

Tendencies in fiscal federalism

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TENDENCIES IN FISCAL FEDERALISM

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TENDENCIES IN FISCAL FEDERALISM

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I. Introduction

Federalism was formerly considered to be a problem limited exclusively to the field of constitutional law. Recently, political economics and political science have begun to concern themselves with aspects of federal state structure. Discussion presently centers around the question of whether federal states are tending to become increasingly centralized.¹⁾ Our paper attempts to deal with this problem in some detail.

In the following, we will attempt to develop a system's oriented approach capable of pointing out and explaining tendencies in federalism.

Central to this approach is the nexus of three aspects of governmental activities, i.e., supply, demand and finance. Each of these three factors has an economic and political dimension. These result in reciprocal tensions which in turn lead to conflicts and through these conflicts the federal structure can be altered. Depending on which conflicts dominate and how they are resolved, one can discern several distinct phases of federal development.

Our paper can be seen as an initial step in this direction. It is beyond our purpose here to present a comprehensive theory of federal development; rather we shall confine ourselves to setting up several theses for discussion.

This analysis is primarily directed to the situation in the Federal Republic of Germany. The application of our ideas to other countries seems feasible, we have, however, not had the opportunity to carry this out.

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II. The contribution of the economic theory of federalism

The economic theory of federalism²⁾ is based on the idea that each government should be organized in such a manner that it can optimally provide for the needs of its citizens.

Since every society consists of heterogenous groups which differ a great deal in their public needs and demands a decentrally organized government can best satisfy the needs of all citizens.

A decentralized provision of public goods and services can better satisfy a larger number of group members than would be possible in a centrally organized state, since the former lacks for the most part the "meritorisation" of minorities.³⁾ This holds true especially for goods with regionally limited benefits such as the supply of public services at the community level (public utilities, schools, theatres, hospitals).

Some public goods however have significant spillover effects regarding costs as well as benefits. Provision of such goods also requires large scale production in many cases if they are to be organized efficiently. This applies to those goods with large external effects in political, social and regional spheres, as in the case of national defense, infra-structure investments in large regions, or global economic and fiscal policies. Production and supply in this case call for a central government as far as economic aspects are considered.

Both aspects together call for a federalistic government, and they are responsible for the shape and context of federalism from an economic point of view. Changing government responsibilities make a variable structure of federalism necessary. The economic theory of federalism however does not tell us anything about the long-range tendencies in the development of the governmental structure, since it does not deal with the question of how the volume and structure of the government responsibilities develop in the nation.⁴⁾

Since modern economic theory cannot tell us anything about the tendencies in federalism, we will first consider an approach which is more politically oriented and which deals with the position of the governmental units in the federalistic system of Germany. We are thinking of the thesis of the German political economist Johannes Popitz.

III. The centralization thesis of J. Popitz

About forty years ago Popitz claimed that in the course of time more and more public functions as well as the public funds would concentrate on the central government. Superior budgets exercise a certain attractive power which will gradually undermine the financial sovereignty of the governmental units.⁵⁾ His contention was based on the effectiveness of three factors:

- (1) An economy tends to standardize the "Lebensraum" of its members. This will necessarily require a uniform economic policy, in particular an extension of the legislative power of the central government in those fields which previously belonged to subordinate levels (education, public welfare).
- (2) The citizens mainly direct their ever-increasing demands to the central government and not to local authorities.
- (3) The revenue of the subordinate levels (state and local governments) will tend to become inadequate in the course of time to fulfill their functions.

Popitz never examined his thesis empirically. This first occurred in the works of Albers, Hansmeyer and Keller following World War II.⁶⁾ It soon became evident that an empirical examination would involve considerable difficulties. It is particularly difficult to obtain appropriate standards and criteria from budgetary statistics. In general the changes in the shares of the direct expenditures or the net outlays for each level of government were examined in order to determine how the performance of public functions has shifted. This expenditure indicator is generally recognized as an

adequate criterion of centralization or decentralization tendencies in federalism. For the Federal Republic of Germany the following developments in the period following World War II are easily recognizable (Cf. tables 1 and 2 in appendix).

The shares, according to direct expenditures, have shifted from the Federal to local authorities. The state units were able to hold their position. These tendencies also hold true for the net outlays of the three governmental units (Federal, state and local authorities), although it is not quite as clear as before. Reductions in the Federal shares were compensated by large state gains, while at the same time the communities increased their shares minimally.

These figures lead to two conclusions:

(1) The trend of the shares as measured by net outlays compared to direct expenditures suggests that governmental functions have become obscured, and that due to changing financial conditions the responsibilities have also been blurred. Thus the Popitz theses of "shared responsibilities" seems to be empirically proven.

(2) Turning to the direct expenditures, the shares have changed in favour of the state and local levels. Along with this development there should have also been, globally speaking, a corresponding transfer of financial means and of public functions. This is quite apparent, especially for the past few years. Thus, instead of a centralization tendency, we are apparently confronted with decentralization movements. Popitz's thesis of increasing centralization therefore cannot be empirically proven for the Federal Republic of Germany.

This conclusion has without doubt been derived from a very global indicator, which however has found recognition in economic literature. One could attempt to break this indicator down in order to undertake a more differentiated examination of the centralization theses. I have dealt with this problem

elsewhere in greater detail and have not reached any other results which significantly differ from these conclusions.⁷⁾ Therefore I do not wish to go into this matter any further, but rather to turn to two questions which might be of greater importance for us:

- (a) Did Popitz grasp the correct determinants for his theses?
- (b) And did he recognize and explain the manner in which these factors exercise their influence, taking into consideration the various interdependencies and related problems?

The first question should be easier to answer. In my opinion Popitz indeed named those factors as determinants of the federalistic development which are likely to be of real importance for actual events. First of all his arguments correctly characterize the supply side of the public sector. Secondly, the behaviour of the citizens regarding their demands on the government reveal a dominant factor on the demand side. The modern theory of public goods can support this.⁸⁾ With the fiscal argument the necessary consideration of the monetary sphere, i.e. the means of financing public activity is also provided for. Thus the most important aspects of government actions have been recognized and taken into consideration. The search for completely new or supplementary factors can be put aside for the moment.

It is questionable, however, whether Popitz - and here we come to our second question - really uncovered the effective components of his three factors in the depth which would fully correspond to his thesis. Popitz's fundamental position was thoroughly political and strongly influenced by the notion of centralization. Thus many latent aspects of his wishful thinking were given concrete form in his thesis.

In his arguments we find the economic side of the question - so important for the modern theory of federalism - almost completely neglected. We have already discussed this aspect. On the other hand, it would be just as incorrect to completely "economize" the thesis of Popitz, i.e. to place

the structural change of federalism entirely in the realm of economic factors as Albers attempted in the case of the Federal Republic of Germany.⁹⁾ A modification of this magnitude must finally be based on the findings of the economic theory of federalism, which, as we have seen, is currently not able to supply a sufficient explanation for certain tendencies in federalism.

A broader and more complex look at the factors presented by Popitz, taking into consideration both economic and political view points, appears to be necessary. Only both dimensions viewed simultaneously present an approach which can explain the tendencies in the federalistic structure of a nation with the necessary depth. This political and economic view can then lead to a dynamic, more comprehensive theory of federalism, whereas the thesis of Popitz, as we shall demonstrate, covers but one of the possible developments in the structure of federalism.

Let us turn to the bases of this approach.

IV. The fundamentals of a politico-economic approach

We begin with the examination of each of our factors individually and thereby at first considering the argument that global economic policy would require intervention of the central government. The economic aspect considers above all the problems of an optimal fulfillment of allocation, distribution and stabilization goals as well as the assignment of all these activities to the various levels of government. From an economic point of view the federalistic structure presents but a rational form for the institutional organisation of governmental functions. The task of controlling the course of economic activity (global economic policy) therein is the responsibility of the central government, the larger part of the supply of real public services (transportation, health, education, public utilities) is carried out by the subordinate levels.

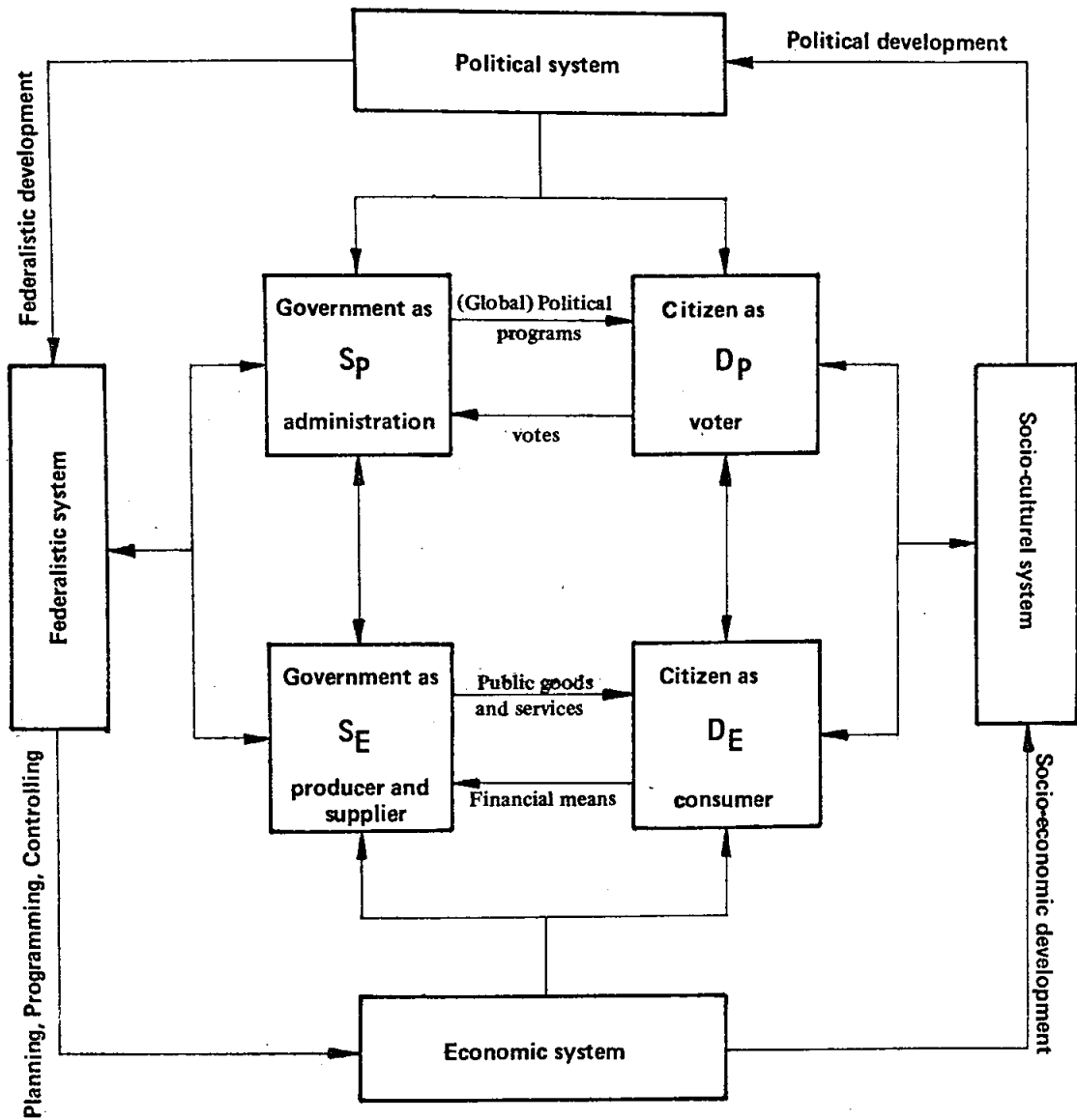
A political dimension is added to the problem of the assignment of functions when we assume that the politician's objective is to maximize votes, or at least to gain the majority of votes.¹⁰⁾ The global control of the economy as well as the supply of public goods and services in all levels of government will also have to be oriented on this goal.

Concerning demand behaviour of the citizens it is also possible to distinguish between an economic and a political dimension. The economic importance lies in the effects of the reactions of individual citizens, as demanders and recipients of real and monetary services, which affect the entire economy. The political area, on the other hand, is characterized by the transformation of their attitudes into the political institutions by way of the election process, as well as the reactions of the politicians.

Considering finally public financing, its economic problem is to finance each form of government activity in a manner compatible with policy goals. Since resources are scarce, the political task becomes that of forming a system of intergovernmental fiscal relations (Finanzausgleich) which will allow for a just distribution and the adequate performance of government functions at all levels.

The following chart has been prepared to display the interactions between economic and political spheres. This is a modified presentation of a system as is frequently found in Political Economy.¹¹⁾ Society has been divided into specific sub-systems: a political, an economic and a socio-cultural sphere. We have added the elements of a federalistic system since this is of particular importance for our problem.

All sub-systems are interrelated either directly or indirectly. Significant changes within one system will inevitably lead to reactions in the other systems, and this can lead to imbalances or disturbances in the whole system or in its elements. Developments of this nature build up a conflict potential of more or less large proportions which can obtain immense importance for all sub-systems and, of course, for the federalistic



- Sp** = Political Supply
- Dp** = Political Demand
- SE** = Economic Supply
- DE** = Economic Demand

structure of the government as well. As is possible for each sub-system, one can formulate a sort of "conflict theory" for federalism, in which changes in the federalistic structure appear as a result of proceedings caused by conflicts in other sub-systems. Let us now take a closer look at this approach.

V. An attempt to explain federalistic developments on the basis of a conflict theory

A very important source of crises in the entire system obviously lies in the economic sphere. Disturbances are possible at any time and in a number of forms. They can appear for example in business cycles, in low rates of growth, in inflation and in unemployment. If these developments are not to affect the system as a whole, the government must interfere, as we know. Government intervention cannot of course always prevent economic disturbances from affecting the political system. Controlling economic activity by means of fiscal policy for example will also affect the entire supply of public goods and services. Global corrections of total supply or demand through public expenditures or revenues are normally accompanied by an expansion or a reduction in the supply of public goods and services. A reduced supply of public goods, however, will sooner or later affect the socio-cultural system and lead to instabilities there as well. The loyalty of the voters at all levels of government is likely to decrease, and in the extreme case could even diminish the stability of the whole political system.

Thus, in these few sentences a series of reactions and interactions has been portrayed which are of central importance for the political economy of our day.¹²⁾ Of special interest for our problem is the potential discrepancy which exists between the goals of economic stability and the governmental supply of public goods and services. This also has a strong influence upon the relationships between governmental units in the nation. For, as experience in federalistic countries has shown, the task of controlling the economy is the responsibility of

the central government, while the subordinate authorities are basically engaged in the provision of public goods and services. Fluctuations in economic activity and, as a result, in the political system could therefore very well lead to changes in the federalistic system itself. The conflict, which plays an important role in the fulfillment of government functions, as just mentioned, is thus institutionalized and carried over to the relationships between Federal, state and local authorities. At the same time, fluctuations in economic activity become a dominant figure influencing federalistic development.

The solution to the conflict in reality and, as a consequence, changing interactions between Federal, state and local units in each individual case also depend on the interplay of these factors as discussed in the previous section. In order to state our thoughts more clearly we have also included these interactions in an expanded form in our diagram. We have distinguished between a supply and a demand area for both the economic and the political system of the society.

Of decisive importance for the Federal development of a nation, besides the economic imbalance, is the relationship between government and citizen, between supply and demand. Thus public decision-making is of utmost importance. How will the citizens, as demanders and consumers, behave towards the government in actual social, political or economic situations. In what manner will they as voters attempt to convert their specific interests into political decisions? On the other hand, how will the politicians, as suppliers, react and what will be the consequences for the governmental bodies?

The following considerations are based on two assumptions concerning the behaviour of the politicians and the voters:

(1) In the political area the government tries to maintain or indeed to increase its degree of approval in the eyes of the voters. This would secure its position as the dominant force in future elections.¹³⁾ In the economic sphere the government, being producer and/or supplier of public goods, would thus seek to satisfy the needs of its citizens as far as possible.

(2) The demand behaviour of the voters, on the other hand, is primarily influenced by the degree of fulfillment of their political and economic wishes. In the minds of the voters those factors will be essentially reflected which have the most direct influence on the daily life of each individual. This assumption seems to be quite plausible, considering the fact that most voters have but a limited horizon and frequently lack information.¹⁴⁾

With regard to the potential conflict between the supply of public goods and economic stabilization this means that the more easily measurable and noticeable goals of stabilization policy attract more attention than the effects of the actual supply of public services. One need only consider functions such as transportation, education, health and social services. The voters' sensibility and their threshold for reactions can be assumed to be fairly high in the case of such goods, so that it takes quite some time before shortages are recognized and become politically acute. The Federal government with its stabilization policies is thus more closely in the center of the voters' interest than the states and local units with their supply of goods and services.¹⁵⁾ Its relationship to the citizens is therefore of political nature. The subordinate levels of government on the other hand must consider their relationship to the citizens primarily as a confrontation between supplier and consumer in the economic sphere.

The demand behaviour of the citizens also contains yet another source of conflict. Discrepancies can also arise from the institutional assignment of functions and the ideas citizens in different regions have about it. Regional and local issues thus also play a part in Federal elections and vice versa. Since the supply on the subordinate levels is an important instrument for the economic stabilization policies of the Federal government, it is safe to assume that the latter has a definite interest in gaining influence on the regional supply of public goods. This occurs even more if the fulfillment of government functions on subordinate levels is closely connected

with the legislative activities of the central government, i.e. in the case of a distinct "Politikverflechtung" (joint political decision-making).¹⁶⁾

On the other hand, both the findings of the economic theory of federalism as well as practical experience show that it would be irrational for the lower authorities to orient their budget policy on the principle of stabilization. They are less embedded in the political sphere and more concerned with economic aspects of the society; their primary concern being the fulfillment of the economic needs of their citizens with the help of public goods and services.

Considering all these elements, different conflict constellations between stabilization and the provision of public goods can be found. The solutions of the conflict will most likely be closely associated with specific phases in the development of Federalism. The term "phase" is meant more in the sense of a logical sequence of development than of a temporal one, without necessarily excluding the latter. In the following section we wish to introduce four distinct phases as exemplary for the realm of possible developments in federalism.

VI. Phases in federalistic development

Phase 1:

The first phase can be characterized as a sort of fair-weather federalism. In the absence of discrepancies between the requirements of stabilization and the demands of the citizens concerning the provision of public goods and services - assuming that the necessary financial funds for government activity have been secured - the federalistic system can develop free of conflicts, from a political point of view.

The economic condition necessary for this development free of conflicts is primarily a rapid, steady rate of growth which a) minimizes the necessity for economic policy and b) assures the revenue side of government activity. In addition, the supply of public goods must coincide with the demand.

The relations of the governmental bodies to one another under these circumstances depend on the manner in which the expanding

margin of revenue is divided amongst Federal, state and local authorities. In a setting free of conflicts the regulations regarding the financial system of the federation can also be a decisive factor (system of fiscal interrelations). Essential changes in the federalistic structure will hardly result from this alone. First shortages will appear as soon as a distribution of the financial means has been established which in the long run prevents an optimal supply of public goods. This will especially affect the local units and could possibly be the cause of further conflict tendencies within the economic and socio-cultural system.

Phase 2:

The second phase in the federalistic development is marked by the first signs of stabilization problems (possibly the result of false developments in the first phase). The causative element is the beginning of economic imbalance in the private sector (inflation, declining growth rates, unemployment). In addition, there are also losses of efficiency in the government sector resulting from conditions during the fair-weather period. Coincidentally there is an increasing rate of expansion of government expenditures as a result of the previous development as well as a condition of the economy's future development. A considerable loss of efficiency can result from the behaviour of the local authorities as "free riders" during the first phase, in consequence of their ever-increasing demands on the Federal government ("competition amongst the mayors"), granted that the latter is able to provide the means necessary to fulfill these demands. This is achieved for the most part by a system of (vertical) revenue sharing, whereby a progressive tax system in a growing economy provides the best foundation.

The reactions of voters and politicians responding to these undesired cyclical developments will be the dominant factor influencing the federalistic development. The supply of public goods however will still tend to be of little importance during this phase, i.e. it will continue to lie within the tolerance

range of the voters. In this situation the responsible government officials, the Federal authorities, must by all means gain control over the cyclical movements of economic activity in order not to endanger their reelection.

Such a policy on the central level will certainly lead to new conflict potentials, especially when these policy measures are directed against inflationary price movements.¹⁷⁾ The federalistic conditions in Western Germany may serve as an example. The Federal government has the legislative power of taxation and thus for the most part the sovereign right to determine government revenue, while state and community units can only determine their expenditure program more or less on their own, whereby the financial means are secured to a great extent through a grant-system. If the stabilization policies during this phase are limited to restrictive budget policy, sooner or later the financial means of the communities are bound to become scarce as we know. This will occur first of all because the Federal government will surely make use of all the various ways available to curtail expenditure activities of the subordinate level by restricting its revenue. The supply of public goods on the community level on the other hand has been stepped up during the fair weather period and cannot be reduced at once to allow for adaptation to the reduced public funds.

This conflict can be solved in a number of ways. To begin with, it would appear to be advisable for the communities, for political reasons alone, to attempt to overcome the existing financial bottle neck in one way or another. This is possible by increasing their debt in the capital market, or by raising additional fees for the various government services. The central government for its part may seek closer co-operation with the communities to prevent compensation of its stabilization efforts. A joint performance of certain government functions by Federal, state and local units could be the first step towards co-operative federalism.¹⁸⁾

In this (second) stage of federalism it is already quite difficult to detect the trend of federalistic developments. It is

nearly impossible to reflect these more complex relations between the Federal, state and local governments with the help of the global criterion measuring relative shares of government spending. In particular, the federalistic interdependence of decision-making and performing government functions does not become apparent.

All things considered and depending on which government level is able to realize its goals either economic stabilization or optimal provision of public goods, or even both, are not fulfilled. The federalistic development will then enter into a third phase. Nothing short of sincere willingness to reach certain compromises on the part of the government units at the various levels can secure a lasting and stable solution to the conflict in this second stage.

Phase 3:

If government does not succeed in stabilizing the economic situation, due to inflationary tendencies, the relationship between Federal, state and local units will continue to change in this third stage. The causative conflict potential will now gain additional importance, since shortages in the supply of public goods will become increasingly noticeable getting not only economic but also political relevance. The demand behaviour of the citizens directed to the Federal government, generally oriented on economic stability, and the demands on the communities, primarily interested in the provision of public goods and services, become more and more incompatible. Thus the specific goals of the government units must sooner or later come into conflict with one another. This will especially be the case when (a) a political dimension is introduced to the supply of public goods through certain social indicators, in addition to the economic dimension, and (b) the individuals in the society expect an increasing level of public goods.¹⁹⁾

Continuing financial deficiency on the one hand and increasing demands on the other hand force not only the Federal and state but also the local governments to develop strategies to solve

the conflict in order to maintain their political power. The strategies of the Federal government in this situation will exhibit centralization tendencies. The Federal powers must attempt

- (a) to influence the structure of expenditures and revenues of subordinate budgetary units in accordance with its goals by intervening in the system of intergovernmental fiscal relations; ultimately this will mean a reduction of the independent budget power of subordinate levels;
- (b) gradually to take over certain functions previously in the realm of state and local units for reasons of cyclical stabilization;
- (c) to leave the task of carrying out the various functions with the subordinate authorities while at the same time centralizing the decision-making power. The Federal government can use its legislative power to a greater degree and increase the number of Federal programs affecting certain branches or the economy as a whole.²⁰⁾

Within this setting the position of the subordinate levels can remain the same or even show slight gains measuring the degree of centralization by the share of each level on total public spending.

The communities for their part will attempt to counter these centralization tendencies. Their financial means can be improved by

- (a) increasing their debt,
- (b) introducing rationalization measures which can serve to improve the efficiency of their activities,
- (c) transferring certain functions into the private sector of the economy.

As opposed to the consequences resulting from the strategies of the Federal government, the share of the subordinate levels measured on total expenditures might actually decrease, while their functional sovereignty can even be increased. It is quite possible to establish the thesis that a federalism of

this sort, loaded with potential conflicts, actually contains a "healthy pressure" to increase efficiency in the government sector of the economy.

Phase 4:

The fourth stage in the federalistic development can be expected to appear in a situation characterized by continual strong economic disturbances, accompanied by an ever increasing discrepancy between public demand and public supply. In such a crisis it must be feared that the loyalty of the voters to the government will diminish, in the course of which the political power, especially that of the Federal government, will be jeopardized.²¹⁾ The economic conflict potential becomes less important and will be overshadowed by its repercussions in the political sphere. The Federal authorities will ultimately be forced to seek a solution to this conflict by planning and programming interventions in the decisions of the subordinate levels in order to regain the loyalty of the voters (policy of the strong man). In the long run this will lead to a continuous reduction of the decision-making power of lower levels cumulating perhaps in a situation where the communities remain formally independent, in reality however are mere administrative organs of the central government.

An alternative to this policy of increased centralization may of course take the form of decentralized decision-making. This possibility will be adopted especially when it becomes obvious that centralization alone cannot solve the conflict between stabilization and the provision of public goods. There is even a danger that the entire political system might collapse for this reason. A political solution might be sought in a decentralized decision-making in order to achieve an absorption of the conflict potential, thus stabilizing the whole system. This strategy will appear more likely and more successful, the greater the regional differences in demands for public goods and services are. They can manifest themselves politically more or less intensive, in the form of separatistic movements.

VII. Federalistic development in the Federal Republic of Germany

It would of course be interesting to examine our theses for the various countries which are organized in a federalistic manner. This applies in particular to the USA, Canada, Switzerland and West Germany. Unfortunately we were not yet able to carry out this comprehensive study and must therefore limit ourselves to a brief consideration of these theses based on the conditions in the Federal Republic of Germany. Our intention is not so much a strict analysis, but rather an illustrative presentation (See the tables in the appendix).

Viewing the development of the Federal Republic of Germany following the war, it becomes apparent that the period up through the early sixties can be characterized as a phase of fair weather federalism. A decreasing rate of unemployment, moderate inflation and high rates of real growth prevented any real stabilization problems from cropping up. Expanding economic activity also provided the necessary financial means for government activity on all levels, with a relatively constant government share of the national product. Thus the slight shift of direct expenditures from Federal to community levels was not connected with a worsened financial status of the communities. Of particular interest is the fact that the share of Federal and state grants for investment expenditures of the communities did not show any rising tendencies. The provision of public goods could so be financed without difficulty at all levels, since the government received the necessary funds out of the rising tax receipts from the private sector.

But in the course of this stage of federalistic development free of conflicts certain undesired effects were already evolving. The lower levels made ever-increasing demands for personnel and for capital goods in order to perform and manage the functions delegated to them by Federal law. To the extent that these rising demands could be met within

the bounds of the financial equalization system, the first signs of an expanding government administration and an increasing loss of efficiency became apparent.

During the mid-sixties federalism in Germany would appear to have entered the second developmental stage. This is marked by increasing problems of economic stabilization. Although full employment was maintained, the declining growth rates along with an increasing rate of inflation, which more and more came to dominate the political discussion, set us new standards for economic policy. Simultaneously a deterioration of the finances of the community level took place, compensation of which was sought by increasing local debt as well as Federal and state grants. The rise in the share of state and local expenditures as measured by direct outlays indicates that the provision of public goods still had priority over stabilization policy.

The recession of 1966/67 marked a temporary end to this unsolved conflict between the aims of the Federal government and those of the state and local units. The goal of economic stability has since attained major importance, and as a result of this development there emerged a demand for a stronger commitment of state and local authorities to the economic policy of the Federal government. Efforts in that direction have concentrated on increased co-operation, as practiced by the financial planning and economic advisory boards, or as expressed in the constitutionally ankered joint provision of certain public goods and services (Gemeinschaftsaufgaben). The so-called debt ceiling of the "Stabilitätsgesetz" (Law to Promote Stability and Growth of the Economy) was intended to present an additional instrument of control for the volume of local expenditures in line with stabilization goals. Thus the development towards a co-operative federalism was initiated.²²⁾

Despite these measures it was not possible to achieve the desired harmony between economic stability and provision of public goods and services. The federalistic development in West Germany would thus appear to be on the verge of entering

the third stage at the present. Stagflation, along with growing demands for public goods which are socio-politically motivated, and an increasing shortage of financial funds, especially on the community level, aptly characterize the conditions in the mid-seventies.

The political necessity to solve these conflicts has already led to measures which place limits on an autonomous decision-making of the state and local authorities. The formula reads: centralize the decision-making powers, decentralize the performance of government functions.²³⁾ This is achieved first of all with the help of various superior Federal and state plans and programs which severely limit the margin of independent planning at the local level. In addition, the current outlays of the communities (and states) have been so strongly affected by rising prices and the legislative assignment of government functions that their expenditures for investment are dwindling steadily. They must be financed almost entirely through Federal and state grants and by means of increasing local debt.

This of course opens additional possibilities for the Federal government to increase its degree of influence. The efforts of the communities, which try to prevent the loss of their decision-making power, can do little to change matters. Thus measures are being considered at present in the Federal Republic of Germany, more intensively than ever, (a) to rationalize local activities, and (b) to remove completely certain tasks from the government sector and transfer them to the market sector.²⁴⁾ Of primary interest is the wide range of public utilities. If it is not possible in the near future to stabilize the national economy in Germany, the centralization tendencies which are already noticeable can be expected to expand further.

Footnotes

- * The author is Professor of Economics at the University of Augsburg, Germany. He is grateful to Rudi Fischer for helpful suggestions and assistance in preparing the paper. Responsibility for errors is the author's alone. Paper prepared for the Congress of the Institut International de Finances Publiques, Edinburgh, September 6-10, 1976.
- 1) See for example the paper given at this Congress by W.E. Oates, The Changing Structure of Intergovernmental Fiscal Relations.
 - 2) W.E. Oates, Fiscal Federalism, New York 1972; A. Scott, The Economic Goals of Federal Finance, in: Public Finance, Vol.19, 1964, pp. 244 ff.
 - 3) M. Neumann, An Economic Theory of Federalism, in: German Economic Review, Vol. 10, 1972, p. 1 ff.
 - 4) This problem is intensively discussed in Wagner's law of the "expending scale of state activity", see R.A. Musgrave, Fiscal Systems, New Haven and London 1969, p. 73 ff.; H.C. Recktenwald, Umfang und Struktur der öffentlichen Ausgaben in säkularer Entwicklung. Eine theoretische und empirische Analyse, in: Handbuch der Finanzwissenschaft, 3. Aufl. Tübingen 1975/76.
 - 5) J. Popitz, Der Finanzausgleich, in: Handbuch der Finanzwissenschaft, 1. Aufl., Bd. 2, Tübingen 1927, pp. 346 ff. In the nineteenth century for the American federalism Lord Bryce has expounded a "law" similar to the one Popitz developed for Germany, Bryce, The American Commonwealth, New York 1896; see also E. Mc Whinney, Comparative Federalism, 2nd ed., Toronto 1965.
 - 6) W. Albers, Das Popitzsche Gesetz der Anziehungskraft des übergeordneten Etats, in: F. Neumark, (Hg.), Strukturwandlungen einer wachsenden Wirtschaft, Berlin 1964, pp. 835 ff.; K.-H. Hansmeyer, Das Gesetz von der Anziehungskraft des zentralen Etats, in: H. Timm u. H. Haller, (Hg.), Beiträge zur Theorie der öffentlichen Ausgaben, Berlin 1967, pp.197 ff.; T.Keller, Das Popitzsche Gesetz und die Schweizer Gemeinden, in: Archiv für Kommunalwissenschaften, Jg. 5, 1966, pp. 78 ff.
 - 7) More specific criteria showing the degree of centralization might be: (1) Current budget surplus/capital outlay, (2) local debt / capital outlay, (3) grants for investment / capital outlay, (4) grants for investment / investive expenditure, See tables 6 and 7, and H. Hanusch, Central or Decentral Tendencies in Federalism? The Case of West Germany. Paper prepared for the ISPE Conference on Fiscal Federalism, Berlin 1976.



- 8) H. Hanusch, Public Goods, Allocation and Distribution, in: M. Pfaff (ed.) Grants and Exchange, Amsterdam 1966, pp. 184 ff.; B.S. Frey, A Dynamic Theory of Public Goods, in: Finanzarchiv, N.F. Vol. 32, 1974, p. 155 ff.; K. Schmidt, Zur politischen Reaktion auf Nachfrageswogen in der Staatswirtschaft, in: Finanzarchiv, Vol. 33, 1974, pp. 30 ff.
- 9) W. Albers, op. cit.
- 10) A. Downs, An Economic Theory of Democracy, New York 1957; B.M. Barry, Sociologists, Economists and Democracy, London 1970.
- 11) F. W. Scharpf, Politische Durchsetzbarkeit innerer Reformen, Göttingen 1974.
- 12) B.S. Frey, Die Renaissance der Politischen Ökonomie, in: Schweizerische Zeitschrift für Volkswirtschaft und Statistik, Vol. 110, 1974, pp. 357 ff.
- 13) D. Easton, A System Analysis of Political Life, New York, London, Sydney 1965.
- 14) A. Downs, op. cit.; M. Lücke, Kollektive Planungs- und Entscheidungsprozesse dargestellt an der Steuerung kommunaler Entwicklung, Tübingen 1975.
- 15) W. Kaltefleiter, Beziehung zwischen wirtschaftlicher und politischer Stabilität, in: H.K. Schneider u.a. (ed.) Stabilisierungsprobleme in der Marktwirtschaft, Berlin 1975; J.L. Sundquist, Politics and Policy, The Eisenhower, Kennedy and Johnson Years, Washington 1968.
- 16) F. W. Scharpf u.a., Politikverflechtung: Theorie und Empirie des kooperativen Föderalismus in der Bundesrepublik, Kronberg/Ts. 1976.
- 17) For the importance of the inflation problem see: I.S. Friedman, Inflation- A World Wide Disaster, Boston 1973; J.A. Trevithik, The Economics of Inflation, London 1975.
- 18) For the discussion concerning cooperative federalism see: H. Haller, Wandlungen in den Problemen föderativer Staatswirtschaften, in: Finanzarchiv, Vol. 27, 1968, p. 255 ff.; G.F. Sawyer, Modern Federalism, London 1969.
- 19) For the political problems of social indicators see G. Kirsch, Einige Bemerkungen zur Abbildung individueller Wohlfahrtslagen in sozialen Indikatoren, paper prepared for the international DFG-Symposium in Augsburg 1976.
- 20) F. Wagener, Integrierte Entwicklungsplanung, Schriftenreihe der Hochschule Speyer, Vol. 55, Berlin 1975.

- 21) Theorists influenced by the Marxian political economy argue much more specifically in that direction, especially in Germany. See for example J. Habermas, Legitimationsprobleme im Spätkapitalismus, Frankfurt 1973.
- 22) See § 19 of the "Gesetz zur Förderung von Stabilität und Wachstum" 1967.
- 23) F. Wagener, op. cit.
- 24) More detailed H. Hanusch, Markt im Staat, unpublished paper 1976.

Table 1

Direct Expenditures of Federal, State and Local Governments
in the Federal Republic of Germany (BRD)
- Selected Years -

Year	All Govern- ments	Bill. DM				as Percent of all Governments		
		Federal	State	Local	Federal	State	Local	
1951	36,68	17,89	11,40	7,41	48,7	31,1	20,2	
1955	51,39	22,39	16,15	12,85	43,6	31,4	25,0	
1961	98,81	43,79	30,71	24,29	44,3	31,1	24,6	
1962	114,60	49,44	35,21	29,95	43,2	30,7	26,1	
1965	157,55	63,17	42,99	51,39	42,7	29,0	28,3	
1968	167,33	69,41	50,51	47,41	41,5	30,2	28,3	
1969	190,71	82,29	54,91	53,51	43,1	28,7	28,1	
1970	205,01	80,31	63,20	61,50	39,2	30,8	30,0	
1971 ¹⁾	233,50	88,70	72,43	72,37	38,0	31,0	31,0	
1972 ¹⁾	252,32	94,62	76,94	80,76	37,5	30,5	32,0	
1973 ¹⁾		105,90		90,50				
1974				99,61				
1975				107,91				

1) Budget proposals and estimates

Sources: A. Schmid, Entwicklung und Bedeutung der Gemeindefinanzen in der BRD mit einem Vergleich dreier strukturtypischer Gemeinden: 1950 - 1968, Diss. Freiburg 1971, p. 17, own calculations.

Table 2

Net Outlays of Governmental Unities in the BRD
- Selected Years -

Year	All Governments	Federal ²⁾	State	Local	Federal	State	Local	as Percent of all Governments			
								Federal	State	Local	
		Bill. DM									
1951	37,04	18,38	10,19	6,41	49,1	27,3	17,1				
1955	51,23	22,40	15,53	10,76	43,7	30,3	21,0				
1961	95,27	45,76	28,77	18,25	48,0	30,2	19,2				
1962	107,23	50,41	33,34	19,99	47,0	31,1	18,6				
1965	140,58	64,99	44,56	27,71	46,2	31,7	19,7				
1968	159,10	75,27	50,06	30,20	47,3	31,5	19,0				
1969	174,72	81,38	55,50	33,99	46,6	31,8	19,5				
1970	196,15	86,70	64,76	40,95	44,2	33,0	20,9				
1971	225,18	97,53	74,44	49,87	43,3	33,1	22,2				
1972 ³⁾	251,24	111,17	82,11	54,59	44,3	32,7	21,7				
1973 ³⁾	275,41	120,98	93,27	61,16	44,0	33,9	22,2				
1974 ³⁾	312,51	136,53	107,97	68,01	43,8	34,6	21,8				
1975				74,98							

1) Including LAG, ERP, etc.

2) Excluding LAG, ERP, etc.

3) Budget proposals and estimates

Sources: Statistisches Bundesamt, Lange Reihen zur Wirtschaftsentwicklung 1974, pp. 118 ff.
Bundesministerium der Finanzen, Finanzbericht 1975, pp. 25 ff., R.R. Klein and J.M. Gleitze, Gemeindefinanzbericht 1975, in: Der Städtetag, Januar 1975, p. 13, own calculations.

Table 3

Year	Annual percent change of GNP based		Percent price increase from previous year (consumer prices)	Unemploy- ment rates
	on current prices	on constant 1962 prices		
1950	22,3	10,4	2,0	7,2
1952	14,2	8,9	2,1	6,1
1953	7,8	8,2	1,8	5,5
1954	7,4	6,8	0,2	5,2
1955	14,4	9,0	1,6	3,9
1956	10,5	9,4	2,5	3,1
1957	9,0	8,9	2,0	2,7
1958	7,2	8,1	2,2	2,7
1959	8,8	8,4	1,0	1,9
1960	11,7	9,0	1,4	1,0
1961	10,0	5,4	2,3	0,7
1962	8,3	4,0	3,0	0,6
1963	6,6	3,4	3,0	0,7
1964	9,6	6,7	2,3	0,6
1965	9,4	5,6	3,4	0,5
1966	6,6	2,9	3,5	0,6
1967	1,0	0,2	1,4	1,7
1968	9,0	7,3	1,3	1,2
1969	12,1	8,2	2,0	0,7
1970	13,3	5,8	3,2	0,6
1971	11,1	3,0	5,1	0,7
1972	9,5	3,4	5,3	0,9
1973	11,2	5,1	6,8	1,0
1974	7,2	0,4	7,0	2,6
1975	4,4	-3,4	6,0	4,7

Source: Statistisches Jahrbuch für die Bundesrepublik Deutschland, various years

Table 4

Structure of Local Expenditures in the BRD
Bill. DM

Year	Total Expenditures	Current Expenditures			Capital Outlays				
		Total	Personal Welfare	Public Welfare	Interest Payments	Total	Investments	Property acquisition	Constructions
1951	8,22	5,62	2,48	0,84	0,04	2,59	1,99	0,34	1,64
1955	13,63	8,07	3,59	1,14	0,21	5,55	3,31	0,66	3,29
1961	25,26	13,07	5,99	-	0,55	12,11	8,33	1,55	6,78
1962	29,42	14,44	6,57	2,71	0,61	14,99	10,51	2,03	8,47
1965	43,01	22,17	9,25	3,18	1,30	20,84	15,02	2,66	12,35
1968	48,76	27,65	11,59	4,43	1,92	21,11	14,36	2,61	11,75
1969	55,15	30,30	13,13	3,97	2,07	24,93	16,44	3,20	13,24
1970	62,41	34,47	15,22	4,40	2,40	28,02	20,21	4,00	16,21
1971	73,47	40,65	18,26	5,30	2,81	32,94	24,20	4,20	20,00
1972	81,93	46,48	20,53	6,41	3,39	35,61	25,77	4,36	21,41
1973	92,18	53,53	23,40	7,15	4,00	38,81	27,27	5,03	22,24
1974	101,46	62,45	27,28	8,56	4,60	39,20	29,44	5,43	24,01
1975	109,99	69,89	29,98	10,17	5,37	40,32	30,29	5,25	25,04
Growth rates (as percent):									
1951-1961	207,30	132,56	141,53	-	-	367,56	318,59	355,88	313,41
1962-1968	65,73	91,48	76,41	63,46	146,15	40,82	36,63	27,94	38,72
1969-1975	99,44	130,66	128,33	156,17	159,42	61,73	84,24	64,10	89,1

Sources: Statistisches Bundesamt, Statistik der Bundesrepublik Deutschland, Die kommunalen Finanzen im Rechnungsjahr 1951ff., annual (1951-1958), Statistisches Bundesamt, Finanzen und Steuern, Reihe 1, Kommunal финанzen, annual (1959-1972), R.R. Gleitze and J.M. Klein, op. cit., p. 13, own calculations.

Table 5
Structure of Local Revenues in the BRD
Bill.DM

Year	Total Revenues	Current Revenues			Federal/State Grants	Total	Capital Revenues			Total - Current Revenue Surplus
		Tax Receipts	Charges	Federal/State Grants			Current Revenue Surplus	Grants for Investment	Local Debt	
1951	8,36	3,30	1,06	1,64	2,75	1,57	0,38	0,39	1,18	
1955	13,73	4,95	1,90	2,47	5,63	2,66	0,56	1,48	2,97	
1961	25,73	9,42	3,51	4,51	12,18	6,10	1,42	2,46	6,08	
1962	30,13	10,12	3,88	6,16	14,99	8,11	1,86	3,12	6,88	
1965	42,84	11,87	5,78	7,73	20,71	8,02	3,18	5,57	12,69	
1968	48,92	13,40	7,83	8,89	21,33	8,34	3,65	4,65	12,99	
1969	56,47	17,24	8,87	9,55	26,38	10,73	4,25	5,07	15,65	
1970	60,91	16,68	9,87	10,51	26,73	8,90	4,63	5,82	17,83	
1971	72,92	19,27	11,81	11,81	32,64	9,16	5,34	10,32	23,48	
1972	82,72	23,22	13,78	13,71	36,69	11,81	6,05	11,07	24,88	
1973	92,80	27,34	14,65	15,72	39,46	12,68	7,60	10,06	26,78	
1974	101,81	30,23	15,95	17,91	39,78	10,47	9,24	10,26	29,31	
1975	110,07	32,65	17,46	18,64	40,64	7,89	10,00	13,45	32,75	
Growth rates (as percent):										
1951-1961	207,77	185,45	231,13	275,01	369,82	410,19	-	530,76	316,10	
1962-1968	62,36	32,41	101,80	44,32	32,73	4,12	68,98	49,03	57,64	
1969-1975	94,91	89,38	96,84	95,18	54,06	-26,5	135,29	165,29	109,26	

Sources: See table 4.

Table 6

Financial Cover Ratios of Local Units

Year	Relation of									
	Current Budget Surplus to Capital Outlays	Grants for Investment to Capital Outlays	Grants for Investment to Spending for Investment	Grants for Investment to Spending for Construction	Local Debt to Capital Outlays	Local Debt to Spending for Investment	Local Debt + Grants for Investment to Capital Spending	Local Debt + Grants for Investment to Spending for Investment	Local Debt + Grants for Investment to Spending for Construction	
1951	60,7	14,7	19,1	23,2	15,2	19,6	29,8	38,7	47,0	
1955	47,9	18,0	16,9	17,0	26,6	44,7	36,7	61,6	62,0	
1961	50,8	11,7	17,1	20,9	20,2	29,5	31,8	46,6	57,2	
1962	54,1	12,4	17,7	21,9	20,8	29,7	33,2	47,4	58,8	
1965	38,5	15,2	21,1	25,7	26,7	37,0	42,0	58,2	70,8	
1968	39,5	17,3	25,5	31,1	22,1	32,4	34,6	57,8	70,7	
1969	43,1	17,1	25,9	32,1	20,4	30,9	37,4	56,7	70,4	
1970	31,8	16,6	22,9	28,6	20,8	28,8	37,3	51,7	64,5	
1971	27,8	16,3	22,1	26,7	31,4	42,7	47,6	64,8	78,3	
1972	33,2	17,0	23,5	28,3	31,1	43,0	48,1	66,5	80,0	
1973	32,7	19,6	27,9	34,2	26,0	36,9	45,5	64,8	79,4	
1974	26,7	23,6	31,4	38,5	26,2	34,9	49,8	66,3	81,3	
1975	19,6	24,8	33,1	40,0	33,4	44,4	58,2	77,5	93,7	

Sources: See tables 4 and 5, own calculations.

Table 7
Local Revenues and Expenditures
- Selected Key Numbers -

Year	R e l a t i o n o f							
	Local Revenues	Local Revenues to Total Revenues	Local Current Expenditures to Tax Receipts	Local Current Revenues to Total Revenues	Unconditional Grants to Total Grants	Local Debt to Total Revenues	Local Capital Outlays to Total Spending	Local Spending for Investment to Total Spending
1951	8,39	23,3	58,7	85,8	57,4	4,8	31,5	24,2
1955	12,83	23,8	61,4	78,4	81,4	10,8	40,7	24,3
1961	25,73	24,5	47,8	76,6	76,0	9,6	48,4	33,3
1962	30,13	25,6	44,9	74,8	76,8	10,4	51,7	36,2
1965	34,69	26,6	53,5	70,4	70,8	13,0	48,4	34,9
1968	41,48	27,4	48,2	73,4	70,9	9,5	43,3	29,4
1969	48,17	27,2	56,6	72,9	69,2	9,0	45,2	29,8
1970	50,83	27,1	48,1	71,4	69,4	9,6	44,9	32,4
1971	58,47	27,9	47,2	68,5	68,8	14,2	44,8	32,9
1972	67,62	28,6	49,7	70,6	69,4	13,4	43,5	31,5
1973	78,50		50,7	71,9	67,4	10,9	42,1	29,6
1974			47,2	72,0	66,0	10,1	38,6	29,0
1975				71,0	65,1	12,3	36,6	27,5

Sources: Statistisches Bundesamt, Lange Reihen zur Wirtschaftsentwicklung 1974, pp. 118 ff., own calculations.

