

“Structure and Development of the Grants System in Germany”

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1. Introduction

The general purpose of unconditional transfer schemes is either to improve the vertical fiscal balance by providing general-purpose funding to the Subnational level or to improve the horizontal fiscal balance by compensating for fiscal disparities across regions and municipalities. Fiscal disparities refer to the differences across subnational governments in their ability to raise revenue to meet the public expenditure need of their residents. This kind of variation is not only caused to differences in revenue raising capacity but as well as to differences in the cost of providing public services. However, one should take into consideration that those differences may occur for reasons that are out of direct control of Subnational government¹: On the expenditure side these differences can be caused by demographic change, high or low population density or for geographic reasons; on the revenue side they are determined due to unequal regional economic development, different patterns of industrial specialisation, central versus peripheral position etc. Therefore, fiscal equalisation is becoming increasingly relevant both economically and politically.²

One focus in the theoretical literature on fiscal equalization grants has often been on a phenomenon called the flypaper-effect.³ Along these lines of the literature, some results for Germany on this topic are given. Although it is another important field of analysis, I will not consider question that deal with the influence of an equalization scheme on the choice of tax rate or how the tax rate within a local jurisdiction affects the tax base.⁴ Instead, the paper mainly seeks to achieve two objectives. First, it is providing a comprehensive overview of the intergovernmental fiscal relations in Germany. Due to the fact that there are great differences in fiscal capacity on the vertical as well as on the horizontal level, the grant system is a necessary source for financing subnational levels of governments. With respect to state-local equalization grants in general, nearly 30% can be counted for as earmarked grants. Second, some thoughts on the reasons for this structure of grants are offered. As we will seen, conditional grants are mainly used to pursue state goals rather than compensating for external effects. The paper proceeds as follows. In the next section, a brief overview of the intergovernmental fiscal relations in Germany is given. In section 3 the federal supplementary

¹ See Buchanan, 2002, p. 3.

² In the context of this paper “fiscal equalization” is used as a notion for a supplementary fiscal equalization scheme.² This means that the assignment of tasks and tax sources (and/or shares of them) among all tiers of government has already be done.

³

grants to the German States are presented. Section 4 then offers a description of the local fiscal equalization scheme and the ratio of conditional to unconditional grants. Finally, conclusions are drawn in section 5.

2. Intergovernmental Fiscal Relations in Germany

Germany is constitutionally a federal country with three levels, the federal level, 16 states (“Länder”), and 12.299 (in 2007) local governments.⁵ The state level can be characterized as an independent level of government which is endowed with autonomous rights and obligations. The state level fulfils those tasks that are allotted to them under the German constitution (“Grundgesetz”) and therefore have to be funded with sufficient financial resources. As well, the states must also have free and independent control over these resources. Germany’s constitution guarantees that the Federation and Länder receive appropriate levels of funding.⁶

2.1 Equalization Grants between the Federal-States Level

The process of fiscal equalization can be divided into four steps:

1. First, the vertical distribution is done by distributing all tax revenues to the federation and all states; the local level receives a supplementary grant of revenue. The Constitution jointly allocates several particularly important taxes to the Federation, Länder and, to a degree, the municipalities.⁷ Income tax, corporation tax and VAT are divided between the Federation and the Länder as a whole. The municipalities are entitled to a share of the income tax and VAT. These taxes are therefore referred to as joint taxes. The Federation receives 42.5%

⁴ See Büttner, 2006.

⁵ The local level can further be divided in so-called ‘Boroughs’ (“Kreisfreie Städte”), which execute all functions of the local government as well as those of the district (“Landkreis”). Yet, the administrative districts are the lowest administrative bodies of the Länder level, executing delegated states functions as well as specific responsibilities of their associated municipalities. With the exception of the administrative districts, all local governments are considered equal in carrying out their responsibilities, although they vary significantly in size, type, economic and administrative capacity, level of development, and revenue.

⁶ This and the next chapter is mainly based on Bundesministerium der Finanzen (no year): The Federal Financial Equalization System in Germany.

⁷ The Federation receives all of the revenue from the federal taxes. The majority of the excise duties (such as mineral oil duty and tobacco duty) as well as the insurance tax are federal taxes. The Länder are entitled to receive all of the revenue from Länder taxes. These include the inheritance tax, the motor vehicle tax, most types of transactions taxes (in particular, the real property transfer tax) as well as some other types of taxes that generate small amounts of revenue. The municipalities receive the revenue from the trade tax, the real property tax as well as the local excise taxes.

of the income tax, 50% of the corporation tax and 2006 around 53% (from 2007 on around 55%) of VAT. The revenue accruing to the Länder is 42.5% of the income tax, 50% of the corporation tax and 2006 around 45% (from 2007 on around 43%) of VAT. 15% of the income tax and around 2% of VAT at present go to the municipalities.

2. In a second step, the horizontal distribution is made by assigning the complete Länder share of tax revenue to the various states; At the second stage, the tax revenue belonging to the Länder as a whole is distributed among the individual Länder. Apart from VAT, the individual Länder are entitled, in principle, to the tax revenue which is collected by the revenue authorities on their territory (principle of local revenue). In the case of income tax and corporation tax, the principle of local revenue is corrected by special regulations, or what is referred to as allotment. With regard to income tax, this means that in the end every Land receives approximately the tax revenues that are collected for the income of its inhabitants inside or outside of its territory. Companies pay corporation tax centrally. In line with the principle of allotment, this tax is distributed to all states in which a company maintains a place of business. VAT is not distributed according to the principle of local revenue. A part of the Länder share of VAT, but not more than 25%, goes as a supplementary portion to those Länder whose receipts from the income tax, the corporation tax and the Land taxes per capita are lower than the per capita average of all the Länder. This partially, but by no means fully, closes the gap between the tax revenue of the fiscally weak Länder and the Länder average. The exact amount of the VAT supplementary portions depends on the amount by which the per capita tax revenue of a Land falls below the average per capita tax receipts for all Länder. A linearprogressive topping-up schedule is used to calculate the exact amount of the VAT supplementary portions. The remainder of the Länder share of VAT, at least 75%, is distributed according to the number of inhabitants. The distribution of VAT is thus, in itself, a first form of financial equalisation, because its purpose and effect is to harmonise the tax receipts of the Länder. It massively increases the amount of tax revenue that financially weak Länder receive.

3. Next to this, there is a horizontal fiscal equalisation scheme among the states that equalizes fiscal disparities between “poor” and “rich” states; The system of financial equalisation among the Länder further reduces the differences in receipts among the Länder. Poor Länder receive adjustment payments. These payments have to be funded by the wealthy states. The system of financial equalisation among the states ensures that fiscally weak states also have adequate financial resources to fulfil their tasks and develop their sovereignty. Aligning the revenue of the Länder is intended to create and maintain equal living conditions for the entire population in all of Germany. The financial equalisation among the Länder is not, on the other hand, intended to do away with their fiscal autonomy and sovereignty. This is why differences in receipts among the Länder are only reduced and not fully compensated. The starting point for the financial equalisation among the Länder is the financial capacity per inhabitant of the various Länder. The financial capacity of a Land is the sum of its receipts and (64%) of the receipts of its municipalities. The local authority revenues are taken into account when assessing financial capacity because the Länder are responsible for providing their municipalities with appropriate and adequate financial resources. Länder with financially strong municipalities are required to spend less of their own finances on the financial resources of their municipalities than Länder with financially weak municipalities. In principle, all types of Länder and municipality revenue are taken into account when determining the financial capacity. However, there are exceptions to this rule. This means that, ultimately, the tax revenues of the Länder and municipalities mainly flow into the financial equalisation among the Länder. In principle, the system of financial equalisation among the Länder assumes that the financial requirement per inhabitant is the same in all the Länder. This assumption is not appropriate in the case of the Länder of Berlin, Bremen and Hamburg, which are city-states. The city-states are simultaneously both municipalities and Länder in their own right. They have a much higher financial requirement per inhabitant than the normal Länder. Therefore, for the purposes of the equalisation system, their populations are notionally increased by 35%. The three sparsely populated Länder of Brandenburg, Mecklenburg-Western Pomerania and Saxony-Anhalt also have

a slightly higher financial requirement per inhabitant. Their populations are therefore slightly notionally increased for the purposes of the financial equalisation. The exact size of the adjustment payments to a poor, fiscally weak Land, depends on the amount by which its financial capacity per (fictitious) inhabitant falls below the average financial capacity per inhabitant. The difference from the average is topped-up partially, but not completely. A linear-progressive topping-up schedule is used to calculate by how much the difference is topped-up. Similarly, the size of the adjustment amounts which a rich, fiscally strong Land has to pay depends on the amount by which its per capita financial capacity exceeds the average fiscal capacity per inhabitant. The difference from the average is skimmed-off partially, but not completely. A linear-progressive skimming-off schedule is used, which is symmetrical to the topping-up schedule. To ensure the sum of the adjustment amounts correspond with the sum of the adjustment payments, the adjustment amounts are either increased or decreased by a corresponding percentage. The regulations are designed to ensure that the order of the Länder, in terms of financial capacity per inhabitant, does not change as a result of the financial equalisation among the Länder. The system of financial equalisation among the Länder further reduces the differences in the levels of their financial resources. Take the example of a fiscally weak Land with a financial capacity per capita that is 70% or 90% of the average before financial equalisation. Once the financial equalisation system has been applied, this increases to 91% or 96% of the average. On the other hand, a fiscally strong Land with 110% or 120% of the average financial capacity per inhabitant before equalisation, has between 104% and 106½% per cent afterwards.

4. In addition, some poor states are funded additionally by the Federation in form of supplementary federal grants.

2.2 Fiscal Equalization on the State-Local Level

According to the constitutional rules on public finance, local jurisdictions are treated as parts of the states. In contrast to the fiscal equalization among the German states (“Länderfinanzausgleich”), which is a horizontal scheme of equalization among the states without central government interference, the German system of local fiscal equalization can

be characterized as a vertical equalization scheme with a horizontal effect.⁸ Instead of equalization payments among each other the equalization of fiscal disparities between the local authorities is made by lump-sum as well as conditional grants from the state level.

3. The Grant System between the Federal-States Level

Supplementary federal grants are grants which the federal level transfers to poor states to complement the system of financial equalisation among the states. These grants are unconditional and serve to meet general financial requirements. There are two different kinds that can be differentiated: general supplementary federal grants and supplementary federal grants for special needs. General supplementary federal grants further reduce the gap between the average financial capacity per (fictitious) inhabitant and that of poor Länder which still remains after financial equalisation among the Länder. General supplementary federal grants go to Länder whose financial capacity per inhabitant, after financial equalisation among the Länder, is less than 99.5% of average financial capacity per inhabitant. The shortfall is made up proportionally. This means that a financially weak Land, whose financial capacity per inhabitant stands at 70% or 90% of the average before financial equalisation among the Länder, has 97½% or 98½% of the average per capita financial capacity once the equalisation and general supplementary federal grants have been applied (see also Table 1). The difference from the average for the Länder is therefore considerably and clearly reduced overall.

Table 1:

Financial capacity per inhabitant before financial equalisation among the Länder as a % of the average financial capacity per inhabitant	Financial capacity per inhabitant after financial equalisation among the Länder as a % of the average financial capacity per inhabitant ¹	Financial capacity per inhabitant after financial equalisation among the Länder and the general supplementary federal grants as a % of the average financial capacity per inhabitant
70	91	97½
80	93½	98
90	96	98½
100	100	
110	104	
120	106½	
130	109	

Source: Bundesministerium der Finanzen (no year): The Federal Financial Equalization System in Germany

The volume of all supplementary federal grants is shown in table 2. Notice that there has been a change in the supplementary federal grants systems due to negotiations between the federal

⁸ See Zimmermann/Henke, 2001, p. 201.

and the states level in 2005. Since then the so-called transition grants for some old states have disappeared. Instead, a federal grant is given to those states that suffer under the problem of high structural unemployment. Furthermore, the transfer volume of the so-called special needs grants to the new states have been raised which was another result of the political negotiations. These grants are part of the “Solidarity Pact II”. They will be paid until the year 2019 and decrease every year, which means that these fiscal flows has been subject to a sunset legislation.

Table 2: Supplementary federal grants and supplementary federal grants for special needs, 1995-2007, in Mio. €

1995					
Recipient state	Equalization of financial capacity	Cost of political system	Transition grants for “old” states	Special need grants for “new” states	Grants for budget consolidation
Lower Saxony	347	-	259	-	-
Rhineland-Palatinate	175	112	231	-	-
Schleswig-Holstein	-	84	116	-	-
Saarland	102	78	41	-	818
Bremen	62	64	41	-	920
Berlin	434	112	-	1.361	-
Saxony	429	-	-	1.870	-
Saxony-Anhalt	258	84	-	1.129	-
Thuringia	235	84	-	1.027	-
Brandenburg	237	84	-	1.015	-
Mecklenburg-Western Pomerania	171	84	-	765	-
Total	2.449	786	688	7.158	1.738

2000					
Recipient state	Equalization of financial capacity	Cost of political system	Transition grants for “old” states	Special need grants for “new” states	Grants for budget consolidation
Lower Saxony	841	-	129	-	-
Rhineland-Palatinate	430	112	116	-	-
Schleswig-Holstein	264	84	58	-	-

Saarland	114	78	20	-	537
Bremen	84	64	20	-	818
Berlin	481	112	-	1.361	-
Saxony	475	-	-	1.870	-
Saxony-Anhalt	281	84	-	1.129	-
Thuringia	260	84	-	1.027	-
Brandenburg	277	84	-	1.015	-
Mecklenburg- Western Pomerania	190	84	-	765	-
Total	3.696	786	344	7.158	1.355

2005				
Recipient state	Equalization of financial capacity	Cost of political system	Grants for structural unemployment	Special need for grants for “new” states
Lower Saxony	197	-	-	-
Rhineland-Palatinate	153	46	-	-
Schleswig-Holstein	79	53	-	-
Saarland	53	63	-	-
Bremen	121	60	-	-
Berlin	768	43	-	-
Saxony	385	26	319	2.003
Saxony-Anhalt	222	53	187	2.746
Thuringia	217	56	176	1.657
Brandenburg	224	55	190	1.509
Mecklenburg- Western Pomerania	161	61	128	1.110
Total	2.579	517	1.000	10.553

Source: Bundesfinanzbericht 2008, p. 151-154.

Although these federal grants are transferred unconditional, the special needs grants to the new German states are of special interest. They have to be used for public investments and each recipient state has to deliver a written report on the usage of those fiscal resources to the federal ministry of finance. There has been an intensive discussion in Germany due to the fact that these transfers often have been misused. Insofar, it could be interpreted as a lack of

political accountability. But this result is more an expression of the calculation method used than a problem of political control.

4. Structure of Grants between the State-Local Level

In general, the German system knows two kinds of local government responsibilities: compulsory tasks which are determined by higher tiers of government and voluntary tasks which are completely determined by the preferences of each local authority. Although local jurisdictions have some kind of tax autonomy the assignment of revenue sources to the local level is insufficient for financing all local public tasks. Therefore the German States are obligated to undertake a fiscal equalization at the local level.⁹ Thus round 1/3 of the revenues are descended from the fiscal equalization system.¹⁰ In so far grants from the higher levels of government are playing an important part for the financial equipment of local authorities.

The rules and regulations with regard to local fiscal equalization are established by the constitution of each State, thus there are 13 different procedures of local fiscal equalization.¹¹ Beside some differences in legal and administrative treatments¹² in the German states the system of local fiscal equalization presents a common structure with regard to its overall functions.¹³ In a normative sense the equalization scheme should fulfil three main goals¹⁴: first a fiscal function, e.g. grants to increase the financial capacity of the local level. Second, distributional issues which means that differences in fiscal capacity between each single local unit should be reduced. And thirdly, a regional policy objective: This is truly a matter for the states to reach their policy objectives, whereas the arrangement of grants should correspond with the assignment of regional aims that are given by the states.¹⁵

However, regardless of some differences in detail, the basic mechanism of fiscal equalization at the local level is comparable across the German States (see table 2).

Table 4: Basic structure of local fiscal equalization

⁹ Article 106 VII GG, German Constitution.

¹⁰ The revenues of the local level in the five eastern States of Germany are even financed by grants to nearly 50%.

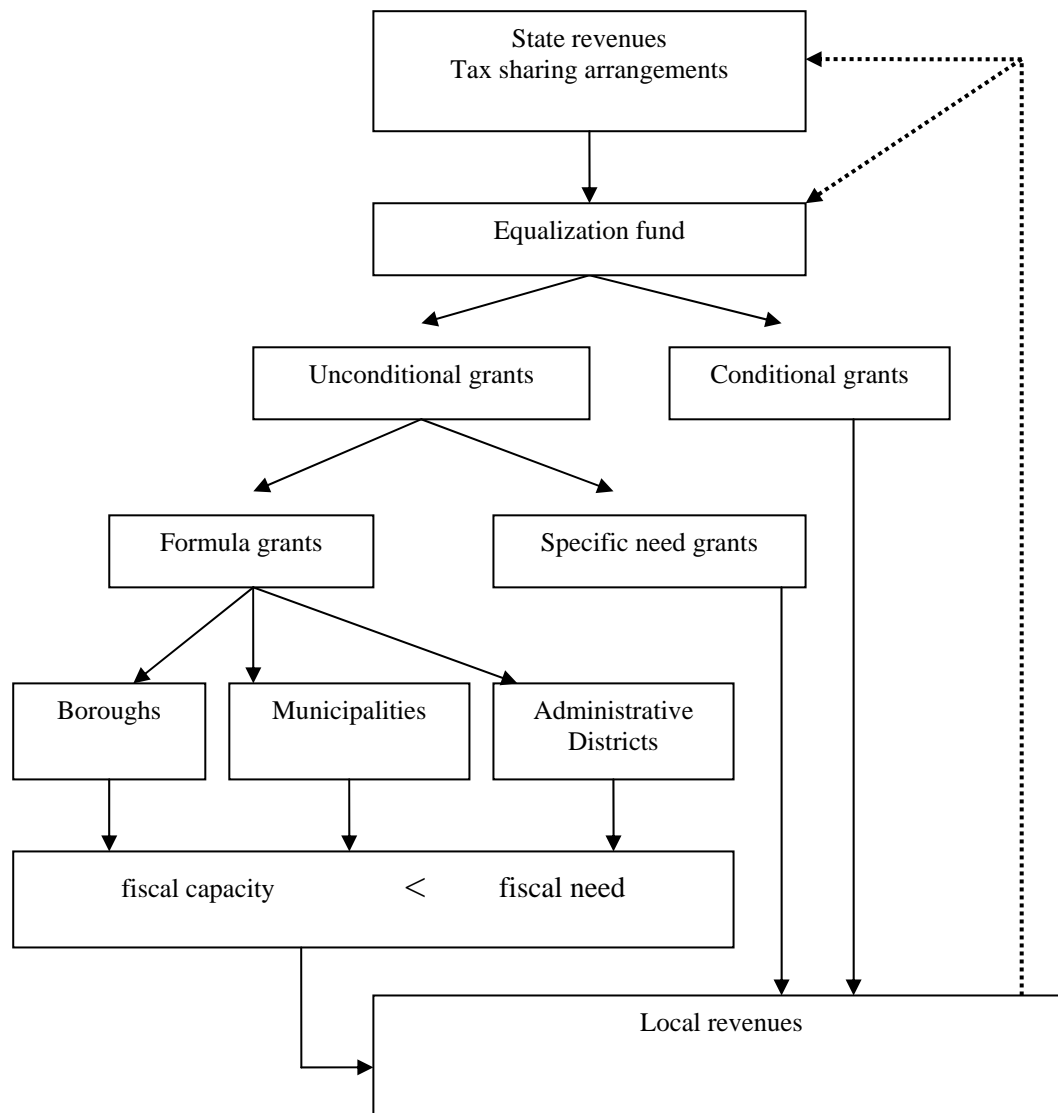
¹¹ Although Germany consists of 16 states, the three city states Bremen, Hamburg and Berlin are eliminated from the following considerations because there is no necessity for a local fiscal equalization process by logical manner.

¹² For further information of these specific state laws see Henneke, 2002.

¹³ See Henneke, 1998, p. 131.

¹⁴ See Otter 2008.

¹⁵ See Postlep, 1993, p. 173.



Source: Otter 2008.

After the total sum of the equalization fund is defined by the state it is subdivided into conditional grants and unconditional transfers. These grants can further be differentiated in:

1. unconditional formula-based grants (“Schlüsselzuweisungen”);
2. unconditional special needs grants (“Bedarfszuweisungen”);
3. conditional grants (“Zweckzuweisungen”).

The first kind of grants represents the main portion and serves as general revenues to be spent for any purpose that local governments pursue, the second type is used in order to cover high

budget deficits, and the third type represents all earmarked grants that are transferred for specific purposes, e.g. local investments. The quantitative meaning of these grants are shown in table 5.

Table 5: Volume and structure of state grants aided to all local jurisdictions, 2003/2007

	2003		2007	
	Mrd. €	in % of all grants	Mrd. €	in % of all grants
Total of state grants	46,6	100%	56,7	100%
Unconditional	27,0	57,9%	32,7	57,6%
Compensation for tax losses ¹⁶	1,2	2,6%	3,5	6,2%
Formula-based grants	21,5	46,1%	24,3	42,8%
Special needs grants	0,3	0,01%	0,3	0,01%
Others	4,0	8,6%	4,6	8,1%
Conditional	19,6	42,1%	24,0	42,4%
Grants for state services	5,2	11,1%	8,1	14,3%
Grants for current purposes	6,7	14,4%	8,2	14,5%
Grants for debt service	0,0	0%	0,0	0%
Grants for investments	7,7	16,6%	7,6	13,4%

Source: Own calculation based on Bundesministerium der Finanzen (several years): Bundesfinanzbericht, p. 158/168.

As one can see, the overall volume of grants to the local level has risen from 46,6 to 56,7 Mrd. Euro. This reflects mainly the vertical fiscal imbalance on the local level. But beside this fact, the ratio between conditional (43%) to unconditional grants (57%) has been relatively stable. A further view on the structure of the state grants offers that there has been an increase in grants that should compensate local governments for tax losses (from 2,6% to 6,2%) as

well as an increase in grants for the delivering of certain state services (from 11,1% to 14,3%). Both developments can be interpreted as fiscal transfers that are intended to equalize the cost of new functions that have been delegated to the local level, thus confirming the statements of local jurisdictions.

Another point in question can be seen in the the so-called flypaper effect. The flypaper effect describes the unexpectedly strong impact of grants on the recipient government expenditures. Whereas the microeconomic model predicts that some of the matching grants will be returned to local citizens in the form of lower taxes because the price elasticity of demand for local public goods has been found to be less than unity. Such models also predict that block grants (or general purpose grants) should be a less potent stimulant of expenditures and therefore lead to a somewhat large decrease in local taxes. However, empirical studies of the effects of intergovernmental grants do not support these predictions. Block grants have universally been found to have a significantly positive effect on local expenditures. In fact, there is little evidence that they induce a decrease in local taxes at all. Furthermore, matching grants are observed to be an even greater stimulant of local government expenditures and appear to be accompanied by increased tax levels.

The initial article is *Bradford/Oates 1971*. They contend that a city, if there are fixed tax shares and a pivotal voter framework, will not increase its total revenues by the total amount of the grant. Because people like both public and private goods, the local government will return part of the grant as a tax refund for citizens to spend as they please. Similarly, in case a grant is cut down, the municipal total revenues should be relatively unresponsive. If revenues are unchanged after grant receipt, they should be similarly little changed by grant decline. Therefore, the flypaper effect was labeled an “anomaly” in a widely cited paper by *Hines/Thaler*, and various alternative explanations have been put forward to account for it, including fiscal illusion on the part of voters and the control exerted by expenditure-maximizing bureaucracies.¹⁷ A large literature has attempted to test the Bradford and Oates contention.¹⁸

¹⁶ Due to the German family policy.

¹⁷ See Hines/Thaler 1995, Dollery/Worthington 1996, Bailey/Connolly 1998, and Gamkhar/Shah 2007 for surveys of the empirical evidence on the flypaper effect and the various attempts that have been put forward to explain it.

¹⁸ See Gramlich 1989.

The first wave of articles attempting to test the Bradford and Oates contention found little evidence of tax cuts in response to grant increases; instead, researchers found that almost all grant funds were used as an addition to total revenues. Others found that grants are likely to be spent in the targeted category.¹⁹ Both of these effects are known in the literature as the flypaper effect, named for the idea that money sticks where it hits.

A second wave of literature on the flypaper effect using more rigorous empirical techniques has produced mixed conclusions. In the context of federal highway aid, once *Knight* controls for the endogeneity of these grants, he finds no evidence of any flypaper effect.²⁰ Similarly, looking at grants to school districts in New Hampshire, *Lutz* finds that equalizing state government grants to local school districts for education are returned almost entirely as tax cuts.²¹ However, *Evans/Owens*, analyzing the Clinton Administration Community-Oriented Policing Services program and *Singhal*, analyzing the state tobacco windfall, both find evidence of some flypaper effect.²² Examining school district funding, *Gordon* finds a flypaper effect that dissipates within two years of grant receipt.²³ Thus, the quantity of the flypaper effect under various circumstances remains an open question in the literature, and is the first question we address empirically.

Following a study of *Rodden*, there is support for the flypaper effect in Germany. He shows that "...a long-term increase of 100 DM per capita in intergovernmental grants is associated with a decrease of 13 DM per capita in fiscal balance. The revenue and expenditure equations show that an increase of 100 DM in grants is associated with only 30 DM in increased total revenue, but an increase of 86 DM in expenditures."²⁴ In a recent paper *Haug* shows that the complexity of the revenue system seems to increase local public spending because of the significant and positive effect of the relative importance of municipal enterprise revenues and that the same can be applied to the grants received, which might indicate the flypaper effect.²⁵

¹⁹ See various articles in Mieszkowski/Oakland 1979.

²⁰ See Knight 2002.

²¹ See Lutz 2005.

²² See Evans and Owens 2007; Singhal 2006 .

²³ See Gordon 2004.

²⁴ Rodden 2001, p. 23.

²⁵ See Haug 2009, p. 18.

5. Conclusion

The grant system in Germany works with conditional and unconditional grants both on the level between federal government and the states as well as on the state-local level of fiscal relations. The main reason for local fiscal equalization in Germany can be seen in a vertical fiscal imbalance between expenditures and revenues, which consequently has implications for local autonomy, efficiency and political accountability. At present the State government is able to determine the distribution of equalization transfers by the appointment of all essential parameters that are used in the equalization scheme. However, in general there is a stable ratio between conditional and unconditional grants. Only if one reflects the composition of grants to the local level, there might be a slight increase in conditionality. On the one hand this is the result of some additional task which have been delegated to local jurisdictions. On the other hand this result shows the fact that grants are used as a fiscal policy instrument; and conditional grants are therefore mainly used in order to pursue state goals.

Although economists and political scientists have heavily criticized the joint tasks in Germany for the reason that they are blurring the accountability in the federal system, they can also be seen as an institutional design in order to deal with interjurisdictional spillovers and externalities in a framework of interjurisdictional contracting according to a contractual view of federalism.²⁶ In Germany, cofinancing has been criticized extensively by scholars of fiscal federalism. At a theoretical level, matching grants could eventually be criticized on the basis of the so-called “flypaper effect”. With regard to the international empirical evidence on the magnitude, direction, and variations in the flypaper effect is somewhat contradictory and neither confirms nor rejects the theoretical predictions. Or, as Oates has put it: “Taken at face value, the flypaper effect has some rather damning implications for the functioning of democratic institutions. It suggests that the representatives of the populace in state and local government do not follow, in budgetary terms at least, the will of the electorate.”²⁷ On the other hand, Dahlby argues that a large flypaper effect indicates that a subnational government has a high marginal cost of funding and only provides correspondingly low levels of public services. Given these circumstances, a higher transfers to subnational jurisdictions could be

²⁶ See Spahn 2000, p. 7.

²⁷ Oates 1994, p.135.

welfare improving if the central government has a lower marginal cost of funding than the subnational governments.²⁸

Nevertheless, even when flypaper effects can be empirically identified which might be true for the German situation - seen before the background of a failure in the public choice mechanism - there are still difficulties in determining whether or not their causes are malign or not. Or, to put in other words, there are also strong arguments against the existence of flypaper effects, e.g. the fact that a dollar must be raised for a dollar to be spent and this is a political question of marginal funding decisions. This leads to the conclusion that a high level of unconditional grants – ‘vertical fiscal imbalance’ necessarily causes a failure of public choice mechanisms is difficult to support as a general proposition.

However, the developments discussed in this paper provide an interesting case study of the problems arising from sub-national governments pursuing different policy objectives, which might explain that State governments use earmarked grants as an instrument either to reach statewide policy goals or to internalize external effects. As an actual example that fits into the discussion the distribution of the federal stimulus money to the state and local level should be further analysed.

²⁸

See Dahlby 2009.

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