Comparative Fiscal Federalism

Country Report Germany

Work status: September 2021

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1 The goals of the system according to legal order and tradition

The German federal system is regarded as the archetypical case of cooperative federalism (Hueglin und Fenna 2015; Broschek 2012). It stands thus in stark contrast to dualist federal systems which are typically exemplified by the United States. In dualist federal systems, a fundamental antagonism exists between the constituent units (in the case of the US: the federal government and the states). Their relationship is marked by (forced, but limited) interdependence, competition and a strong striving for autonomy (Kenyon/ Kincaid 1991). In a cooperative federal system, such as Germany, in contrast, the constituent units (in that case the federal government and the Länder) share tasks, powers, and money, and their mutual behaviour is predominantly marked by negotiation and cooperation, in horizontal as well as vertical direction (Behnke und Kropp 2020). Solidarity as a guiding normative principle plays an important role in the German constitution (Grundgesetz – Basic Law) as well as in everyday politics. This fundamental normative orientation is also the backbone of German fiscal relations (Behnke 2013).

The cooperative character of German federalism is rooted in the specific division of labour between levels of government as provided by the Basic Law. The federal level is endowed with major legislative powers, leaving only sparse residual legislative powers (e.g. culture, police and education) to the Länder parliaments (Articles 70 through 74 Basic Law; for a more detailed elaboration of the federal power distribution see chapter 3). The Länder, on the other hand, hold the monopoly of executive powers in nearly all policies. The federal government relies thus on Länder administrations to implement policies which were legislated by federal parliament (Articles 83 through 85 Basic Law). This functional in contrast to a sectoral division of powers necessitates a tight cooperation within and across levels of government to ensure efficient policy-making and implementation. It also impacts directly fiscal relations between levels of government. As the Länder are responsible for fulfilling the largest part of public tasks, they need to dispose of the fiscal resources to do so. Thus, it is the basic rationale of the German fiscal constitution to endow all constituent units with the fiscal resources necessary for them to fulfil their tasks.

In order to endow all constituent units with the necessary fiscal resources, a strong emphasis on solidarity marks the system of fiscal relations. Constitutionally, this is founded on the normative premise of producing or safeguarding equivalent living conditions in Germany. The principle appears twice in the Basic Law, in Article 72 and in Article 106. In Article 72 section 2, “the provision of equivalent living conditions” provides the reason why the federal level may claim to attract concurrent legislative powers. In Article 106 section 3, the “uniformity of living conditions” is a criterion for the vertical division of value added tax. Interestingly, during the constitutional reform of 1994, the “uniformity” was attenuated into “equivalence” only in Article 72, but not in Article 106, whatever the reason behind this inconsistency may be (Behnke 2020a: 192). The fiscal constitution is spelled out in

Articles 104a through 115 Basic Law. While its basic features were developed in the 1950ies, it is the part of the Basic Law that was amended most often (for a more detailed description of the historical evolution of the fiscal constitution see chapter 2). This is due to the fact that it contains very detailed regulations (even the percentages of vertical tax distribution are laid down in the constitution) which are subject to recurrent contestation and re-negotiation among the constituent units. This combination of high level of conflict common to federal negotiations on the distribution of resources on the one hand and high hurdles for constitutional amendment on the other explains why details the fiscal constitution were subject to recurrent changes, but only rarely substantive reforms could be achieved (Behnke 2020b).

The concept of solidarity is pervasive in the mechanisms of tax distribution as well as in redistributive payments. The system of tax distribution consists of a mix of 'own' taxes, where the different units of government have individual tax levying powers, and 'joint' taxes which are collected collectively and then shared among the constituent units according to constitutionally prescribed quotas or procedures (Article 106) (Kienemund und Reimeier 2015; Finanzen 2017). The 'own' taxes make up only a small share of each unit's revenues, while the powerful revenue generating taxes (VAT and income tax) are joint taxes, thereby making sure that enough money flows to each constitutional unit. After the primary tax distribution has attributed to each unit a certain amount of money, it is followed by several steps of re-distribution. The horizontal distribution of VAT is the most powerful instrument of re-distributing money among the Länder. It is complemented by vertical equalization payments from the federal level to the financially weaker Länder. All in all, the system of financial re-distribution lifts each unit's income per inhabitant relative to the average income per inhabitant above the 90% level (for a more detailed description of the system of tax distribution and re-distribution see chapter 4).

Most recently, a major reform of the fiscal relations was achieved, entering into force on January 1, 2020. The reform was necessitated formally by sunset legislation from 2004, and substantially by a growing disparity in the financial and economic strength of the Länder resulting in ever more lopsided horizontal re-distributive payments which threatened the fundamental solidarity among the Länder. This recent reform exemplifies that a financial equalisation system that emphasizes solidarity as strongly as the German system does is rather vulnerable to strong disparities in economic and financial strength among its constituent units. In Europe, where the disparities are still much greater, a more flexible system of fiscal relations is needed.

2 Origin and Development of Federalism in the German Federal state

In the following chapter, selected historical events that have had a particular impact on the federalism of the Federal Republic of Germany are considered. In this context, the Herrenchiemseer Constitutional Convention, the results of whose work form the essential preparatory basis for the Basic Law, will be discussed first. Subsequently, some details of the first version of the Basic Law, the Grundgesetz, are described, which are of particular importance for the German post-war order. With the financial reforms of 1955 and 1969, two packages of laws are discussed that have had a particular impact on German federalism in general and the financial constitution in particular to the present day. The German reunification is also a historically outstanding event. Changes in constitutional law and financial policy challenges that accompanied it, some of which are still highly topical, are presented in detail. Subsequently, the results of the federalism reforms of 2006 and 2009 and their respective reform priorities are discussed. Finally, the results of the most recent federalism reform of 2017 are described, which form the essential constitutional basis for the decade from 2020.

A. Debates within the framework of the Herrenchiemsee Constitutional Convention

Federalism in Germany is rooted in the developments leading up to the founding of the Federal Republic of Germany when the Basic Law came into force on 23 May 1949. At the London Conference in the spring of 1948, the Western Allies and representatives of German neighboring states had decided to establish a new Western German state. On 1 June 1948, the Allied Forces mandated the german prime ministers with drafting a democratic constitution and a government with a federal structure. This work was to be carried out in the Parliamentary Council from 1 September 1948 onwards. Preparatory work for the Parliamentary Council was conducted at the constitutional convention at Herrenchiemsee in Bavaria from 10-23 August 1948, which the prime ministers of the states in the western occupation zones convened. Over the course of two weeks, an advisory board consisting of around 30 experts discussed the design of the constitution. Debates were split into three subcommittees, each focusing on a different topic central to the drafting of the constitution. Subcommittee I was to discuss fundamental issues concerning the preamble, naming, as well as national territory and constitutional jurisdiction. Subcommittee II was tasked with jurisdictional issues in legislation, jurisprudence and administration, and financial constitutional issues. It therefore discussed core issues regarding the distribution of legislative and executive powers and fiscal relations between the different federal levels of the government. Lastly, Subcommittee III focused on organizational issues related to the structure, design and function of state bodies.

The convention faced a lack of predictability regarding the public financial needs of the federation as a whole as well as of the individiual levels, which depended on the distribution of tasks and expenditures across the levels that was yet to be defined.[1] This represented a main challenge regarding the allocation and distribution of taxes across the federal levels. As a result, discussions placed an emphasis on the distribution of legislative and executive power between the federal level and the Länder. Regarding legislative power, the convention agreed that the Länder should in principle be responsible for legislation, insofar as it was not assigned to the federal government.[2] The recommendation thus distinguished between concurrent and exclusive legislation. Moreover, the council recommended that the federal government was to be given dominance in tax legislation regarding customs, consumption taxes, value added tax and transport taxes. The Länder, on the other hand, should be given legislative competence for the income tax and wealth tax. Three alternatives were included regarding the design of the fiscal administration: Federal administration, Länder administration, and federal executive administration. Most representatives of Subcomission II were in favor of a Länder fiscal administration.[3]

The documents establishing the recommendations of the Constitutional Convention were submitted for discussion to the Parliamentary Council. A deficit regarding the outcome of the convention can be identified in the lack of recommendations on how to reduce the extreme differences in financial strength between the Länder.[4] This was rooted in the demand for extensive Länder competences accompanied by a flexible design of tax collection rates, which stood in contrast to the concept horizontal fiscal equalization.

B. Grundgesetz 1949

On 1 September 1948, the Parliamentary Council convened in Bonn to discuss the design and details of the constitution based on the results of the Constitutional Convention at Herrenchiemsee. The prime ministers of the Länder had feared that if the constitution applied only to a West German state,

[1] Cf. Renzsch (1991), p. 58.
[2] Cf. Bauer-Kirsch (2005), p. 101.
[3] Cf. Bauer-Kirsch (2005), p. 103.
[4] Cf. Renzsch (1991), p. 59.

it might further solidify the division of Germany. Instead of a constituent assembly, they therefore convened a "Parliamentary Council" with the task of drafting a provisional constitution, the Basic Law. The constitution was to guarantee fundamental rights and provide for a federal state structure. Controversy among members of the Parliamentary Council centered on the distribution of power between the federal government and the Länder as well as on the financial order. The majority of the Parliamentary Council favored a unitary tax administration at the federal level.[5] However, conflict with the Allied Forces erupted regarding the proposed extensive federal responsibilities. In a memorandum from November 1948, the allied forces announced that they would reject the proposal drafted by the Parliamentary Council. Instead, the military governors called for a dual tax system with legislative competence for the level of government to which the tax revenue accrued. Thereby, they wanted to limit federal legislation to those taxes whose revenues the federal government needed to cover its expenditures.[6] The military governors particularly criticized that the Länder lacked adequate sources of revenue that were independent of the federal government.[7] Moreover, language barriers and poor translations led to misinterpretations of the allied forces. For example, the term "priority legislation" was replaced with "concurrent legislation" in a later draft to clarify that the federal government was not to hold general primacy in legislation.[8] Following further disputes within the Parliamentary Council as well as with the allied forces, the proposal for the Basic Law was finally accepted and proclaimed on 23 May 1949. As a result, the council agreed on a divided fiscal administration and a Federal Council whose powers were limited. A proposed combination of value added tax, income tax and corporate income tax to a common tax base could not be realized. Instead, value added tax revenues were to be accrued completely to the federal government. Council members moreover accepted the priority legislation of the federal government.

Articles of the Basic Law 1949 that are of relevance for the fiscal order include:

- Art. 106 (1) and (2) Basic Law described, which tax revenues accrued to which level of government, thereby introducing a tax separation system. At the same time the federal government was granted access to parts of the income and corporation tax by Art. 106 (3) Basic Law, although these tax revenues were formally assigned to the Länder.
- Regarding fiscal equalization between the Länder, Art. 106 (3) and (4) allowed for both federal allocations to financially weak states and a system of equalization among the Länder.
- Art. 107 Basic Law was drafted as a sunset law that allowed the federal legislature, with the consent of the Bundesrat until 1952, to rewrite Art 106 by a simple federal law (i.e., without a constitutional amendment majority). [9] This deadline was extended twice, until Art. 107 was finally rewritten and passed on 31 December, 1955 in the "Small Financial Reform".

In the period leading up to the 1955 reform, Art. 120a was introduced in 1952 to regulate the equalization of burdens between the federal equalization office (*Bundesausgleichsamt*) and the Länder equalization offices (*Landesausgleichsämter*). It stated that laws implementing equalization payments should be implemented in part by the federal level and in aprt by the Länder on behalf of the federal level. Moreover, Art. 120a stated that the powers vested in the Federal Government and the competent supreme Federal authorities under Art. 85 should be transferred in whole or in part to the Federal Equalization Office.

[5] Cf. Wieland (2008), p. 212.
[6] Cf. Renzsch (1991), p. 64.
[7] Cf. Bundesregierung (12.03.2019).
[8] Cf. Bundesregierung (12.03.2019).
[9] Cf. Renzsch (1991), p. 69.

C. "Small Financial Reform" 1955

The „Small Financial Reform“ of 1955 was prompted by the expiration of the deadline for establishing Art. 107 determining the tax revenue distribution, Länder fiscal equalization, and supplementary allocations. The focus of the reform thus rested on the clarification of the definitive distribution of taxes between the federal government and the Länder. Along with the formulation of Art. 107, Art. 106, which regulates revenue authority and financial allocations between the levels of government was rewritten and extended. Specifically, the Article regulates which level of government the different separate taxes accrue to, as well as the distribution of the joint taxes.

Regarding Art. 106, the following provision was added: "The Federation and the Länder shall bear separately the expenses arising from the performance of their duties". The incorporation of this provision into the overall revenue distribution scheme in Art 106 resulted from the limited mandate, which was predominantly seen in the final regulation of tax distribution. With the 1969 fiscal reform the provision was instead inserted in Art 104a. The constitutional amendment clarified that the provision in Art 83, according to which federal laws were to be implemented by the Länder on behalf of the Federation or as their own affairs, also decided on the charging of related tasks (with a few exceptions, such as consequential war burdens and subsidies for social security burdens). This strengthened the implementation linkage, according to which the level that has to perform tasks also has to bear the expenses.[10]

In the period between 1956 and the “Great Financial Reform” of 1969, three laws were enacted in the field of tax distribution, which regulated the participation quotas in joint taxes in more detail. Among others, an amendment of Art. 106 was made in 1956, when further regulations regarding the allocation of tax revenues to the municipalities were added. Art. 106 (6) now stated that the municipalities were to obtain a share of the income tax and corporate tax that was to be defined via Länder legislation. Possible further participation of the municipalities in the Länder tax revenue was also to be determined by Länder legislation. Moreover, Art. 106 (7) introduced financial allocations by the federal level for additional expenses at the Länder an municipal levels that stemmed from institutions initiated by the federal level.Overall, the 1955 reform continued to promote and strengthen policy linkages between the federal and state governments.[11]

D. "Great Financial Reform" 1969

The need for a new reform arose because the distribution of responsibilities between the federal level and the Länder was still not clarified. This was mainly due to the vague formulation of the principle of burden-sharing, which had led to many custom solutions.[12] Such custom solutions concerned, for example, the subsidy measures of the Agriculture Act as well as the costs from the Housing Subsidy Act, which were completely taken over by the federal government. In particular, the reform was neccessary to limit the manifold policy interdependencies as well as increasing centralist-unitarian tendencies, which were increasingly justified with the principle of "uniformity of living conditions".[13] Leading up to the reform, the Troeger Commission had been appointed in 1964 with the task of working out a financial reform. The Commission called for a "cooperative federalism" that strengthened the cooperation between the federal government and the Länder with regard to their tasks.

- Further details of the reform regarding:
    - Joint tasks

[10] Cf. Biehl (1983), p. 92-93.
[11] Cf. Renzsch (1991), p. 19.
[12] Cf. Biehl (1983), p. 95.
[13] Cf. Biehl (1983), p. 97.

- Cash benefit laws and federal contract administration
- Financial assistance
- Unwritten federal powers
- Reorganization of general expenditure distribution
- Distribution of revenues
- Regulation of fiscal equalization in the narrow sense between the Länder ("horizontal fiscal equalization")
  - a revenue-based Länder financial equalization system was developed, which only modifies the underlying inhabitant allocation key in a few areas when calculating the demand measure index
- Municipal finance reform
  - The municipal finance reform had the objective of financially securing local self-government (Renzsch 1991, p. 217)
  - allocation of own tax sources
  - self-responsibility by means of municipal assessment rates
  - Länder allocations have only supplementary function

E. German reunification

- Constitutionally, the reunification was executed on the basis of Article 23 GG (old version) with the accession of the five eastern federal states to the western Federal Republic of Germany
- Reunification led to a significant increase in the structural differences between the Länder
- As a result, the volume in the fiscal equalization increased enormously
- Nevertheless, the financial equalization system from 1969 was not significantly adjusted
- In the years to come, the uniformity of living conditions gained importance due to large differences between the 'new' and 'old' Länder[14]

F. Federalism Reform I 2006

- Objectives[15]
  - To increase transparency regarding the complex interdependencies of responsibilities and allocate political responsibilities more clearly.
  - To strengthen the scope for federal and state governments to shape policy.
  - To reduce the number of federal laws requiring approval of the Bundesrat to a share of around 30 percent. This aimed at a reduction of the possibilities for blocking by the Bundesrat.
  - To strengthen the position of the Federal Republic of Germany in the EU by improving the suitability of the Basic Law for Europe
- Core areas
  - Allocation of tasks between the federal and Länder level
  - The joint commitment of the federal government and the states to budgetary discipline and the sharing of sanctions, in case they are imposed by the EU
- Results
  - The Länder received the option of regulating administrative procedures and the establishment of authorities themselves
    - previously regulated by federal law and required the approval of the Bundesrat

[14] Cf. Wieland (2008), p. 215.
[15] Cf. Bundestag (2020), p. 3.

- ‘Framework laws’ (Rahmengesetze) were eliminated, thereby granting more competences to the Länder
- Deviation legislation introduced in some areas:
  - provides an exception to the rule "federal law breaks state law"
  - as a result, the Länder can enact different regulations than the federal government
  - e.g. applicable to nature conservation, landscape conservation, and water management
- only minor changes regarding federal-Länder-fiscal relations
  - Instead decided as a core topic of Federalism Reform II

G. Federalism Reform II 2009

- Introduction of the debt brake Art. 109 (3) GG
  - Structural new borrowing in Art. 115 GG (and partly in Art. 109 GG)
    - max. 0.35% of GDP p.a. for federal level from 2016, 0% for Länder starting 2020
  - Inclusion of exception clause in case of natural disasters and extraordinary emergency situations
    - Activated during CoVid-pandemic
- Introduction of the Stability Council (Art. 109a GG): monitors the budgets of the federal and state governments, identifies impending budgetary shortfalls and initiates remediation procedure

H. Federalism Reform 2017

I. General Overview

With the federalism reform 2017, politicians have defined the constitutional framework and the single-law structure of the German financial architecture for the period from 2020. It is the result of a long and changeable unification process and is regarded as one of the central achievements of the German legislator in the 18th legislative period, solely because of its extensive components, but above all because of its fiscal federal scope.

The federalism reform was necessary because central legal bases for the vertical and horizontal distribution of available public funds expired at the end of 2019. These legal foundations include the *Maßstäbegesetz*[16] *(MaßstG)* and the *Finanzausgleichsgesetz*[17] *(FAG)*, which concretize the postulate under Article 107 (2) of the Grundgesetz[18] (GG) that the different financial strength of the Länder must be adequately balanced. In addition, the *Solidarpakt II*, from which the eastern German Länder received additional funds to support the economic, financial and infrastructural catch-up process, ended in 2019. These and other statutory time limits required important decisions on follow-up solutions by the legislature. At the same time, they provided an opportunity to comprehensively restructure federal financial relations and to align them with the foreseeable challenges of the future. The issue at stake was no less than the question of how financial resources must be distributed in the future so that local authorities are in a position to adequately fulfill the tasks incumbent upon them.

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16 Maßstäbegesetz from September 9, 2001 (Bundesgesetzblatt 2001 I p. 2302), which was amended by Article 1 of the Act of August 14, 2017 (Bundesgesetzblatt 2017 I p. 3122).

17 Finanzausgleichsgesetz from December 20, 2001 (Bundesgesetzblatt 2001 I p. 3955, 3956), which was amended by Article 2 of the Act of August 14, 2017 (Bundesgesetzblatt 2017 I p. 3122).

18 Grundgesetz für die Bundesrepublik Deutschland in the amended version published in the Bundesgesetzblatt Part III, outline number 100-1, which was last amended by Article 1 of the act of July 13, 2017 (Bundesgesetzblatt 2017 I p. 2347).

In view of this fiscal policy scope, a reform of the fiscal equalization system (in the broad sense) between the federal and Länder governments has been the focus of political and interdisciplinary academic debate for some time.

The outcome of the political negotiations has meant comprehensive changes to the status quo, which was valid until 2019, with significant consequences for the federal government, the Länder, and indirectly also for the municipalities. The reform covers two different aspects of federal governance: One part of the reform covers the existing distribution of responsibilities between the federal levels, the other part covers the existing distribution of public revenues in the Länder. However, there is no direct connection between the results of the two parts of the reform. The changes in the distribution of tasks and revenues were - in contrast to the fundamental demands of the economic theory of federalism - not coordinated with each other, but rather discussed and ultimately decided upon as different packages of demands side by side. In the following, the income-related aspects of the outcome of the negotiations will be considered in particular.

The new Article 107 of the Grundgesetz in conjunction with the new *Finanzausgleichsgesetz*, which will take effect on January 1, 2020, led to a considerable restructuring of the multi-level system of federal fiscal equalization. In addition, there have been changes in the financial relations between the federal government and the Länder outside the system of fiscal equalization with a significant financial weight.

The fiscal equalization among the Länder, the central level of the multi-level tax allocation and fiscal equalization system in Germany until 2019, was abolished with the reform. Differences in financial strength between the Länder are now balanced out within the framework of the horizontal allocation of value added tax. The equalization tariff was lowered on average compared to the old fiscal equalization among the Länder. The horizontal equalization component thus lost both structural and financial significance. At the same time, federal vertical equalization funds have gained in importance. General supplementary federal grants were increased with the 2017 federalism reform; new vertical equalization instruments have been introduced, which have led to an additional increase in the revenues of poorer Länder. In total, the Länder are recording additional revenues of about €10 billion annually, which are largely generated by dynamic distribution mechanisms and are likely to tend to increase in the following years.

II. The negotiation genesis 2012-2017

A broad-based reorganization of federal-Länder financial relations for 2020 had already become very clear in the early 2000s as a result of various legislative measures. Not only the *Solidarpaktfortführungsgesetz* provided its most important part, the *Finanzausgleichsgesetz*, and other regulations with an explicit time limit until December 31, 2019, but the two subsequent federalism reforms in 2006[19] and 2009[20] also established a clear and direct reference to this date. Within the framework of Federalism Reform I, the legislator was obliged by Article 143c of the Grundgesetz to provide financial compensation for burdens or reduced revenues that the Länder incur as a result of the abolition of joint tasks and financial assistance (see *Entflechtungsmittel*); the regulation covers the period from 1 January 2007 to 31 December 2019. Federalism Reform II ratified

[19] Federalism reform I: Gesetz zur Änderung des Grundgesetzes (Artikel 22, 23, 33, 52, 72, 73, 74, 74a, 75, 84, 85, 87c, 91a, 91b, 93, 98, 104a, 104b, 105, 107, 109, 125a, 125b, 125c, 143c) from August 28, 2006 (Bundgesetzblatt 2006 I p. 2034).

[20] Federalism reform II: Gesetz zur Änderung des Grundgesetzes (Artikel 91c, 91d, 104b, 109, 109a, 115, 143d) from July 29, 2009 (Bundesgesetzblatt 2009 I p. 2248).

the law by inserting a third paragraph in Article 143c of the Grundgesetz. Article 109 of the Grundgesetz, the Federalism Reform II ratified a ban on structural new debt for the federal government and the Länder, which at the same time, however, allowed exceptions by Article 143d of the Grundgesetz - these apply to the federal government until the end of the financial year 2015 and to the Länder until the end of the financial year 2019. The transition from 2019 to 2020 therefore marks a break in financial law and financial policy in several respects, the form of which has yet to be determined.

Accordingly, the discussion about follow-up solutions for the numerous regulations that were to lose their validity as of December 31, 2019, began early on. The debate initially began in the scientific community and was conducted across a broad spectrum of content. The published proposals ranged from marginal adjustments in individual details and the fundamental retention of the status quo to far-reaching changes to existing regulations and closed reform concepts.[21]

The topic increasingly entered the political discourse from 2012 onwards, initially with general positions of individual parties on key parameters for a reorganization of federal financial relations and various negotiation principles.[22] The parliamentary groups of the CDU/CSU and SPD included the topic in their coalition negotiations in 2013. An agreement was reached to the effect that an agreement on fundamental lines of resolution should be reached in the 18th legislative period (2013-2017).[23]

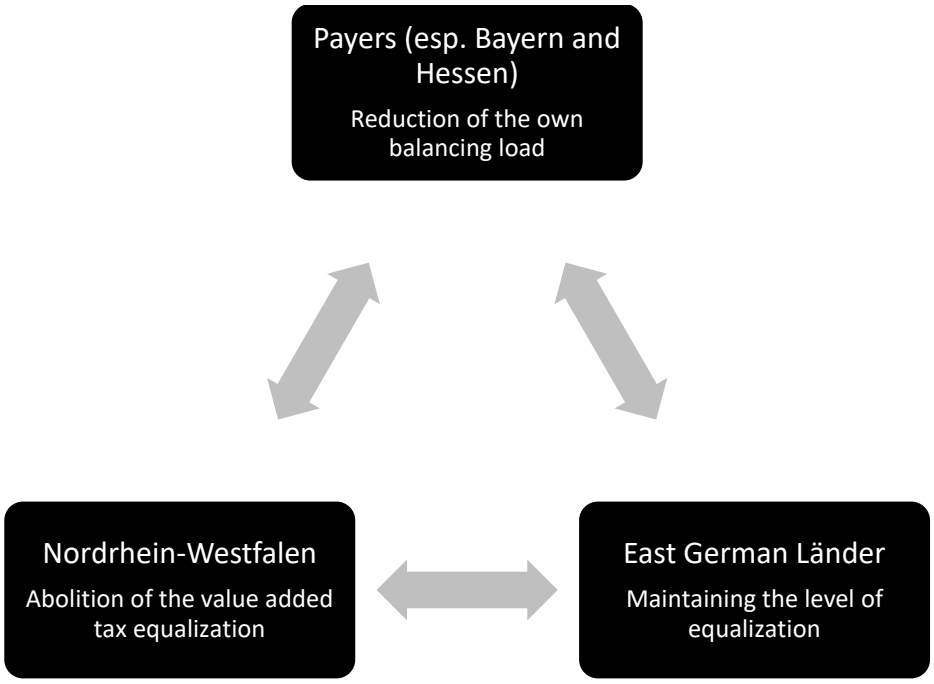
The heads of government began to concretize the issue in mid-2014. At the Minister President's Conference on June 12, 2014, the decision was made to recommend the establishment of federal-Länder working groups to work out the "basis for agreements on questions of federal financial relations"[24].[25] A list of tasks for these working groups was defined.[26] As expected, however, finding a solution proved to be extremely difficult in view of the complexity of interests and the sometimes diametrically opposed positions of the Länder. A compilation of the positions of the Länder on the reorganization of the federal-Länder financial relations of September 18, 2014, is indicative of this: "Some Länder are of the opinion that it is not appropriate to relieve the burden on the payers in the horizontal fiscal equalization system. ... From the point of view of other Länder, solutions in the other areas ... can only be considered if significant relief for the payers in the fiscal equalization among the Länder is part of the overall package"[27].[28]

However, the positions of the Länder did not differ solely in the question of the future burden on the payers. Nordrhein-Westfalen, for example, took a special position, as it felt particularly disadvantaged by the rules of value added tax distribution. The fact that up to 25 % of the Länders' share of the sales tax was not distributed according to the principle of an inhabitant-based distribution of revenue, but instead according to a revenue-level-based allocation key, proved to be disadvantageous for the most populous Länder for a long time. Nordrhein-Westfalen thus sought to abolish the advance value added tax equalization.[29] However, both components of the federal fiscal equalization system - the value added tax equalization on the one hand, and fiscal equalization among the Länder on the other - secure substantial portions of the revenues of the East German Länder in particular, right up to the current

21 For a systematization of the scientific reform discussion see Lenk/Glinka (2015), p. 23 et seq. and Heinemann et al. (2014), p. 22 et seq.
22 See Buscher (2016), Attachements 1 and 2.
23 Bösinger (2016), p. 12.
24 Translation of the original quotation from the German language.
25 See Buscher (2016), Attachement 4.
26 See Buscher (2016), Attachement 5.
27 Translation of the original quotation from the German language.
28 See Buscher (2016), Attachement 8.
29 See Buscher (2016), Attachement 11.

margin. A reduction of the equalization tariffs or even an abolition of one of the two system stages would therefore not have been compatible with the interests of the East German Länder. Other particular interests represented by various Länder or groups of Länder included the retention of existing inhabitant upgrades, the continuation, supplementation or expansion of special needs situations that are offset by supplementary federal grants within the framework of the fiscal equalization system, and separate financial assistance to support budget consolidation and compliance with the debt brake.[30]

Figure 1: Network of interests at the Länder



Source: Own representation.

After an agreement was first not foreseeable, the then Federal Minister of Finance SCHÄUBLE together with the then First Mayor of Hamburg SCHOLZ presented considerations for the reorganization of the federal-Länder financial relations[31], which were to supply some new contentwise reference points to the agreement process. However, the so-called Schäuble-Scholz paper did not have the desired effect, partly because some of the negotiators did not see their interests sufficiently taken into account.[32]

Further proposals and reform concepts followed, which again significantly increased the complexity of the negotiating framework. Among other things, Nordrhein-Westfalen reaffirmed its position that it wanted to abolish the advance value added equalization. Baden-Württemberg presented the so-called KRETSCHMANN/SCHMID compromise concept, which, among other things, provided for a reduction (but not abolition) of the value added tax equalization scheme and a stronger burden limit for the payers in the fiscal equalization system, while at the same time providing the East German Länder with additional financial assistance. €2 billion per year to the East German Länder and interest subsidies of €263 million and €155 million per year to the heavily indebted Länder Bremen and Saarland, respectively, which are to be financed equally by the federal government and the Länder as a whole in

30 Lenk/Glinka (2016). p. 132 et seq.
31 See Buscher (2016), Attachement 7.
32 Bösinger (2016), p. 13.

line with their respective shares of the turnover tax revenue. Financial resources from the *Gemeindeverkehrsfinanzierungsgesetz*[33] *(GVFG)* and *Entflechtungsmittel* were to be integrated into the value added tax distribution and allocated to the Länder in the form of value added tax points.[34] Finally, the federal government submitted a new proposal which, in particular, took up the position of Nordhrein-Westfalen and also included an abolition of the advance value added tax equalization. At the same time, the equalization tariff in the fiscal Länder-equalization scheme was to be linearized and the degree of inclusion of municipal financial resources was to be increased to 100%. The federal concept also provided for interest subsidies for Bremen and the Saarland. The Entflechtungsmittel and the federal program for the GVFG were to be continued at the same level.[35] Further impetus for negotiations was provided by Sachsen, which for its part introduced various parametric proposals into the debate. These included the explicit retention of the value added tax equalization. In addition, Sachsen also spoke out in favor of continuing the GVFG and the Entflechtungsmittel - the latter, however, with an annual dynamization.[36]

How deadlocked the discussion has become increasingly is illustrated by a contribution from the Ministry of Finance in Niedersachsen in June 2015, which states: "After extensive preparatory work and a number of minister-presidents' conferences, the negotiations on the reorganization of federal-Länder financial relations are still at a standstill. An agreement within the circle of the Länder fails due to irreconcilable positions on individual elements and without a coordinated Länder opinion, no agreement with the federal government is possible. Only a radical change of perspective can offer a way out of the dilemma of ever new interest-based calculation models"[37].[38]

A decisive consolidation of the different positions of the Länder took place in late summer/autumn 2015, when both the A and B Länder[39] presented their own concepts.[40] Finally, a working group under the leadership of Hamburg and Bayern was set up with the task of working out a viable compromise between the two models. The proposal that was subsequently developed finally led to a solution that appeared acceptable to all 16 Länder. On December 3, 2015, the Minister-Presidents surprisingly agreed on a joint compromise that was to be presented to the federal government as a united front. The model would lead to significant additional revenues for all Länder. It would relieve the burden on the financially strong Länder and yet ensure a noticeable equalization of financial power between the Länder. However, the equalization funds would increasingly be provided by the federal government, which would be burdened considerably more within the framework of supplementary federal allocations. The additional equalization burdens of the federal government for the first year of application were estimated at approximately € 9.7 billion.[41]

As expected, the reactions of the federal level to the agreement of the Länder were cautious to negative. The Federal Minister of Finance at that time SCHÄUBLE replied: “The Länder always agree 16:0

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33 Gemeindeverkehsfinanzierungsgesetz in the version promulgated on January 28, 1988 (Bundesgesetzblatt 1988 I p.100), last amended at August 31, 2015 (Bundesgesetzblatt 2015 I p. 1474).

34 See Buscher (2016), Attachement 12.

35 See Buscher (2016), Attachement 13.

36 See Buscher (2016), Attachement 14.

37 Translation of the original quotation from the German language.

38 See Buscher (2016), Attachement 15.

39 The division into A and B Länder is based on the party affiliation of the government majority. Traditionally, SPD-led Länder are referred to as A-Länder and CDU/CSU-led Länder as B-Länder. Thüringen (Land government led by DIE LINKE) is increasingly assigned to the A side, Baden-Württemberg (Land government led by BÜNDNIS 90/DIE GRÜNEN) to the B side.

40 See Buscher (2016), Attachements 16 and 17.

41 See Buscher (2016), Attachement 18.

at expense of the federation and mean, the federation must nod there only and pay."[42] Also the parliamentary groups in the Bundestag evaluated the agreement of the Länder in the result predominantly negative. SCHNEIDER from the SPD parliamentary group found: "Again an agreement between the Länder was obviously possible only at expense of the federation, without it thereby to take part."[43] Later SCHNEIDER expressed itself - just like BRINKHAUS, deputy chairman of the parliamentary group of CDU/CSU, and HAJDUK, parliamentary business guide of the parliamentary group BÜNDNIS 90/DIE GRÜNEN in the Bundestag, with a critical contribution in a special edition of Jahrbuch für öffentliche Finanzen.[44]

On April 21, 2016, a list of claims that the federal government had against the Länder became public. The paper contained two different topics. On the one hand, the federal government demanded some improvements in the federal-Länder financial relations and modified the parametric design of the fiscal equalization model on which the Länder had agreed in December 2015 - without, however, significantly changing the fiscal distribution result of the Länder model. On the other hand, in return for its additional financial burden, the federal government provided for the strengthening of its competencies in the performance of certain tasks at the expense of the Länder, for example in the areas of tax administration, digitization, the administration of federal highways or investments in the municipal education infrastructure. The federal government's demands, in turn, met with a clearly negative response from the Länder. SIELING, Mayor of Bremen, reaffirmed the concept of the Länder by referring to its balancing of interests and fixed fine tuning, which did not allow for any changes. SCHÄUBLE's demands would "... lead to the whole construction collapsing and the agreement between the Länder no longer functioning"[45]. The unity of the Länder thus depended directly on the adherence to the model negotiated at the end of 2015. Once again, the negotiations seemed to be deadlocked - this time between the entirety of the Länder and the federal government.

It was not until October 14, 2016 that the heads of the federal and Länder governments reached a final agreement. The Länder had largely prevailed in the reorganization of federal-Länder financial relations. In return, the Länder agreed to the transfer of responsibilities demanded by the federal government in April 2016. In its entirety, the compromise involved a comprehensive legislative initiative. The required approval of both chambers of parliament was still pending for the multiple amendments to the Grundgesetz and the drafting and rewriting of numerous individual laws. In the parliamentary groups in particular, there seemed to be a certain amount of resistance to the design of the reform.

In the first reading of the federal government's draft laws in the Bundestag on February 13, 2017[46], this resistance became apparent across all parliamentary groups. In particular, there was criticism of a reduction in solidarity among the Länder and the increasing dependence of financially weak Länder on the federal government that the compromise would entail. The draft bills were referred to the Budget

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42 SCHÄUBLE in Handelsblatt (April 21, 2016). Translation of the original quotation from the German language.

43 Translation of the original quotation from the German language.

44 See Brinkhaus (2016), Schneider (2016) and Hajduk (2016). BRINKHAUS and SCHNEIDER had already published a joint critical guest article in the FRANKFURTER ALLGEMEINE ZEITUNG in the run-up to the special volume of the Jahrbuch für öffentliche Finanzen, see: Brinkhaus/Schneider (2016).

45 SIELING in Handelsblatt (April 21, 2016). Translation of the original quotation from the German language.

46 Entwurf eines Gesetzes zur Änderung des Grundgesetzes (Artikel 90, 91c, 104b, 104c, 107, 108, 109a, 114, 125c, 143d, 143e, 143f, 143g) (Printed matter18/11131) and Entwurf eines Gesetzes zur Neuregelung des bundesstaatlichen Finanzausgleichssystems ab dem Jahr 2020 und zur Änderung haushaltsrechtlicher Vorschriften (Printed matter 18/11135).

Committee, which, among other things, set up several expert hearings.[47] Most of the invited experts were critical of the reorganization of federal-Länder financial relations.[48]

After selective amendments to the draft laws by the Budget Committee,[49] the Bundestag approved the bills in amended committee form by a majority in its second and third reading on June 1, 2017. The necessary amendments to the articles of the Grundgesetz were adopted by 455 votes in favour, 87 against and 61 abstentions.[50] The amendments to the individual laws and changes to the federal fiscal equalization system were also adopted by a majority in an amended committee version. This was followed by approval by the Bundesrat on June 2, 2017. The law amending the Grundgesetz has been in force since July 20, 2017.[51] The Gesetz zur Änderung des bundesstaatlichen Finanzausgleichs was announced in the Bundesgesetzblatt on August 17, 2017. Major parts, including the amendments to the *Maßstäbegesetz* and the *Finanzausgleichsgesetz*, came into force on January 1, 2020.

III. Changes in financial relations within the framework of the *Finanzausgleichsgesetz*

The value added tax share of the Länder was increased by about € 4.02 billion at the expense of the federal share (Bundesgesetzblatt 2017 I S. 3122, 3124, Art. 2, No. 1). The increase was partly by means of an annual fixed amount and partly in a dynamic form by a relative increase in the Länders' share of total value added tax revenue. This resulted in the following vertical allocation of the value added tax revenue:

Table 1: Vertical allocation of value added tax revenue from 2020

	Federation	Länder	Municipalities
From 2020	52,80864227 %	45,19541378 %	1,99594395 %
2020	-6.737.954.667 €	+4.337.954.667 €	+2.400.000.000 €
From 2021	-6 871 288 000 €	+4.471.288.000 €	+2.400.000.000 €

Source: Bundesgesetzblatt 2017 I S. 3122, 3124.

With the distribution of the Länder share of the value added tax to the single Länder, the horizontal financial balance of power between the Länder will take place in the future. If the allocation criterion is generally based on the number of inhabitants, additions and deductions will be made according to the financial strength of the Länder. Financially weak Länder will receive a surcharge, financially strong Länder a discount. Gaps in financial strength will be uniformly compensated by 63% (Bundesgesetzblatt 2017 I S. 3122, 3124, Art. 2, No. 2-9). The direct fiscal equalization among the

47 Deutscher Bundestag (Ed.)(February 16, 2017).

48 The experts at the 3rd hearing in the Budget Committee, which dealt with the reorganisation of Federal-Länder financial relations, included BÜTTNER, HÄDE, KORIOTH, LENK, REIMER, VOß, WEHNER and WIELAND. Deutscher Bundestag (ed.)(March 20,.2017).

49 Decision recommendation and report of the Budget Committee (8th Committee) on the Federal Government's draft bill – printed matter 18/11131, 18/11186 and on the motion by Sabine Leidig, Roland Claus, Caren Lay, other MEPs and the DIE LINKE parliamentary group - printed matter 18/11165 (printed matter 18/12588).

50 The required 2/3 majority was achieved with at least 420 votes. Decision recommendation and report of the Budget Committee (8th Committee) on the Federal Government's draft law - printed matter 18/11135, 18/11185 (printed matter 18/12589).

51 Gesetz zur Änderung des Grundgesetzes from July 13, 2017 (Bundesgesetzblatt 2017 I p. 2347) and Gesetz zur Neuregelung des bundesstaatlichen Finanzausgleichssystems ab dem Jahr 2020 und zur Änderung haushaltsrechtlicher Vorschriften from August 14, 2017 (Bundesgesetzblatt 2017 I p. 3122).

Länder and the preceding advance value added tax equalization of the former system were thus completely abolished.

The arithmetical methodology for determining the relative financial strength positions of the Länder has been retained in principle, in that for each Land the financial strength measurement figure is set in relation to the equalization measurement figure. However, there is a change in the inclusion of municipal financial strength. Since 2020, 75 % of this is credited to the Länder (instead of 64 % as was previously the case). As a result, the assessment basis for calculating the financial strength of the Länder has been expanded and greater account has been taken of differences in financial performance between the Länder at the municipal level. On the other hand, the degree of inclusion of the Förderabgabe has been reduced. This was fully taken into account in the system in force until 2019, since 2020 only 33% (Bundesgesetzblatt 2017 I p. 3122, 3124, Art. 2, No. 6b, 7). The current inhabitant refinements for the city-states as well as Mecklenburg-Vorpommern, Brandenburg and Sachsen-Anhalt in the calculation of the compensatory measurement figures remained unchanged.

The significance of the supplementary federal grants was noticeably increased. The equalization tariff and the degree of equalization of the general grants increased. While in the old system after the fiscal equalization among the Länder existing financial strength gaps of up to 99.5 % were equalized at 77.5 %, the financial strength gap has been closed at 80 % since 2020 up to 99.75 % (Bundesgesetzblatt 2017 I p. 3122, 3124 f., Art. 2, No. 10a, b). The special needs grants remained almost unchanged - with the exception of the “partition-grants”, which expired as planned in 2019. The Pol-BEZ were increased by € 11 million annually for Brandenburg (Bundesgesetzblatt 2017 I p. 3122, 3125, Art. 2, No. 10d, e).

In addition to the already existing supplementary federal grants, two new vertical instruments were introduced. Since 2020, the so-called *Gemeinde-BEZ* provide for an additional consideration of financial power differences between the Länder at the municipal level. Weak performing Länder, whose municipal financial strength is particularly low, receive 53.5 % of the gap up to 80 % of the Länder average municipal financial strength (Bundesgesetzblatt 2017 I p. 3122, 3125, Art. 2, No. 10f (5)).

The new *Forschungs-BEZ* are granted to under-performing Länder that have below-average net inflows from federal research funding under Article 91b of the Grundgesetz. The difference to 95% of the average of the Länder population is to be compensated with a degree of compensation of 35%. (Bundesgesetzblatt 2017 I S. 3122, 3125, Art. 2, No. 10f (6)).

The agreed regulations on federal fiscal equalization are generally valid for an unlimited period. According to Art. 143f of the Grundgesetz, a further reorganization is possible after 2030 at the earliest, provided that it is requested by the Federal Government, the Bundestag or at least three Länder. Until a further reorganization has been decided, the recently agreed regulations continue to exist with a maximum duration of 5 years, starting from the time of the request for negotiations on a reorganization (Bundesgesetzblatt 2017 I p. 2347, 2348, Art. 1, No. 11).

IV. Changes in financial relations outside the *Finanzausgleichsgesetz*

Part of the reorganization of the federal-Länder financial relations was the introduction of restructuring assistance for Bremen and the Saarland. Since 2020, both Länder have been receiving €400 million each year as assistance in complying with the debt rule of the Grundgesetz in accordance with Article 109 (3). In contrast to the previous consolidation aid under the *Konsolidierungshilfengesetz (KonsHilfG)*, which was financed in equal parts by the federal government and the Länder, these funds are financed entirely by the federal government. The granting of the funds is subject to various

conditions, which are specified in the new *Sanierungshilfengesetz*[52] *(SanG)*. Both Länder undertake to successively reduce their debt by at least 1/8 of the restructuring aid granted annually. In addition, increasing financial surpluses and a strengthening of their own economic and financial power are to be strived for (Bundesgesetzblatt 2017 I p. 3122, 3126, Art. 5).

The federal financial aid for seaports granted to the Länder of Bremen, Hamburg, Mecklenburg-Vorpommern, Niedersachsen and Schleswig-Holstein was extended in unchanged amounts (Bundesgesetzblatt 2017 I p. 3122, 3126, Art. 3). Under the old law, these funds would have expired at the end of 2019. The federal program under the *Gemeindeverkehrsfinanzierungsgesetz* was also continued to the same financial extent.

However, the *Entflechtungsmittel*, also limited until 2019, were not extended. In the political agreement, however, an argumentative link was established to the increase in the Länder share of the value added tax revenue, which consequently has a compensatory effect on the Entflechtungsmittel that are no longer required.[53] In this context, the earmarked Entflechtungsmittel are converted into general covering funds which are made available to the Länder within the scope of the value added tax allocation.

The competences of the Stability Council have been institutionally strengthened. The Stability Council, which consists of the federal and Länder finance ministers and the Federal Minister of Economics and Energy, was additionally entrusted with monitoring compliance with the structural ban on new borrowing under Article 109 (3) of the Grundgesetz. Since 2020, the Stability Council has been reviewing in autumn each year whether the Federal Government and the Länder have complied with the debt rule in the past year and whether they are likely to do so in the current and following year (Bundesgesetzblatt 2017 I p. 3122, 3126, Art. 4). Further details are regulated in the *Stabilitätsratsgesetz*[54] *(StabiRatG)*.

To improve the educational infrastructure of financially weak municipalities, the federal government provides the Länder with investment assistance totaling €3.5 billion. To this end, the special fund "Kommunalinvestitionsförderungsfonds" was increased to €7 billion. The allocation of the funds to the single Länder is governed by the K*ommunalinvestitionsförderungsgesetz*[55] *(KInvFG)*. The funds are intended to promote investment projects that are generally realized and settled in the period between 2017 and 2023 (Bundesgesetzblatt 2017 I p. 3122, 3127, Art. 6, 7).

V. A comparison to the old system

The financial effects of the legal restructuring of financial relations from 2020 are generally presented on the basis of a comparison with the old law. This means that the financial distribution result after application of the new regulations is compared with the result that would have been achieved if the old system had been abolished. Consequently, this comparison scenario is immanent in that under the old fiscal equalization system, the partition grants will be granted for the last time in 2019 and will cease to apply from 2020. Similarly, if the current legislation were to be extended after 2019, Entflechtungsmittel would no longer be granted; the GVFG federal program would cease to exist

52 Sanierungshilfengesetz from August 14, 2017 (Bundesgesetzblatt 2017 I p. 3122, 3126).

53 See results table in: Konferenz der Regierungschefinnen und Regierungschefs von Bund und Ländern am 14. Oktober 2016 in Berlin (Ed.) (2016).

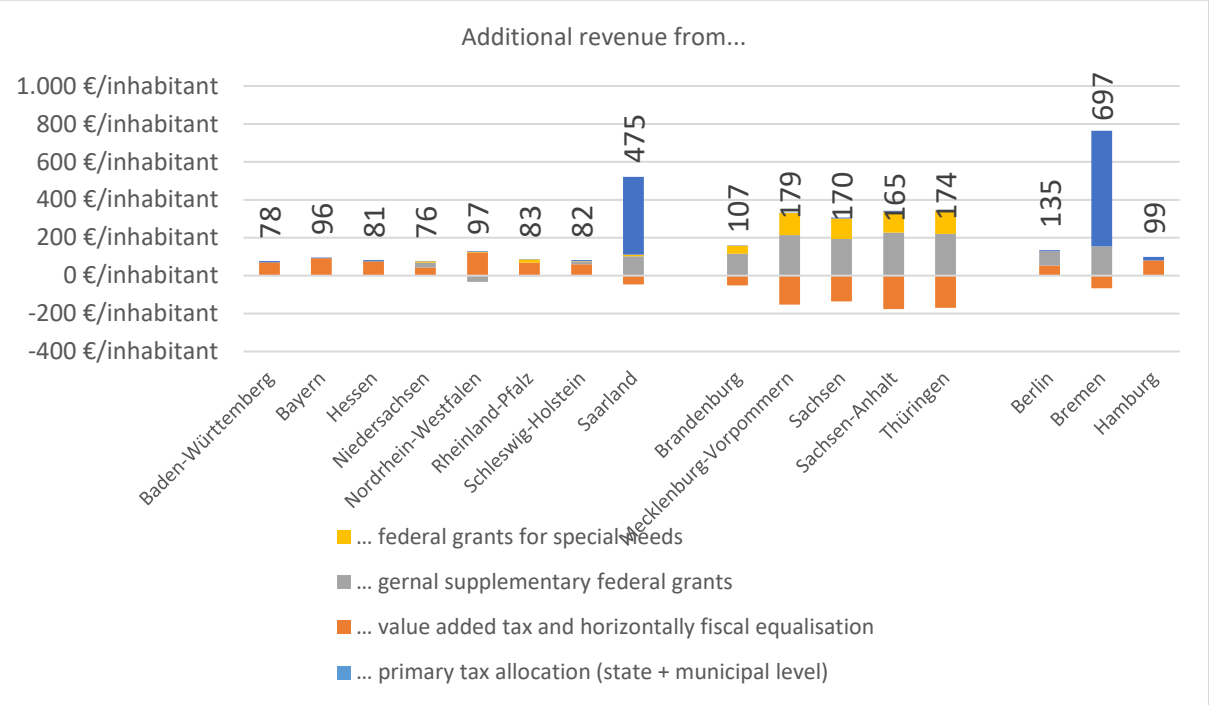
54 Stabilitätsratsgesetz from August 10, 2009 (Bundesgesetzblatt 2009 I p. 2702), last amended by Article 4 of the Act from August 14, 2017 (Bundesgesetzblatt 2017 I p. 3122)

55 Kommunalinvestitionsförderungsgesetz from June 24, 2015 (Bundesgesetzblatt 2015 I p. 974, 975), which was amended by Article 7 of the Act from August 14, 2017 (Bundesgesetzblatt 2017 I p. 3122).

completely, as would federal financial assistance for seaports. The systemic elements of the old fiscal equalization system, so the equalization system and tariff, as well as the federal grants for special needs would remain in place beyond 2019 in this scenario.

Compared with this scenario, the application of the reform regulations in 2020 results in the additional revenues for the single Länder shown in Figure 1.

Figure 1: Additional revenues for the Länder in 2020 through the 2017 federalism reform.



Source: Own representation, own calculations. Data basis: Tax estimate.

Overall, it can be seen that all Länder are generating revenue-side benefits from the 2017 federalism reform. The additional revenues of the Länder population in 2020 will amount to a total of €10 billion compared to the old system. The federal government, which is burdened with the same amount of money by the new fiscal equalization mechanism and the additional regulations, is in the opposite position. The reorganization of federal financial relations will therefore mean a vertical shift in revenues at the expense of the federal government and in favor of the Länder in the long term.

In a comparison of the single Länder, Bremen and the Saarland have made the clearest gains from financial reform. These gains are mainly fed by the reorganization assistance under the new SanG. In addition, the East German Länder in particular benefit from the new regulations, but - although to a lesser extent - all the others, including the former payers, also benefit.

The differences in the composition of the additional revenue components between the individual groups of Länder are striking. As Figure 1 also illustrates, three other relatively homogeneous groups emerge with respect to the structure of additional revenues in addition to Bremen and Saarland. The financially strong Länder - including Bayern, Baden-Württemberg, Hessen and Hamburg - achieve their reform-induced advantages primarily through the restructuring of the horizontal equalization system. These Länder, which in the old system are payers in the fiscal equalization among the Länder, profit on the one hand from the additional value added tax revenues of the Länder population and on the other

hand are noticeably relieved by the lower equalization tariff in the horizontal equalization system. A second homogeneous group can be seen in the financially weak western German Länder Niedersachsen, Nordrhein-Westfalen, Rheinland-Pfalz, Schleswig-Holstein and, to a very small extent, Berlin. The combination of additional value added tax resources and the new horizontal equalization mechanism also has a positive effect for them. Even after the horizontal equalization stage, these Länder are already recording additional revenues compared to the old system. There are differences within this group as to whether additional revenues arise due to the modified federal grants, which essentially corresponds to the modified degree of compensation of the horizontal equalization instruments. In contrast, the eastern German Länder form a third group with similar characteristics in the additional revenue structure. They are among the financially weakest Länder and have benefited in particular from the previous advance value added tax equalization system and the fiscal equalization system among the Länder. Their abolition will lead to a loss of revenue compared to the old system, which the new horizontal equalization mechanism cannot fully compensate for. Only the newly adjusted general equalization base and the additional funds granted by the federal government will lead to financial reform gains in the eastern German Länder, which are even above average compared to the Länder as a whole.

3 Distribution of tasks and expenditure in the German federal state (passive fiscal equalisation)

A. General overview

As was sketched in the introduction, the power distribution between levels of government in federal systems can be organised following either a sectoral or a functional logic. According to the sectoral logic, the power to legislate on and execute public tasks in specific policy areas (e.g. foreign affairs, food safety, schooling, ...) is allocated exclusively to either the federal government or the substate governments. Mostly, even the right to adjudicate in those matters follows the same allocation. The idea behind this federal architecture is to enable the constituent units to act largely autonomously by creating 'watertight compartments' of jurisdictions for either unit (Behnke & Benz 2020: 168). Even in federations which are organized according to that logic, such as the United States or Canada, however, this clear sectoral separation of tasks cannot work in practice, resulting in recurrent litigations between levels or units of government over their respective jurisdictions (Aroney & Kincaid 2017).

The Federal Republic of Germany, in contrast, follows the functional logic of power allocation. The Basic Law allocates powers to either the federal or the Länder level not according to policy areas, but according to legislative or executive functions. The federal level has wide legislative powers, whereas the Länder have a preponderance concerning the executive and the judicial power. The federal level has, especially, the power to legislate in most areas of fiscal relevance as to revenue (e.g. tax laws), and spending (e.g. social security law). The Länder, on the other hand, execute most of the legislation passed by the federal government, and Länder courts decide most cases. Accordingly, spending power (or the duty of financing tasks) follows the power to execute tasks and thus resides predominantly at Länder level, subject to variations that will be detailed below.

B. Starting point of the Grundgesetz order of competencies

As many other federal constitutions (see e.g. the Tenth Amendment to the US Constitution), the German constitution states the general rule that “Except as otherwise provided or permitted by this Grundgesetz, the exercise of state powers and the discharge of state functions is a matter for the

Länder" (Article 30 Basic Law). As a consequence, all federal measures have to be constitutionally justified, whereas the Länder are not depending on a Grundgesetz competence title. They have their own constitutions, which may, however, not conflict with the Basic Law.

The formal preponderance and normative precedence of the Länder is, however, hedged by Article 31 which states that federal law prevails over Länder law. As a matter of fact, the federal level has far more extended legislative powers than the Länder. And also in the executive and judicial state functions, the federal level reserves the power to control or in part overrule, Länder decisions. Furthermore, several decisions of national relevance are vested exclusively in the federal level (see below). Finally, again in parallel to the US constitutional law, a counterpart of the implied powers doctrine is acknowledged in the Grundgesetz as well. To give an example: the power to define a national anthem is unanimously regarded as vested in the Federal level, although the Grundgesetz does not explicitly mention this matter as a federal issue.

C. Legislative power

Article 70 para. 1 of the Grundgesetz—being lex specialis to aforementioned Article 30—states that the Länder shall have the right to legislate insofar as the Grundgesetz does not confer legislative power on the Federation. The division of legislative authority between the Federal level and the Länder is governed by some constitutional provisions concerning "exclusive" and "concurrent" legislative powers.

On matters within the "exclusive" legislative power of the Federal level, the Länder have power to legislate only when and to the extent that they are expressly authorised to do so by a federal law. The Federal level has such exclusive legislative power with respect to a couple of policy areas—many of which are nowadays supranationalised and vested in the European Union—such as foreign affairs and defence, freedom of movement, currency, money and coinage, weights and measures, the unity of the customs and trading area, the exchange of goods and payments with foreign countries, customs duties and fiscal monopolies, postal and telecommunications services, industrial property rights, and the law on weapons and explosives.

On matters within the "concurrent" legislative power, the Länder have the power to legislate as long as and to the extent that the Federal level has not exercised its legislative power by enacting a law. The mattes of concurrent legislation (the Basic Law lists 30 different instances) are split in three categories (Uhle 2007): First, matters of 'unconditional concurrent powers'. In those matters, the federal level may legislate without further qualification. Second, matters of 'conditional concurrent powers'. In those matters, the federal level may legislate only insofar as it contributes to securing equivalent living conditions in the territory. Otherwise, federal legislation may be contested by the Länder. Third, matters where the Länder have the right to deviate unilaterally from federal legislation. Unconditional concurrent legislative power extends to numerous matters; among them are virtually all taxes (including income, wealth, inheritance, corporate, and turnover tax) except certain local taxes on consumption and expenditures, civil and criminal law, public welfare, the law relating to economic matters (including most aspects of industry, energy, crafts, trades, commerce, banking, stock exchanges, private insurance, labour law (including social security such as unemployment insurance), prevention of the abuse of economic power, urban real estate transactions, land law, transportation law, and state liability.

Thus, in spite of Article 30 Basic Law, the Länder retain only a tiny set of matters on which they have autonomous legislative powers, the most important among which are education, police, culture. Minor issues that have been 'given back' to the Länder as a consequence of the above mentioned

constitutional reform of 2006 are public service working conditions and remuneration, shop opening hours and resaturants and fairs regulations.

D. Executive (and judicial) power

The execution of Länder laws is an exclusive Länder power. But federal laws (including all tax laws except customs duties, taxes on consumption regulated by a federal law, the motor vehicle tax and other transaction taxes related to motorised vehicles and charges imposed within the framework of the European Union) are commonly executed by the Länder, too. Depending on special constitutional provisions, they do this either "in their own right" or "on federal commission". Execution of laws "in their own right" is the general rule (Article 83 Basic Law). In that case, the Länder provide for the establishment of the requisite authorities and regulate concomitant administrative procedures. The federal government shall only exercise oversight to ensure that execution occurs in accordance with the law. When, on the other hand, Länder execute laws "on federal commission", establishment of the authorities shall remain the concern of the Länder, except insofar as federal laws otherwise provide. The Länder authorities shall be subject to instructions from the competent highest federal authorities. Federal oversight shall extend to the legality and appropriateness of execution. Execution "on federal commission" especially applies where taxes accruing wholly or in part to the Federal level are administered by revenue authorities of the Länder (art. 108 para. 3 of the Grundgesetz).

In all three cases, execution of Länder laws in their own right, execution of federal laws in their own right and execution of federal laws on commission, the Länder are ultimately responsible for providing not only institutions and administrative procedure, but to deliver the public tasks and services to the citizens. In part they use Länder ministries and offices, but the major part of executive tasks is further transferred from the Länder to their municipalities who act as lower administrative units for the Land (Schrapper 2020). Thus, effectively public tasks and services are delivered in a cascading system of legislation and transferred or original executive powers from the federal to the Länder to the municipal level. This high vertical stratification in the functional division of powers necessitates intense coordination within, among and across constituent and administrative units, while clearly allocating responsibility and also accountability for specific tasks to certain levels of government.

The judicial power is exercised by the Federal Constitutional Court, by the federal courts provided for in the Grundgesetz, and by the courts of the Länder. Federal courts are the Federal Court of Justice, the Federal Administrative Court, the Federal Finance Court, the Federal Labour Court, and the Federal Social Court as supreme courts of ordinary, administrative, financial, labour and social jurisdiction. The courts of first instance and the appellation courts are institutions of the Länder.

E. "Joint tasks" as exception

Whereas generally a specific matter or issue is exclusively vested in either the federal government or the Länder, the Grundgesetz provides for several "joint tasks", where both levels shall cooperate (art. 91a et seq.). This applies especially to programmes aiming at the improvement of regional economic structures, of the agrarian structure, and of coastal preservation, furthermore to agreements regarding the promotion of sciences, research, and teaching in cases of supraregional importance. Joint tasks, while conflicting with the logic of clear task assignment to one level of government and functional power distribution, proved to be a necessity in the case of larger tasks that create externalities beyond regional borders or are simply too big and costly to be shouldered by one unit alone. They were introduced in the Basic Law in 1967, cut back in the course of the constitutional reform of 2006, but subsequently extended to new tasks (Kropp & Behnke 2016; Renzsch 2020). In 2009, with the insertion

of Article 91e, joint tasks were extended even to a cooperation between federal and local institutions in the organization of unemployment benefits and employment service (Lenk et al. 2013). Typically, joint tasks involve a joint decision-making body staffed by federal and Länder representatives and an agreement on how the costs of the task are split between levels of government.

F. Financing competencies (apportionment of expenditures)

Regarding the responsibility to pay for public tasks and services, the Basic Law generally follows the logic of the so-called 'principle of connectivity' (art. 104a para. 1). Basically, the principle of connectivity means that the financial burden for public tasks is linked to the task itself. It can be interpreted in two variants, however. The standard interpretation in the German system of burden sharing follows an executive causality ('Vollzugskausalität'), meaning that that level or unit of government bears the burden of paying that executes a task. According to this (standard) interpretation, the Federal level and the Länder separately finance the expenditures resulting from the discharge of their respective responsibilities insofar as the Grundgesetz does not otherwise provide. However, where the Länder act on federal commission (according to Article 85 Basic Law, meaning that the federal level disposes of extended rights of control and oversight), the Federal level shall finance the resulting expenditures. The second variant of the principle of connectivity which has increasingly been gaining ground in the fiscal relations between levels of government in the past 15 years follow a logic of causality of origin ('Verursacherkausalität'). In that case, the financial burden falls upon that level or unit of government were a task originates, typically the one that passed the law. The logic of executive causality heavily burdens local governments to bear the costs of implementation. At the same time, local governments have the lowest revenues. Acknowledging this discrepancy, in 2006 the wording of Articles 84 and 85 were amended, inhibiting the federal level to directly transmit tasks to the local level. At the same time, Länder governments added clauses to their constitutions or fiscal equalization laws establishing connectivity according to the logic of origin. Thus, nowadays, local governments can be obliged to shoulder new tasks only by Länder law. The Länder have committed themselves, however, to compensate their local governments for additional costs they must incur due to Länder legislation by way of local fiscal equalization payments.

Exceptions to this burden-bearing rule resulting from those two interlinked interpretations of the principle of connectivity are provided for in the Basic Law, first, by Articles 91a through 91e Basic Law – the joint tasks as elaborated above; second, Articles 104a section 3 and 104b Basic Law contain special provisions which are, however, highly consequential in the everyday reality of federal fiscal relations. Article 104a section 3 stipulates that in cases where the federal level issues a law granting financial assistance to citizens ('Leistungsgesetze'), e.g. in the realm of social security or education assistance, the federal and Länder governments can agree on a percentage of burden sharing. If the federal level bears 50% of the cost or more, the task automatically shifts to 'execution in commission' according to Article 85 Basic Law, thereby restricting leeway for the Länder in how they execute the task. Article 104 section 3 gained relevance in the past years in the discussion whether and to what extent the federal level would compensate local governments for social security expenses for refugees (rent and heating costs) and gave rise to considerable legislative creativity (Henneke 2017). Article 104b Basic Law finally, provides for federal assistance to Länder or local investments, thereby providing the federal level with a powerful lever for influencing lower level policy-making ('golden strings').

All in all, the complex assignment of tasks to levels of government, complemented by a system of burden sharing which basically follows the principle of connectivity according to the logic of execution causality, but is complemented by elements of causality of origin and burden sharing, necessitates a

similarly refined and complex system of tax allocation and fiscal equalization payments as will be elaborated in the next section.

4 Distribution of revenues in the German federal state (active fiscal equalization)

A. General overview

State financing does not pursue an end in itself. Rather, it is intended to enable the community to make certain expenditures associated with the performance of specific tasks. A (federal) state therefore requires revenues. In simple terms, revenues are all funds that flow to the state. A state does not (at least not regularly) engage in economic activity itself. The necessary financial resources must be provided primarily (and at best without any obligation to repay) by the citizen. This is the reason why a state's revenues result primarily from the collection and assessment of taxes. A federal financial constitution in a federalist state must therefore determine who has the power of tax legislation and who is responsible for administration and jurisdiction of tax matters. Of particular importance is at the end how the tax revenue is to be distributed between the federal and the constituent states.

B. Legislative power in tax legislation

The tax legislative power contributes significantly to the question how much distribution mass is available at all. However, it must be strictly separated from the question of how the tax revenue is to be distributed between the federal and the constituent states. Consequently, an extensive allocation of tax legislative power to the federal or the constituent states does not indicate (at least not as long as there is no connection between legislative power and the distribution of tax revenues) whether an allocation of legislative power is accompanied by a high allocation of funding.

The responsibilities for the enactment of tax laws are determined by art. 105 of the Grundgesetz. The regulation takes over the differentiation between “exclusive” and “concurrent” legislative power known from art. 71 and 72 of the Grundgesetz. The Federal level has the “exclusive” legislative power over customs duties and fiscal monopolies (art. 105 para 1 of the Grundgesetz). In addition, the Federal level has a “concurrent” legislative power for other taxes (with the exception of local taxes on consumption and expenditures under art. 105 para 2a of the Grundgesetz), if it is accrued to the revenue from these taxes in wholly or in part. In this respect, the legislative power to enact a tax law is linked to the distribution of the tax revenue according to art. 106 of the Grundgesetz. In addition, the Federal level possesses also a “concurrent” legislative power, if the conditions of the art. 72 para 2 of the Grundgesetz are present (art. 105 para 2 of the Grundgesetz), a uniform regulation is thus necessary for the establishment of equivalent living conditions throughout the federal territory or for the maintenance of legal or economic unity in national interest.

According to art. 105 para. 2a of the Grundgesetz, the Länder shall have the power to legislate with regard to local taxes on consumption and expenditures. They have largely delegated this legislative power to the municipalities and empowered them to enact corresponding taxes through statutes. As a compensation for the comprehensive power in the field of tax legislation of the Federal level, the Länder have been given a right of approval through the Bundesrat (art. 105 para 3 of the Grundgesetz).

C. Tax administration competencies

Art. 108 of the Grundgesetz – being lex specialis to the general regulations in art. 83 et seq. of the Grundgesetz – standardizes structure, authorities and procedures of the administration of taxes in the Federal level and in the Länder. However, the provision is not exhaustive, so that in some cases the general regulations must be used.

In principle, the Federal level and the Länder have their own financial administration. The Federal level administers the taxes and duties listed in art. 108 para 1 of the Grundgesetz (customs duties, fiscal monopolies, taxes on consumption regulated by federal law, motor vehicle tax and charges imposed within the framework of the European Union) by federal finance authorities. The financial authorities of the Länder administer the other taxes (art. 108 para 2 of the Grundgesetz). They act "on federal commission" when they administer taxes whose revenue accrues wholly or in part to the Federal level (income tax, turnover tax, corporation tax, e.g.). In this respect the Federal level exercises a right to issue instructions (art. 85 of the Grundgesetz).

The organisation of the federal finance authorities shall be regulated by a federal law according to art. 108 para 1 sentence 2 of the Grundgesetz. In contrast, according to art. 108 para 2 sentence 2 of the Grundgesetz, the structure of the administration of the Länder may be regulated by a federal law requiring the consent of the Bundesrat (authorization of the Federal level to regulate the administration of the Länder). The corresponding regulations can be found in the Finanzverwaltungsgesetz. The same applies to the administrative procedure: The procedure to be applied by the federal fiscal authorities shall be prescribed by federal law (art. 108 para 5 sentence 1 of the Grundgesetz), the procedure to be followed by Land revenue authorities may be prescribed by a federal law requiring the consent of the Bundesrat (art. 108 para 5 sentence 2 of the Grundgesetz). The regulations prescribed by federal law can be found in the Abgabenordnung.

According to art. 108 para 4 of the Grundgesetz, a federal law (requiring the consent of Bundesrat) may provide for collaboration between federal and Land revenue authorities in matters of tax administration and transfer the administration of taxes incumbent on the federal authorities to the Land authorities or vice versa the administration of taxes incumbent on the Land authorities to federal authorities. Art. 108 para 7 of the Grundgesetz authorizes the Federal level to issue general administrative rules (internal administrative rules).

Art. 108 para 6 of the Grundgesetz establishes an exclusive legislative power of the Federal level for the regulation of the fiscal jurisdiction. On this basis, the Finanzgerichtsordnung has been issued.

D. Distribution of tax revenues

I. Ways of distributing revenues in a federal state

The share of the total tax revenue to which the federal and constituent states are entitled depends on the distribution of tax revenue. Only an adequate financial supply can ensure that federal and the constituent states can exercise and fulfil their assigned responsibilities. Revenues are allocated by law (especially by constitutional order). There is no over-constitutional requirement as to the proportion or manner in which revenues are to be distributed in a federal state. A state system consisting of a federal and a constituent state level can implement the distribution of revenues in different ways. It would be possible to allocate the total revenue to the federal or the constituent states, with the proviso that the financial needs of the other side are met by appropriate contributions (contribution system). Another option would be to provide the federal and constituent states with separate revenues from different types of taxes or tax sources (separation system). Finally, it would also be

conceivable to bundle the tax revenues of all tax types and distribute them among the federal and constituent states according to a (fixed or changing) key (combined system).

II. The financial equalization

The distribution of revenue in the Grundgesetz is carried out in a multi-stage income distribution procedure, also known as financial equalization.

1. Vertical apportionment of tax revenue between the Bund and the Länder

In a first stage, the revenue of the respective tax types is divided between the Federal level and Länder. This distribution is regularly referred to as primary vertical fiscal equalization. The legal basis can be found in art. 106 of the Grundgesetz. The apportionment is detached from the corresponding legislative power and combines different systems for the distribution of tax revenue.

The Grundgesetz makes partial use of a system of separation in that certain tax revenues are allocated solely to the Federal level (art. 106 para 1 of the Grundgesetz) and certain tax revenues solely to the Länder (art. 106 para 2 of the Grundgesetz). In addition, in the area of by far the most profitable joint taxes (income tax, corporation tax and turnover tax), a combined system is used (art. 106 para 3 of the Grundgesetz).

Half of the corporate tax is divided between the Federal level and the Länder. The municipalities receive a share of 15% of the income tax (art. 106 para 5 of the Grundgesetz, sec. 1 of the Gemeindereformgesetz). Half of the remaining 85% (i.e. 42.5%) is divided between the Federal level and the Länder (art. 106 para 3 sentence 2 of the Grundgesetz). The turnover tax is divided between the Federal level and the Länder according to the key defined in § 1 of the Finanzausgleichsgesetz (art. 106 para. 3 sentence 3 of the Grundgesetz). The municipalities receive a very small share of the turnover tax revenue (about 2 % in 2020). The remaining part is divided roughly equally (with a small surplus in favor of the Federal level) between the Federal level and the Länder.

2. Horizontal apportionment of tax revenue between the Länder

As soon as it has been determined what share of the total tax revenue the Länder are entitled to, the question of how the Länder share is to be distributed between the individual Länder must be addressed at a second stage. This is also known as primary horizontal fiscal equalization. Theoretically, there are two possible ways: First, the tax could be allocated to the country in which it was collected (principle of local revenue). Secondly, the tax could be divided according to the number of inhabitants of the countries (population principle).

According to art. 107 para 1 sentence 1 of the Grundgesetz, the revenue from Land taxes and the Land share of revenue from income and corporate tax are distributed depending on the extent that such taxes are collected by finance authorities within their respective territories (local revenue). Possible distortions (enterprises with several permanent establishments in different countries, e.g.), are corrected by a separation and an allotment of local revenue (art. 107 paragraph 1 sentence 2 and 3 of the Grundgesetz). This means a legal regulation, which contains supplementary specifications for the distribution of the tax revenue. Taxes on trades, corporate tax, wage tax and interest deduction are affected by the separation. For trade tax, the separation is legally anchored in the Gewerbesteuergesetz. The separation for other taxes is regulated in a separate law, the Zerlegungsgesetz.

The Land share of revenue from the turnover tax is divided to the individual Länder in a per capita basis (art. 107 para 1 sentence 4 of the Grundgesetz and sec. 2 Finanzausgleichsgesetz). It is therefore of no relevance for the horizontal distribution of the turnover tax revenue within the Länder where a service that is subject to turnover tax is performed. The previously envisaged possibility of allocating supplementary parts of the turnover tax to states whose revenues are below the average of the states

(also known as turnover tax advance compensation) was deleted with the reform of the financial relations between the Federal level and the Länder with effect from January 2020 (art. 143g of the Grundgesetz).

3. Equalization of financial capacity and federal supplementary grants

The financial capacity of individual countries can vary greatly. However, the Grundgesetz idea of solidarity between the Federal level and the Länder requires that Länder with limited financial capacity receive additional support to enable them to carry out their tasks financially. Therefore, according to art. 107 para 2 sentence 1 of the Grundgesetz, a federal law shall ensure that the financial capacity of the Länder is adequately balanced. Such support – which only occurs secondarily after the primary distribution of tax revenue – can theoretically be provided horizontally (financial payments from financially strong Länder to financially weak Länder) or vertically (financial payments from the Federal level to financially weak Länder). The financial relations between the Federal level and the Länder have been reorganized for the period from 2020 onwards. The fiscal equalization system in force until 2019 provided for both horizontal and vertical fiscal equalization (the result was that fiscal equalization consisted of four stages). Since the reform of financial relations with effect from January 2020, horizontal equalization between the Länder based on equalization allocations and equalization amounts has been abolished. The Länder are no longer directly responsible for each other. Instead, there is only a vertical and secondary equalization of the respective financial capacity by the Federal level, which now forms the third and final stage of financial equalization.

Such vertical financial equalization provides for appropriate additions and deductions from the financial capacity of the respective Länder, which shall be regulated in the allotment of their shares of revenue from the turnover tax (art. 107 para 2 sentence 2 of the Grundgesetz). This adjustment of the financial capacity is regulated by ordinary, “simple” (i.e. sub-constitutional) law in sec. 4 et seq. of the Finanzausgleichsgesetz. The concept of financial capacity is a constitutional term that requires explanation and serves to make the revenues of the Länder comparable. It takes into account all sources of finance to which the Länder have access.

In addition, supplementary grants by the Federal level can also help to support underperforming Länder in order to counteract existing differences between the Länder. Supplementary grants are financial benefits that are allocated from federal funds to needy Länder to supplement their general financial needs (art. 107 para 2 sentence 5 of the Grundgesetz). Such supplementary grants already existed before the reorganization of financial relations but were considerably expanded with effect from January 2020. For example, the tariff of the general federal supplementary grants was increased and the compensation ceiling was raised (sec. 11 of the Finanzausgleichsgesetz). In addition, supplementary grants are now made to Länder with municipals that have particularly weak tax revenues. Also newly introduced are annual grants to underperforming Länder which were only given below-average consideration in the allocation of research funds under art. 91b of the Grundgesetz. These and other extensions, combined with the abolition of the turnover tax advance compensation, make supplementary federal grants considerably more important.

As a result, the Federal level has a greater financial burden as of 2020 because of the new regulation, and its responsibility for an appropriate financial balance of power between the Länder and in the performance of public tasks is likely to increase in the near future.

E. Other financial assistance in the federal system

Financial resources can also flow between the Federal level and the Länder outside the financial equalization system. However, financial aid (payments from the federal budget to the Länder to fulfil

specific purposes), is exceptional in nature. According to art. 104a of the Grundgesetz, the Federal level and the Länder finance separately the expenditures resulting from the discharge of their respective responsibilities, unless otherwise provided for in the Grundgesetz. Such a different regulation is found in art. 104b of the Grundgesetz. Within narrow limits, it allows financial assistance from the Federal level to avert a disturbance of the overall economic equilibrium, to compensate for differences in economic capacities within the federal territory or to promote economic growth. In addition, in the course of the reorganization of the financial relations between the Federal level and the Länder from 2020 onwards, the legislator has taken further measures to improve the performance of tasks in the Federal State. Art. 104c of the Grundgesetz enables the Federal level to provide financial assistance to support investments in the education infrastructure by financially weak municipalities that are of significance to the nation as a whole. Finally, Art. 104d of the Grundgesetz allows the Federal level to grant the Länder financial assistance for investments of significance to the nation as a whole on the part of the Länder and municipalities in social housing.

5 The role of the municipalities in the German federal state

A. The ambivalent position of municipalities in the federal structure

- components of the federal states, at the same time making transparent local self-administration law and the right to financial independence → ambivalent state organisational position within the federal state

B. The role of municipalities in the fulfilment of public tasks

- economic functions of the municipal level, significance for the fulfilment of public tasks

C. Economic disparities

- economic disparities at municipal level (between the municipalities of individual Länder, within the Länder, between independent towns and district areas, etc.)

D. Municipalities within the fiscal equalization systems

- local authorities in the context of the equalization of financial strength between the Länder (inclusion of municipal financial strength at 75%, municipal tax allocations)
- local fiscal equalization systems

6 Current advantages, problems and reform considerations in the German federal state

Advantages

- strong solidarity and high level of equalization payments secures fiscal and economic strength across the territory and prevents cyclical downturns

- especially after unification, the Eastern Länder were strengthened by high transfer payments and a relatively smooth integration in the fiscal equalization scheme

- tradition of tight coordination and cooperation fosters solidarity, while securing a certain amount of autonomy; e.g. system of joint taxes is based on mutual cooperation (federal government cannot withdraw money unilaterally!, in stark contrast to e.g. the UK), but guarantees all units predictable revenues

Problems

tendencies of erosion of solidarity (mainly led by Bavaria); existing fiscal equalization scheme has repeatedly been challenged before the federal constitutional court

intransparency and complexity of the system – unintelligible for ordinary citizens, fosters diffusion of accountability

fiscal and economic sustainability after the pandemic is questionable

Reform considerations

- level of equalization and norm of solidarity – towards more fiscal stratification and autonomy/ granting more tax levying or tax varying powers to the Länder?

- dealing with the inherited debts (Altschuldenproblematik) at Länder and local level – attempts at communalization

- consolidation path and debt brake in the aftermath of the pandemic

- structural deficits of the local level in the light of rising expenses for tasks assigned to local governments

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