per capita of all States. When the average tax capacity is multiplied by the population of each State the result is the so-called *equalization yardstick* of each State.⁹⁷ In calculating the equalization yardstick consideration has been given since 1955, by way of an allowance for population density, to the higher tax needs of the City States and to the size of municipalities. Thus, in so far as tax-strong States also tend to be States with relatively high population densities (large cities) - and this is in fact the general

⁹⁵ *Finanzbericht* 1970, p. 169.

⁹⁶ These are multipliers which municipalities can apply, subject to State law, to their trade, property and payroll tax revenue for which uniform federal tax rates are set. Since *Hebesaetze* vary considerably from State to State and bear no necessary relation to financial capacities, it was decided to employ uniform *Hebesaetze* for purposes of the inter-State financial settlement. See, for example, H. Wick, 'Die Regelung des Finanzausgleichs unter den Laendern', *Deutsche Rentenversicherung*, 1969, p. 263.

⁹⁷ Gumpel, *loc.cit.*, p. 427.

pattern - the intensity of the financial settlement has been somewhat reduced.

Finally, the *financial settlement yardstick* is calculated for each State as the difference between its adjusted tax capacity and its equalization yardstick.

The way the settlement works can perhaps best be illustrated with the aid of symbols, as follows. Consider the process in *three steps*.

In (I), let TC_i represent the taxable capacity of State i . When allowance is made for special burdens facing that State (S_i) then the adjustable taxable capacity ATC_i

$$= TC_i - S_i.$$

In (II), we may represent the average taxable capacity per capita of all States by the expression

$$\frac{TC_a + TC_b + \dots + TC_n}{P_a + P_b + \dots + P_n}$$

where TC_a = taxable capacity of State a

TC_b = taxable capacity of State b

TC_n = taxable capacity of State n

P = population.

This expression can be denoted by

$$\frac{TC_x}{P_x} \quad \text{where } x \text{ refers to the whole Federal area.}$$

But the equalization yardstick for a particular State (E_i) is weighted to allow for the higher revenue needs assumed to be associated

with large population densities, which we can denote by w which is unity when no such allowance is made.

$$\text{Thus } E_i = \frac{TC_x}{P_x} \cdot w P_i$$

where P_i = population in State i .

The final step (III) is to compare I and II above in order to ascertain the financial settlement yardstick and calculate how much a State must pay into the financial settlement pool or how much it is entitled to receive from the pool. If the financial settlement yardstick is denoted by Y , then

$$Y = [TC_i - S_i] - E_i$$

which is positive for a State with above-average taxable capacity (requiring payment into the pool) and negative for a State with below-average taxable capacity (implying revenue entitlement from the pool).

We see, therefore, that the system works in terms of a 'brotherly' rather than a 'fatherly' settlement, that is to say that States whose adjusted taxable capacity exceeds the equalization yardstick (*i.e.*, those whose taxable capacity is computed at above the Federal average) are in effect 'surplus' States and, as such, are obliged to transfer funds to the so-called 'deficit' States whose taxable capacities are calculated to be below the Federal average. No Federal grants, as such, are involved. Instead, tax revenues are simply re-distributed as between States through appropriate allocations in the budgets of the financially strong States. The Federal Government's role is as intermediary or broker - to see that the rules set out in the equalization law are adhered to and that the

appropriate transfers are made each year in accordance with these rules.

These rules govern, *inter alia*, the treatment of deficits and surpluses and the intensity of the financial settlement. For one thing, the settlement is not complete. From 1959 to 1968 the tax capacity of the financially weak States was brought up to only 91 per cent of the settlement yardstick.⁹⁸ During that period the contributions of the financially strong States were calculated to embrace three-quarters of the surpluses between 100 and 110 per cent of the settlement yardstick and all surpluses in excess of 110 per cent of the settlement yardstick.

The financial transfers in terms of the State financial settlement described above between 1965 and 1969 (prior to finance reform) are shown in *Table 11*.

IV (3): The 1969 Finance Reform

Important aspects of this recent finance reform have already been highlighted in Chapters II and III. The finance reform had, as one of its aims, the strengthening of the State financial settlement in favour of the financially weak States. The reform did not fulfil the expectations of the financially weaker States⁹⁹ but it carried several notable

⁹⁸ *Finanzbericht* 1970, p. 172.

⁹⁹ These States, with the initial support of the Lower House, wanted all the joint tax revenues (income and value-added taxes) to be distributed on the basis of need criteria. Had this proposal been accepted, the State horizontal settlement would have been merged with the vertical (Federal - State) settlement. Most writers in Germany believe that the adoption of such a proposal would have been a retrograde step since it would have imposed further limitations on the independent budgeting of the States. See, for example, Wick, *op.cit.*, p. 266. According to Seeger (*loc.cit.*, p. 7), it is on the principle of derivation (distribution according to local receipts), and related to this the separation of the vertical from the horizontal settlement, that the financial/constitutional strength of the States and the guarantee for the Federal equilibrium rest.

Table 11
Financial Settlement between the States 1965-69

(DM million)

	<u>1965</u>	<u>1966</u>	<u>1967</u>	<u>1968</u>	<u>1969</u>
Nordrhein-Westfalen (North Rhine-Westphalia)	-539	-407	-423	-371	-487
Baden-Wuerttemberg	-367	-434	-467	-431	-619
Hessen	-362	-410	-421	-438	-624
Hamburg	-323	-353	-423	-482	-690
Bremen	-	-	-5	-3	-13
Total	-1,591	-1,604	-1,739	-1,725	-2,433
Bayern (Bavaria)	+189	+141	+122	+101	+233
Niedersachsen (Lower Saxony)	+509	+501	+678	+612	+888
Rheinland-Pfalz (Rhineland-Palatinate)	+323	+351	+336	+362	+489
Schleswig-Holstein	+349	+382	+371	+393	+520
Saarland	+209	+220	+232	+257	+303
Bremen	+12	+9	-	-	-
Total	+1,591	+1,604	+1,739	+1,725	+2,433

Source: *Finanzbericht* 1971, p. 185.

advantages and has resulted in some improvement in the relative financial position of these States.

The decisive change occurred with respect to the inter-State distribution of the State share of value-added tax revenue. This change had effect from 1st January 1970. It will be recalled that, through the revised tax-sharing arrangements, the States gained a 30 per cent share of the value-added tax starting with the year 1970. However, unlike the

distribution of income tax revenues which continues to be in accordance with local yields, 75 per cent of the State share of the value-added tax was distributed on a population basis and the remaining 25 per cent (the so-called 'supplementary portion') could be used beforehand to assist the financially weak States.¹⁰⁰ The latter portion is specifically designed to assist States with below-average tax receipts to reach at least 92 per cent of the Federal average (Berlin excepted).

This new development does not do away with the need for a horizontal financial settlement. The mechanism outlined in IV (2) continues but the amounts of the settlement transfers are smaller since the inter-State distribution of the value-added tax already has a significant effect in evening out differences in financial capacities among the States. A law has also been passed (*Zerlegungsgesetz*) for the purpose of correcting distortions in the income tax receipts of the States which result from a distribution according to local receipts. These distortions are particularly acute in the case of the corporation income tax. The new law has been used since 1970 to re-distribute revenue in accordance with the principle that revenue is to be paid to the State in which the business premises are located and not to the State in which the head office is located.¹⁰¹

Apart from the foregoing law, the amended version of *Article 107* means that horizontal fiscal equalization can now be thought of as being the sum of three elements:

¹⁰⁰ The difficulty of distributing value-added tax revenue according to local receipts stems from the fact that the tax is, for the most part, passed on to the buyer. Receipts in a State have no necessary connection with productive capacity of the State.

¹⁰¹ See Excerpt from *Finanzbericht* 1971, Bremen, *loc.cit.*, p. 85.

(a) distribution of the State share of value-added tax on a population basis and according to other 'need' criteria;

(b) contributions from financially strong to financially weak States in accordance with procedures outlined in IV (2) for the State financial settlement; and

(c) Federal supplementary allocations to States whose tax receipts per head of population lie below the Federal average and/or to States in financial need [*Article 107 (2)*].¹⁰²

The new arrangements in respect of the value-added tax therefore considerably ease the burden on the financial settlement.¹⁰³ The total re-distributional effect is clearly increased by virtue of the distribution of 25 per cent of the State share of value-added tax revenue to enable the tax receipts of the financially weak States to reach 92 per cent of the Federal average; this is a distributional effect which is not offset by the final adjustments made in the State financial settlement. Distribution of 75 per cent of the State share (the 75 per cent portion) on a straight population basis is in a slightly different category. It lessens the magnitude of these final adjustments because the resulting changes in State tax capacities are taken into account in arriving at the financial settlement transfers between the States. Inter-State distribution of the

¹⁰² These supplementary allocations date back to 1965. They were not strictly part of the financial settlement and were not therefore mentioned in IV (2). The amounts have also been relatively small, reaching a peak of DM 440 m. in 1968. *Finanzbericht* 1970, p. 173.

¹⁰³ It is probable that financial settlement transfers in 1970 were cut by about 50 per cent as a result of the new system. On this and related points see J.S.H. Hunter, 'Inter-State Fiscal Equalization in the Federal Republic of Germany and Comparisons with Australia and Canada', *Australian Economic Papers*, June 1973.

75 per cent portion has an 'equalizing' effect since participation by the States in the value-added tax is, in essence, a substitute for part participation in income taxes, the distribution of which favours the financially stronger States. Any departure from a distribution of tax receipts on the basis of source or origin of the receipts will tend to have some 'equalizing' effect, although it may not be of the kind desired so that further adjustments will then be needed. In Germany the effects of the decision to distribute the 75 per cent portion according to population are not yet entirely clear but it would appear that some financially weak States (Bavaria and Lower Saxony, in particular) stand to gain much while some financially strong States (such as North Rhine-Westphalia and Baden-Wuerttemberg) stand to lose little.

The significance of the new arrangements is to be found mainly in the unburdening of the financial settlement. This, in turn, carries an advantage from the standpoint of fiscal psychology. The budget appropriations in respect of the financial settlement transfers are more likely to be assured of a smooth passage in the State parliaments of the financially strong States if the amounts can be kept down to a level regarded as reasonable.¹⁰⁴

Apart from these advantages, the distribution of the 75 per cent portion on a population basis does not have far-reaching significance for the financially weak States (Lower Saxony, Rhineland-Palatinate, Saarland, Schleswig-Holstein and Bavaria). Those States are more interested in net cash benefits and to them the really crucial decision

¹⁰⁴ Wick, *loc.cit.*, p. 270.

in their favour was the one taken in April 1969 to intensify the financial settlement by raising below-average tax capacities up to the level of at least 95 per cent of the settlement yardstick.¹⁰⁵ The treatment of surpluses was also changed, so that surpluses in the range 100 to 102 per cent of the settlement yardstick are not counted, and the tax strong States must contribute 70 per cent of surpluses from 102 to 110 per cent of the settlement yardstick together with all surpluses in excess of 110 per cent of that yardstick.

As from 1970, the decision was made to include in tax capacity comparisons, and hence in the financial settlement, the municipal portion (14 per cent) of the wage and assessed income tax paid on the basis of local yield. Since these amounts were previously paid direct to the States on the same basis, the new arrangement would not appear to have had any influence on the inter-State financial settlement.

Two other decisions have, however, had an important influence on the inter-State distribution of tax revenues and should therefore be mentioned:

(a) The increase in special burdens for the Saarland from DM 35 million to DM 55 million (mainly in recognition of high costs associated with the University of Saarbruecken) and the creation of a new special burden for Rhineland-Palatinate at DM 20 million, ostensibly to meet high administrative costs in relation to compensation for victims of Nazi persecution. (The existing scale of special burdens for Hamburg, Bremen

¹⁰⁵ *Finanzbericht* 1970, p. 174. The previous minima guarantees were 61.25 per cent up to 1954, 88.75 per cent from 1955 to 1958 and 91 per cent from 1959 to 1968.

and Lower Saxony for costs of harbour maintenance at DM 55 million, DM 25 million and DM 6 million, respectively, is retained. An allowance of DM 30 million in recognition of excessive burdens in Schleswig-Holstein, a predominantly agricultural State, is also retained.)

(b) A more liberal approach, for purposes of calculating the settlement yardsticks, to burdens imposed on large municipalities. This part of the financial settlement is fairly complicated. The benefits are on a sliding scale starting with a population valuation of 100 per cent for cities with 5,000 people and moving up by steps to a valuation of 135 per cent for cities with 500,000 people. Over and above this level there are extra percentage allocations to synchronize with population density. These range from 2 per cent where there are 1,500 to 2,000 people per sq km to 6 per cent where there are more than 3,000 people per sq km.¹⁰⁶ This adjustment serves to lessen the intensity of the financial settlement since it is by and large the wealthier States - especially North Rhine-Westphalia - which stand to gain most from it (North Rhine-Westphalia has four cities with more than 500,000 people and in which population densities are large enough to attract the favourable valuation in the settlement yardstick for that State).¹⁰⁷ In addition, the valuation rate for Bremen in respect of population density has been brought up to the same level as Hamburg - namely 135 per cent. This change, which secured an additional DM 40 million for Bremen, was necessary to offset the particularly unfavourable effect on that State of the new tax distribution.

¹⁰⁶ See *ibid.*, p. 175; and Excerpt from *Finanzbericht* 1971, Bremen, *loc. cit.*, p. 86.

¹⁰⁷ At the end of 1969, the four cities were Dusseldorf, Essen, Cologne and Dortmund. See Statistisches Bundesamt, *Statistisches Jahrbuch*, 1971, pp. 26-7.

It should be emphasized that the various decisions taken as a result of the 1969 Finance Reform, while they assist some States more than others and provide that an important part of horizontal financial equalization at the State level shall be secured beforehand via changes in the inter-State distribution of the State share of the value-added tax, do not alter the basic mechanism for arriving at a financial settlement between the States. The transfers made in terms of that settlement (*Laenderfinanzausgleich*) still represent the true financial settlement in the Federal Republic. In terms of our earlier formula the finance reform means that the value of the TC_i factors are somewhat larger than they would have been under the previous arrangements; for the financially weak States the increases are particularly significant, for the financially strong States less so. Thus when the formula is used to determine the net receipts from, and net contributions to, the financial settlement pool, there will be clear advantages to States with low income/population ratios, although these advantages are partially offset by the population density rating which clearly favours the wealthier States.

By way of illustrating the order of magnitudes involved and the principles underpinning the financial settlement, it may be helpful to apply the above-mentioned formula to two States - one at each end of the spectrum so to speak. The two States selected for this illustration are Lower Saxony and Hesse. The formula, it will be recalled, is:

$$Y = [TC_i - S_i - \frac{TC_x}{P_x} \cdot wP_i]$$

N.B. The following figures are approximate and are only used for purposes of this illustration.

	<u>Lower Saxony</u>	<u>Hesse</u>
Let:		
TC_1	= DM 4,500 m.	DM 5,000 m.
S_1	= DM 200 m.	NIL
TC_x	= DM 46,000 m.	DM 46,000 m.
P_x	= 60 m.	60 m.
P_1	= 7.1 m.	5.4 m.
w	= 1.02	1.05

In Lower Saxony,

$$\begin{aligned}
 Y_N &= 4,300 - \frac{46,000}{60} \cdot 1.02 \cdot 7.1 \\
 &= 4,300 - 5,552 \\
 &= -1,252
 \end{aligned}$$

The intensity of the financial settlement is such that Lower Saxony should receive an amount which would take its taxable capacity up to 95 per cent of the settlement yardstick, *i.e.*, to 95 per cent of 5,552 = 5,274. Therefore the amount which Lower Saxony would receive from the financial settlement pool would be:

$$\begin{aligned}
 &\text{DM 5,274 million} - \text{DM 4,300 million} \\
 &= \text{DM 974 million.}
 \end{aligned}$$

In the case of Hesse,

$$\begin{aligned}
 Y_H &= 5,000 - \frac{46,000}{60} \cdot 1.05 \cdot 5.4 \\
 &= 5,000 - \frac{4,600}{6} \cdot 5.67 \\
 &= 5,000 - \frac{26,082}{6} \\
 &= 5,000 - 4,347 \\
 &= + 653
 \end{aligned}$$

The rule currently applicable is that Hesse must pay into the financial settlement pool 70 per cent of surpluses from 102 to 110 per cent of the settlement yardstick plus all surpluses in excess of 110 per cent of that yardstick

102 per cent of settlement yardstick = 4,434

110 per cent " " = 4,782

Hesse's net contribution therefore amounts to (70 per cent of 348) + (5,000 - 4,782)

= DM 244 million + DM 218 million

= DM 462 million.

IV (4): Impact of Horizontal Fiscal Equalization

Prior to 1970, total inter-State fiscal equalization was the sum of the financial settlement transfers and the Federal supplementary payments to the financially weak States. Between 1965 and 1969, the sum of these two elements tended to increase somewhat faster than State tax revenues as a whole, as shown in *Table 12*.

The new procedures instituted in 1970 made it possible to reduce both the financial settlement transfers and the Federal supplements, because an important re-distributional effect was already achieved through the decision to distribute 75 per cent of the State share of value-added tax revenue on a population basis. The revenue which the States derive from this source more than offsets the loss of income tax revenues which are distributed largely on a local collection basis. This meant that in 1970 the financial settlement transfers (including the effect of distributing 25 per cent of the State share of value-added tax revenue on a

Table 12

Financial Settlement and State Tax Revenues 1965-71

	(1) LFA*	(2) Federal Supple- ments	(3) (1) + (2)	(4) State Tax Revenues	(5) (3) as % of (4)
	DM m.	DM m.	DM m.	DM m.	%
1965	1,590	-	1,590	32,366	4.9
1966	1,604	180	1,784	34,869	5.1
1967	1,740	260	2,000	36,177	5.5
1968	1,725	440	2,165	39,404	5.5
1969	2,433	190	2,623	46,684	5.6
1970	2,075 ^φ	100	2,175 ^φ	50,482	4.3
1971	2,386 ^{**φ}	100	2,486 ^{**φ}	56,607	4.4

* = *Laenderfinanzausgleich* (State Financial Settlement)

** = Estimated

φ Includes DM 880 m. in 1970 and an estimated DM 1,012 m. in 1971 for the redistributational effect on State revenues of the 25 per cent portion of value-added tax received by the States.

Sources:

- (a) *Finanzbericht* 1970 (p. 172); 1971 (p. 186); 1972 (p. 192).
- (b) *Monthly Report of the Deutsche Bundesbank* Vol. 24, No. 10, October 1972, pp. 56-7.
- (c) Wick, 'Die Regelung des Finanzausgleichs ...' *loc.cit.*, Table 4, p. 271.

basis other than population), together with the Federal supplements, amounted to only DM 2,175 million, or 4.3 per cent of total State tax revenues (compared with about 5.5 per cent between 1967 and 1969). For 1971, with a 15 per cent increase in total receipts from the value-added tax, a slight increase in financial settlement transfers and no change in Federal supplements, the comparable figure was estimated at DM 2,486

million, or 4.4 per cent of State tax revenues. Thus it is clear that the new tax-sharing arrangements devised as part of the finance reform have significantly reduced the need for financial settlement transfers and Federal supplements.

To gauge the impact for particular States it is useful, as a first step, to compare the equalization or settlement transfers on a per capita basis and in relation to State revenues. This is done in *Table 13*. From this Table it is quite apparent that the horizontal settlement is of major importance in terms of additional revenue for financially weak States - especially to the Saarland, Schleswig-Holstein, Rhineland-Palatinate and Lower Saxony - and in terms of reduced revenue for financially strong States such as Hamburg and Hesse. Thus Hamburg's net contribution to the financial settlement in 1969 amounted to DM 690 million (DM 380 per capita), or almost one-third of revenues collected in that State and taken into account for purposes of the settlement. At the other end of the spectrum the Saarland gained DM 303 million (DM 260 per capita), an amount equivalent to 35.5 per cent of revenues collected in that State; and this does not include the Federal supplementary payments.

The estimates for 1971 shown in *Table 13* relate only to financial settlement transfers and are therefore not strictly comparable with the figures for 1970 which include the distribution of the 25 per cent portion of State value-added tax to assist low income States. However, when compared with the equalization transfers in 1969 (and 1968), the subsequent 'unburdening' of the financial settlement through the new arrangements for distributing the State share of the value-added tax is clearly indicated.

Table 13

Horizontal Equalization Transfers for Each State - Per Head of Population and in Relation to State Revenues

	1968 (a)			1969 (a)			1970 (b)			1971 (a)		
	(1)	(2)	(3)	(1)	(2)	(3)	(1)	(2)	(3)	(1)	(2)	(3)
	DM m.	DM per capita	DM per (1) as % of State Revenues (c)	DM m.	DM per capita	DM per (1) as % of State Revenues (c)	DM m.	DM per capita	DM per (1) as % of State Revenues (c)	DM m.	DM per capita	DM per (1) as % of State Revenues (c)
North Rhine-Westphalia	-372	-22	2.8	-487	-29	3.8	-488	-29	3.5	-460	-27	2.9
Baden-Wuerttemberg	-431	-50	6.3	-619	-70	9.1	-593	-69	8.2	-378	-42	4.6
Hesse	-438	-83	10.2	-624	-116	14.4	-473	-89	10.7	-255	-47	5.2
Bavaria	+101	+10	1.4	+233	+22	3.2	+209	+20	2.5	+186	+18	2.0
Lower Saxony	+612	+87	12.9	+888	+126	18.0	+680	+97	13.0	+448	+13	7.3
Rhineland-Palatinate	+363	+100	14.8	+489	+134	19.3	+417	+114	15.1	+250	+68	8.1
Schleswig-Holstein	+393	+156	22.6	+520	+204	28.2	+441	+175	22.3	+226	+89	10.0
Saarland	+257	+227	28.4	+303	+268	35.5	+295	+261	31.7	+155	+138	14.7
Hamburg	-482	-264	22.1	-690	-380	32.4	-521	-285	26.6	-281	-158	12.8
Bremen	-3	-4	0.6	-13	-17	1.8	+34	+45	4.3	+109	+148	12.4
	±1,726			±2,433			±2,075(d)			±1,374		

(a) LFA (Financial Settlement) transfers.

(b) LFA transfers *plus* redistributinal effect of inter-State distribution of 25 per cent State portion of value-added tax revenue.

(c) Revenues included for purposes of the State financial settlement.

(d) Of which approximately DM 880 m. represents the 25 per cent State portion of value-added tax allocated other than on a straight population basis.

Source: See Table 12. *Statistisches Jahrbuch* 1971, p. 25, and 1972, p. 27 (population figures).

It should be stressed that *Table 13* does not measure the full impact on State revenues in terms of the horizontal financial settlement. We have seen that there are two reasons for this:

(a) In 1970 and 1971 (and subsequently), a re-distributional element has already been injected in terms of the distribution of 75 per cent of the State portion of value-added tax revenue on a population basis. Since this has had the effect of narrowing tax capacity differences between States it has accordingly reduced the volume of financial settlement transfers.¹⁰⁸

(b) The exclusion of Federal supplementary payments to financially weak States which, strictly speaking, do not form part of the financial settlement.

This defect can, in large measure, be remedied by calculating per capita State revenues after financial settlement and relating the latter to the Federal average (excluding West Berlin). The results of this exercise are set out in *Table 14* for the period 1968 to 1971. Here we have unmistakeable evidence that the measures taken in the context of finance reform (and outlined in IV (3) above) have had a major effect in re-distributing revenues from financially strong to financially weak States. Federal supplementary payments to the latter are not shown in this Table because it has not been possible to obtain a detailed breakdown of this information. However, it seems very likely that because these payments were relatively large in 1968 (see *Table 12*), their inclusion would have brought per capita revenues in each State after financial

¹⁰⁸ Taxes received according to local receipts are taken as the appropriate index of neutrality with respect to horizontal fiscal equalization.

Table 14

* after Financial Settlement Relative to the Federal Average

	<u>1968</u>		<u>1969</u>		<u>1970</u>		<u>1971</u>	
	Per Capi- ta State Revenues DM	As Related to Federal Average %	Per Capi- ta State Revenues DM	As Related to Federal Average %	Per Capi- ta State Revenues DM	As Related to Federal Average %	Per Capi- ta State Revenues DM	As Related to Federal Average %
North Rhine- Westphalia	773	101.8	755	100.0	814	100.9	922	101.5
B.-Wuerttemberg	790	104.1	771	102.1	807	100.0	903	99.4
Hesse	808	106.4	806	106.7	806	99.9	905	99.7
Bavaria	701	92.4	701	92.8	772	95.7	865	95.3
Lower Saxony	678	89.3	698	92.4	766	94.9	856	94.3
R.-Palatinate	676	89.1	691	91.5	772	95.7	868	95.6
S.-Holstein	691	91.0	723	95.8	790	97.9	899	99.0
Saarland	708	93.3	755	100.0	837	103.7	938	103.3
Hamburg	1,191	156.9	1,170	155.0	1,080	133.8	1,228	135.2
Bremen	963	126.9	958	126.9	1,036	128.4	1,188	130.8
Federal	759		755		807		908	

* Revenues included for purposes of the financial settlement.

Source: See Tables 12 & 13.

settlement up to at least 92 per cent of the Federal average. Since then the position of States with relatively low taxable capacities has been markedly improved. This is especially true of the Saarland, Schleswig-Holstein, Rhineland-Palatinate and Lower Saxony, which have gained revenues largely at the expense of Hesse and Baden-Wuerttemberg. Hamburg, Bremen, and to a lesser extent North Rhine-Westphalia, are left with relatively large per capita revenues since the valuation rate for population density¹⁰⁹ has worked in their favour.

IV (5): Some Special Features of the Horizontal Financial Settlement in the Federal Republic of Germany

The features of the West German system for regulating the horizontal financial settlement which should be of particular interest to the Australian reader are as follows:

(a) The task of horizontal fiscal equalization is easier than in other federations because State tax rates are uniform in the Federal Republic. This means that problems which arise in allowing for differing efforts by States to raise revenue through increases in tax rates are avoided.

(b) No attempt is made to bring the financially weak States up to the level of financial affluence experienced in the States with the highest per capita incomes. Aside from the City States (Hamburg and Bremen) which have exceptionally high per capita incomes, Hesse, North Rhine-Palatinate and Baden-Wuerttemberg rank high on the income scale.

¹⁰⁹ See *supra.*, p. 85.

The equalization yardsticks, while modified in several respects, are based essentially on average experience in the whole Federation.

(c) Financial settlement takes the form of what is probably best described as a 'brotherly' rather than a 'fatherly' system. The Federal Government is prominent enough in several spheres but as far as horizontal financial settlement is concerned it keeps very much in the background, being content to ensure that the 'settlement rules' are properly observed and that new rules are formulated to meet new conditions. There is Constitutional provision for Federal supplementary payments to assist financially weak States but the actual amounts paid have been small and used only to offset, at the margin, unfavourable and unanticipated developments in the revenues of these States. Rather than being a question of how much money the Federal Government will hand out to particular States, the real issue becomes one of how much money the tax-strong States will be obliged to transfer to the tax-weak States. To the sophisticated student of public finance there may not be much difference, but in terms of an awareness of who pays what and why the German method of securing a settlement as between the States has real advantages.

(d) The focus is on differences in financial capacity rather than on differences in financial need (although there is some recognition of financial need and this is discussed in (f) below). The Canadians, it may be noted in passing, lean even more heavily in this direction.¹¹⁰ Moreover, the German approach to differing tax capacities of the States is fairly broad-based. A large part of municipal revenues is included.

¹¹⁰ See Clark, *loc.cit.*

So far the Germans have managed to resist the temptation to revert to a widespread use of financial need yardsticks. For this we have to thank the structure of government in the Federal Republic. Thus, the Council of States, with the support of the tax-strong States (which have relatively larger voting power) and Bavaria (which puts great stress on State tax sovereignty), was able to defeat a proposal by several States (a proposal which had the support of the Lower House), which was clearly intended as a preliminary to embracing a system of financial transfers based on an assessment of financial need.

(e) When proposals for changes in the inter-State distribution of taxes are initiated by a particular State or by several States, with or without the support of the Federal Finance Minister, intensive bargaining takes place by each State within the Committee system of the Council of States. States may be outvoted in the final analysis, but they exert as much pressure as they can to ensure that any changes are in their own interests. This is an essential part of the federal process. In 1969, for example, the inter-State financial settlement was strengthened to provide a guaranteed revenue to each State of 95 per cent of the Federal average. The legislation to give effect to this proposal was opposed by both North Rhine-Westphalia and Hamburg - the States which stood to lose most - but these States did not have sufficient votes in the Council to 'kill' the proposal. On another occasion, however, the tax-strong States acted in unison to defeat a proposal, put forward by Lower Saxony, that the distribution of tax receipts should be made in accordance with 'need' yardsticks. The tax-strong States had the necessary votes in the Council and the proposal was not accepted. These and other examples suggest two things:

(i) The Federal Government, acting through the Lower House, cannot change the system of inter-State financial settlement transfers without gaining the necessary support in the Upper House.

(ii) Financially-weak States can initiate proposals for change - and these proposals may even have the support of the Federal administration - but they cannot succeed if opposed resolutely by the financially strong States.

(f) Aspects of financial need intrude into the financial settlement in only three respects. The first relates to the allowance for special burdens, the second to population valuations and the third to the distribution of the so-called supplementary portion (25 per cent) of State value-added tax revenue. With regard to the latter, the over-riding purpose is to strengthen the intensity of the financial settlement so that revenues of the tax-weak States are brought up to at least 92 per cent of the Federal average (and, as noted earlier, this is only a preliminary step since in the main exercise revenues are, in fact, brought even closer to the Federal average - see *Table 14*). Given that one is in favour of 'equalization' there will be no difficulty in accepting this approach. The other elements are more debatable, especially the allowances for special burdens. These allowances are intended to apply to expenditures which affect States unevenly or which benefit the nation as a whole. However, if this is the intention it is clearly not being taken very seriously since it would not be difficult to compile a fairly long list of expenditures which fit into these categories and for which at

present no special allowance is made.¹¹¹ In the opinion of this author the authorities have acted wisely in quashing attempts to extend the range of expenditures for which special burdens (*i.e.*, deductions from tax capacity) could apply. Any such step would tend to destroy the simplicity and apparent effectiveness of the present system. If any move is made it would be better to get rid of the 'special burdens' element altogether, especially as it seems to be Hamburg - the State with the highest income and tax capacity per capita - which gains most from the present scale of special burdens. There is more logic in the second element, the higher population valuation which is applied to areas with high population densities. But there is, of course, the implicit assumption that the financial needs of densely populated areas are greater, per head of population, than the more sparsely populated areas.

(g) A major advantage of the West German system is that equalization is explicit. It is not difficult to calculate, with the aid of the formula employed above,¹¹² how much revenue has been transferred from States A', B' ... to States A'', B'' ... for purposes of horizontal financial equalization. Use of an explicit equalization formula can be counted as a major advantage in that it limits the scope for subjective judgment or piecemeal subsidies to placate particular States. Although the particular distribution of value-added tax revenues since the 1969 Finance Reform has reduced the volume of equalization transfers, the *Laenderfinanzausgleich* (State financial settlement) is still the focal point for horizontal fiscal equalization in the Federal Republic. In any event, each of the component parts of the equalization process is clearly identifiable. The same cannot be said of the Australian system. In

¹¹¹ On this point, see Noell v.d. Nahmer I, *loc.cit.*, p.358.

¹¹² See *supra.*, pp. 77-8; 86-8.

Germany the term 'financial settlement' is moreover truly applicable since what the financially weak States receive, the financially strong States have to pay. A 'brotherly' financial settlement tends to make for a clear separation between vertical (Federal - State) and horizontal (inter-State) financial settlement. Use of an explicit formula for inter-State fiscal equalization makes it clear to all parties how much revenue is being redistributed and what criteria are being used to determine the net result. Looking ahead each State can therefore make a reasonably accurate assessment of how much it will have to pay into the financial settlement pool or how much it can expect to receive from that pool. In short, a 'brotherly' type financial settlement appeals as an orderly system in which, for the most part, objective criteria are used.

(h) As a final point it may be noted that the Germans have not set up an independent Commission - such as the Grants Commission in Australia - to inquire into, and assess on a continuing basis, the financial needs of States which apply for special assistance. It is unlikely that this approach will ever be followed in West Germany, especially as it took about 5 years from the time the *Troeger Commission* was set up until its recommendations, embodied in the Finance Reform, were put into effect. Neither the Federal nor State governments would welcome the establishment of an independent authority to evaluate relative financial needs and make appropriate recommendations for assistance. This would not be in tune with the historical development of techniques for inter-State fiscal equalization; and it would make the system vulnerable to acceptance of *ad hoc* payments - a practice which the authorities have so far, with conspicuous success, managed to avoid. The German mentality is accustomed,

especially in areas where controversy between interested parties is inevitable, to the practice of reaching a compromise in terms of a set of rules embodied in law. This mentality does not take kindly to loose arrangements which give a few Federal officials the power to make decisions. A system of checks and balances is an integral part of the governmental structure and it is nowhere more evident than in the sphere under discussion. The equalization law sets down certain guidelines to be observed, including criteria to be used in assessing the below- or above-average tax capacities of particular States, and the extent to which deficiencies or surpluses of adjusted tax capacities of each State in relation to the equalization yardstick are to be included in the financial settlement. This law does not leave a great deal of discretion to Federal officials and yet the law can and has been adapted to meet changing circumstances and pressures for change. The law has proved to be reasonably elastic although it cannot be changed without the approval of the Council of States. There is, of course, no shortage of expert advice either at the Federal or State level. In fact if it had not been possible to read the many articles written on the subject by these experts, this study would have proved a much more difficult assignment. It is evident that in the State Finance Ministries there are several key people who have a firm grasp of the principles involved and who can advise their respective ministers accordingly. These ministers are therefore able to attend the Committee Meetings of the Council of States fully equipped to deal with the relevant issues in this and related areas. In these circumstances it is difficult to see any role for an independent advisory body.

V: CONCLUSION

This study has attempted to demonstrate the importance of revenue sharing in the Federal Republic of Germany, with emphasis on both the vertical (Federal - State) and horizontal (inter-State) settlements. In each case the techniques of revenue sharing have been described in some detail.

In order to gauge the real significance of revenue sharing in West Germany it is essential to have a clear understanding of the structure of government, and especially the important role of the Council of States (*Bundesrat*). The latter is a forum for State Ministers or their deputies and, as such, has acted to ensure that the interests of the States are adequately protected. An identity of State interests is not always possible and, through the Committee system, the Council of States has been active in working towards, and arriving at, compromise solutions when the interests of various States diverge and/or when some States have managed to elicit the support of the Lower House (*Bundestag*).¹¹³ At the same time the Council of States has been instrumental in giving the Federal Government adequate powers to control the overall direction of the economy. What has therefore evolved is a particular form of co-operative federalism - in which connection the Economic Stability and Growth Law (see Chapter II (6)) is of the utmost importance.

As far as the vertical financial settlement is concerned, neither party is in a superior position. But there was early recognition that a basic pre-requisite for an appropriate sharing of tax revenues

¹¹³ The important part played by State civil servants in this system has been noted. Laufer, *loc.cit.*, pp. 12-17.

between the Federal Government and the States (the joint taxes comprise more than 70 per cent of their total tax revenues) was a co-ordinated effort for the forward planning of public sector expenditures.

The arrangements for revenue sharing (with respect to income and value-added taxes) have made it possible to achieve a close 'correspondence' between revenue resources and expenditure commitments at each level of government. The States have been able to gain access to revenues commensurate with their spending needs.

The attention to intergovernmental co-operation and planning in company with the techniques for revenue sharing explain why the Federal Government has been able to avoid large-scale financial assistance to the States with no strings attached and why the rise in State debts has been kept to modest proportions. Federal officials cannot act in an arbitrary fashion; they must conform to the law which, as far as Federal - State matters are concerned, requires the prior approval of the Council of States.

In short, the system of revenue sharing in the Federal Republic is seen to have the following advantages: (a) it is simple and flexible; (b) it affords adequate protection to State rights; (c) it is not unduly 'bureaucratic';¹¹⁴ (d) it provides a clear separation between vertical and horizontal financial settlement; and (e) it leaves little scope for Federal *ad hoc* assistance to particular States. It has thus become possible for Federal assistance to the States to be planned in terms of

¹¹⁴ This is a judgment which may be queried by some experts. Clearly, the bureaucrats have adequate scope for their talents, but no one group of bureaucrats (Federal or State) can dominate decision-making in the Federal - State sphere.

the arrangements for joint (Federal - State) financing and to be concentrated in those task areas which have national importance or which are likely to assist towards the goal of uniform economic development (the determination of tasks which are to be jointly planned and financed must have the approval of the Council of States).

Federal grants for the purpose of uniform economic development are also relevant to revenue sharing between the States for purposes of the horizontal financial settlement. Fiscal uniformity has made the latter task easier without impairing the financial sovereignty of the States.

According to one of West Germany's foremost financial experts, the aim of horizontal fiscal equalization in the Federal Republic is '*to secure a high degree of uniformity in the provision of public services in all regions of the federation.*'¹¹⁵ In striving to reach this goal the authorities have, for the most part, relied on objective criteria and broadly-based measures of taxable capacity. Subjective judgments have been pushed into the background. The principles governing the equalization transfers are openly stated and, it seems, generally understood.

The analysis carried out in IV (4) leaves no doubt that the financially weak States, while not completely happy, have gained significantly from the equalization transfers, especially in the last 2-3 years.

It should not be overlooked that the task of the West German authorities has been made easier by fiscal uniformity, by making the financial settlement the centre-piece of the equalization process and,

¹¹⁵ H. Haller, 'Changes in the Problems of Federative Public Economies', *The German Economic Review*, Vol. 8, No. 3, 1970, p. 193.

perhaps more importantly, by the refusal to get bogged down with fiscal needs yardsticks. On the other hand, the authorities have been active in seeking solutions to special problems as they arise. When different points of view have emerged - and different points of view are bound to emerge because States are obviously affected differently whatever decisions are made - the authorities have proved remarkably adept in seeking compromise solutions which would gain the required support in both Houses.

Once the *Troeger Commission* had filed its Report, the authorities moved quickly in implementing the main recommendations. An onlooker from 'outside'¹¹⁵ would surely be impressed with the record. The intensification of the financial settlement (*i.e.*, the decision to augment the revenue of tax-weak States up to at least 95 per cent of the settlement yardstick) and the arrangements for re-distributing the State portion of value-added tax revenue seem to warrant special mention, because opposition from several of the tax-strong States had first to be overcome. The Federal authorities have, moreover, moved swiftly to assist States which were able to demonstrate above-average financial stringency; and they have done it without leaving the impression that they were 'subsidizing' those States. The unburdening of the financial settlement (through the arrangements on inter-State distribution of the value-added tax) was also a wise move from the standpoint of fiscal psychology, because it kept the 'brother to brother' transfers down to what State legislators would think was a reasonable level.

¹¹⁵ The author, whilst Visiting Professor at the University of Muenster, was able to examine at close range the impact of the recent finance reform. See J.S.H. Hunter, 'Finance Reform in West Germany: Its Nature and Impact', *M Series No. 33: Report to the Committee for Economic Development of Australia*, November 1971.

APPENDIX

Constitution of the Federal Republic of Germany: Clauses referred to in Text*

(as amended by the Finance Reform Law of 23/4/69)

Article 51

(1) The Council of States consists of members of the governments of the States or their nominees.

(2) Each State has at least three votes; States with more than two million people have four votes; and States with more than six million people have five votes.

(3) Each State can send as many members as it has votes. Votes by members for each State must be uniform.

Article 71

In the sphere of the exclusive legislation of the Federal Government, the States can only legislate when explicitly authorized by Federal law.

Article 72

(1) In the sphere of competing or concurrent legislation, the States can legislate only when the Federal Government does not exercise its powers to legislate.

(2) The Federal Government in this connection has legislative powers when there is a need for Federal legislation for the following reasons:

* Author's (somewhat liberal) translation of key clauses.

- (i) when States are not able effectively to legislate in a particular area;
- (ii) when regulation by State law could affect the interests of other States or the States as a whole;
- (iii) when the maintenance of legal and economic unity, especially the safeguarding of the uniformity of living conditions throughout the Federal area, is desired.

Article 73

The Federal Government has exclusive legislative competence with respect to several matters, amongst which are foreign affairs, defence, citizenship, currency, air traffic, railroads, immigration and posts and telegraphs.

Article 74

Concurrent legislation relates, *inter alia*, to the following matters:

- (i) civilian and criminal law;
- (ii) refugees;
- (iii) public health and welfare;
- (iv) war damage and reparations;
- (v) industry, commerce and finance;
- (vi) production and use of atomic energy for peaceful purposes;
- (vii) industrial relations, including unemployment insurance;
- (viii) promotion of scientific research;
- (ix) protection against misuse of corporate monopoly powers;
- (x) property development;
- (xi) shipping and roads.

Article 91a

(1) The Federal Government co-operates in the following areas in the fulfilment of State tasks if these tasks are of significance for the whole nation and the co-operation of the Federal Government is required in order to improve living conditions:

- (i) extension and new building of institutes of higher education, including university-clinics;
- (ii) improvement of the regional economic structure; and
- (iii) improvement of the agricultural structure and of coastal protection.

(2) The joint tasks are to be more clearly defined in Federal law.

(3) The law sets down the procedures for joint framework planning. Inclusion of a project in a plan requires approval of the State in which the project is initiated.

(4) The Federal Government finances half the expenditures under (1) (i) and (1) (ii). In category (1) (iii) it finances at least half the expenditure.

Article 91b

On the basis of agreement, the Federal Government and the States can co-operate in educational planning and in the promotion of scientific research of extra-regional significance. The distribution of costs is regulated in the agreement.

Article 93

(1) The Federal Constitutional Court decides on the interpretation of the Constitution when there are differences of opinion as to the rights and duties of various organs or agencies of government. The Court also acts in the event of differences of opinion or doubts about the formal or material comparability of Federal or State law with the Constitution; and in particular where there are differences of opinion concerning the rights and duties of the Federal Government and the States, especially in case of the execution of Federal legislation through the States.

Article 104a

(1) The Federal Government and the States each bear the costs associated with their own activities, unless the Constitution specifies otherwise.

(2) If the States act in accordance with instructions from the Federal Government, the latter must bear the cost of any expenditures which result.

(3) If a Federal law determines that the Federal Government is to meet half or more of the expenditures, the law is administered at the order of the Federal Government. If the law determines that the States bear one quarter or more of the expenditures, the approval of the Council of States (*Bundesrat*) is required.

(4) The Federal Government can extend financial aid to the States for important investments of the States and municipalities, when such investments are necessary to fend off a disturbance to total economic

equilibrium, to even out differential economic capacity in Germany, or to promote economic growth. Details of the investments to be promoted are regulated either by Federal law, which requires approval of the Council of States, or on the basis of the Federal budget law through administrative agreement.

Article 105

(1) The Federal Government has exclusive jurisdiction with respect to customs and Federal monopolies^{*}.

(2) The Federal Government has concurrent legislative powers with respect to all other taxes if it derives revenue from those taxes or if the conditions of *Article 72 (2)* prevail.

(2a) The States have legislative power with respect to local consumption taxes, provided the taxes are not regulated by Federal law.

Article 106

(1) The yield from Federal monopolies and from the following taxes are assigned to the Federal Government:

- (i) customs duty;
- (ii) consumption taxes, in so far as they are not received by the States under (2), shared by the Federal Government and the States under (3) or belong to the municipalities under (6);
- (iii) road transport tax;

* The most important of which is the alcohol monopoly. See Gumpel, *loc. cit.*, p. 422.

- (iv) taxes on insurance, securities, company incorporation and share turnover;
- (v) capital levies to equalize burdens as a result of differential war damage;
- (vi) surcharge on personal and corporate income taxes;
- (vii) levies in connection with the EEC.

(2) Yields from the following taxes are assigned to the States:

- (i) wealth and inheritance taxes;
- (ii) motor vehicle tax;
- (iii) beer taxes;
- (iv) levies from gambling casinos.

(3) Revenue from income taxes is shared equally between the Federal Government and the States, after a portion has been allocated to municipalities in accordance with (5). The turnover tax distribution is fixed by Federal law which needs the approval of the Council of States. In determining the appropriate distribution, the financial needs of each level of government have to be balanced so that an excessive burden on tax-payers is avoided and the uniformity of living conditions in West Germany is maintained.

(4) The portion of the value-added tax receipts which goes to each level of government is to be adjusted by Federal law in accordance with changes in the income/expenditure patterns of each level. Such adjustment requires approval of the Council of States.

(5) Municipalities receive a portion of income tax revenue on the basis of the income tax payments of their citizens. Details are laid

down in a Federal law which needs approval of the Council of States.

(6) Income from property taxes is assigned to municipalities, as is the revenue from local consumption taxes. Municipalities can apply surcharges to their property taxes within the framework of the law. If there are no municipalities within a State, the yield from property and local consumption taxes accrues to the State. The Federal Government and the States can share in the yield from trade taxes through a levy, of which details are set out in Federal law (such law requires approval of the Council of States). In accordance with State legislation, the property tax and the municipal portion of revenue from the income tax can be used as a calculation basis for these levies.

(7) Of the State portion of the joint or shared taxes, a certain percentage as determined by State law is channelled to municipalities or municipal corporations.

Article 107

(1) The yields from State taxes and from the State portion of income taxes are to be received by particular States on the basis of local collections. Detailed rules governing the extent to which this basis can be changed are to be set out in a Federal law which requires approval of the Council of States. The State portion of revenues from the value-added tax belongs to particular States in accordance with population numbers; for a part, but at most one-quarter, States can receive supplementary portions but this applies only to States whose receipts from State taxes and income taxes per head of population lie below the average of all States.

(2) The law must ensure that the differential financial capacity of the States is appropriately offset; and for this purpose the financial capacity and financial needs of municipalities have to be considered. The terms of settlement between the States are to be determined by Federal law; and this law also refers to allocations from the Federal Government to cover the general financial needs of weaker States.

Article 108

(1) Customs duties, revenue from Federal monopolies, consumer taxes regulated by Federal law (including the import turnover tax) and the EEC levies are administered by Federal agencies.

(2) Other taxes are administered by State agencies. The structure of these agencies and the uniform training of their civil servants can be regulated in Federal law with approval of the Council of States.

(3) If the State agencies administer the taxes which go wholly or in part to the Federal Government, they are acting at the order of the Federal Government.

Article 109

(1) The Federal Government and the States are independent in their budgeting.

(2) In their budgeting the Federal Government and the States have to consider the requirements of total economic equilibrium.

(3) By Federal law financial planning can cover several years.

(4) With approval of the Council of States, and in order to avoid a disturbance to total economic equilibrium, a Federal law can regulate:

- (i) the maximum amounts, conditions and time periods for borrowing by governments and governmental bodies;
- (ii) non-interest bearing deposits held by the Federal Government and the States with the Central Bank.

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