

# Contents

## Part I Fiscal Federalism in Germany

1	The Theory of Fiscal Federalism	27
1.1	The First Generation Theory	28
1.1.1	Normative Vertical FGT: Efficient Competence Allocation	29
1.1.1.1	The Decentralization Theorem	29
1.1.1.2	Optimal Jurisdictional Size	34
1.1.1.3	Interjurisdictional Spillovers and Intergovernmental Grants	35
1.1.1.4	Institutional Congruence	37
1.1.2	Positive Vertical FGT: Competition among Tiers	38
1.1.3	Normative Horizontal FGT: Locational Efficiency	39
1.1.4	Positive Horizontal FGT: Competition among Jurisdictions	40
1.1.5	Summary	43
1.2	The Second Generation Theory	44
1.2.1	Main Principles	45
1.2.1.1	Methodological Individualism	45
1.2.1.2	Transaction Costs	46
1.2.1.3	Property Rights	47
1.2.1.4	Agency Costs	48
1.2.1.5	Incomplete contracts	50
1.2.2	The 'Industrial Organization' of States	51
1.2.3	Federal Governance	53
1.2.4	Normative Vertical SGT: Accountability and Innovation	54
1.2.4.1	Accountability and Spillovers	54
1.2.4.2	Innovation	56
1.2.5	Positive Vertical SGT: Yardstick Competition	58
1.2.6	Normative Horizontal SGT: Coasian Contracts	59
1.2.7	Positive Horizontal SGT: Yardstick Competition	60
1.2.8	Summary	63
1.3	Interim Summary: Towards Evolutionary Federalism	64
2	The German Federal Fiscal Constitution	66
2.1	Federalism in the Basic Law	69
2.2	Principles of Vertical Federalism in Germany	70
2.2.1	Three-tiered system	70
2.2.2	Division of competences	71
2.2.2.1	Legislative	71
2.2.2.2	Executive	72
2.2.2.3	Judiciary	73

2.2.3	Vertical Federal Solidarity	74
2.3	Principles of Horizontal Federalism in Germany	74
2.3.1	Equality of the Länder	75
2.3.2	Horizontal Federal Solidarity	75
2.4	The Fiscal Constitution	76
2.4.1	The Vertical Dimension	76
2.4.1.1	The Principle of Connexity	76
2.4.1.2	The Principle of Budgetary Autonomy (Art. 109 GG)	78
2.4.1.3	The Division of Fiscal Competences (Art. 105 GG)	78
2.4.1.4	Borrowing Restrictions (Art. 115 GG)	85
2.4.2	The Horizontal Dimension	85
2.4.2.1	The Länder level: Interstate Equalization	85
2.4.2.2	The Municipal Level: Intrastate Equalization	86
2.5	No Bankruptcy of Corporations under Public Law	88
2.6	The Recent Debate about Germany's Fiscal Constitution	89
2.6.1	Centralization	90
2.6.2	Institutional Incongruence	91
2.6.3	The Soft Budget Constraint	92
2.6.4	Incentive Distortion: Inter- and Intrastate Equalization	94
2.7	Interim Summary: German Federalism – Stable, Static and Stagnating	95

## **Part II**

### **Soft Budget Constraints in German Fiscal Federalism**

3	The Soft Budget Constraint: Theory and German Practice	99
3.1	The Soft Budget Constraint: Definition and Rationale	100
3.2	The Government-Induced Soft Budget Constraint	103
3.2.1	The Bailout Game	104
3.2.2	The Political Economy of a Bailout	110
3.2.2.1	The Model	112
3.2.2.2	Systemic Relevance	113
3.2.2.3	Deficit Sensitivity	114
3.2.2.4	Return on Political Investment	118
3.2.2.5	Two Fictitious Calculations	122
3.3	The Market-Induced Soft Budget Constraint	127
3.4	Soft Budget Constraints in Practice	130
3.4.1	International Financial Crises	131
3.4.2	Financial Crises in Germany	132
3.4.2.1	Federal Tier: Sovereign Bankruptcy	133
3.4.2.2	Länder Tier: State Bankruptcy	133
3.4.2.3	Municipal Tier: Municipal Bankruptcy	135
3.4.3	Bailout Expectations in German Federalism	136

3.4.3.1	The German Länder	137
3.4.3.2	Municipalities in the German Länder	141
3.4.3.2.1	Calculation for Brandenburg (with and without Berlin)	143
3.4.3.3	Application to the Private Sector: Firm and Bank Bailouts	145
3.5	Interim Summary: Size Matters	145
4	Fiscal Governance and the Soft Budget Constraint	148
4.1	Corporate Finance vs. Public Finance	149
4.1.1	Corporate vs. Public Sources of Finance	149
4.1.2	Corporate vs. Public Financial Management	152
4.1.3	Summary: Similarities and Differences	156
4.2	The Subnational Government as a Firm	156
4.2.1	The Separation of Ownership and Control	157
4.2.2	The Agency Costs of Equity: Overinvestment	158
4.2.3	The Separation of Liability and Control	160
4.2.4	The Agency Costs of Debt: Underinvestment and Overborrowing	161
4.2.5	Summary: The Equivalence of Firms and Governments in Germany	164
4.3	Five Devices of Corporate Governance	165
4.3.1	Corporate Governance: Definition and Rationale	165
4.3.2	Reward regimes	166
4.3.2.1	Bonuses	167
4.3.2.2	Stock Options	167
4.3.3	Ownership regimes	167
4.3.3.1	Dilution	168
4.3.3.2	Concentration	168
4.3.4	Control regimes	169
4.3.5	Liability regimes	170
4.3.6	Regulatory regimes	171
4.4	Five Devices of Fiscal Governance	172
4.4.1	From Corporate Governance to Fiscal Governance	172
4.4.2	Fiscal Governance: Definition and Rationale	173
4.4.3	Reward regimes	175
4.4.3.1	Performance-based bonuses	175
4.4.3.2	Rating-based bonuses	175
4.4.4	Ownership Regimes	176
4.4.4.1	Dilution	176
4.4.4.2	Concentration	177
4.4.5	Control Regimes	178
4.4.5.1	Coalition Decision	178
4.4.5.2	Parliamentary Impeachment	179

4.4.6	Liability Regimes	179
4.4.6.1	Receivership	180
4.4.6.2	Bailout	181
4.4.6.3	Public Bankruptcy	182
4.4.6.4	Abolition of Debt Financing	183
4.4.7	Regulatory Regimes	184
4.4.7.1	‘National Stability Pact’	185
4.4.7.2	Constitutional Debt Brake	186
4.4.7.3	Balanced Budget Rule	186
4.4.7.4	Lending Ceilings	187
4.5	Interim Summary: Agency Cost-Effective Governance	188

**Part III**  
**The Political Economy of Soft Budget Constraints**  
**in German Fiscal Federalism**

5	Fiscal Governance in a Three-Tiered System	191
5.1	Generally Desirable Measures	192
5.1.1	Reward Regimes: Performance-Based Pay	192
5.1.2	Control Regimes: Coalition Decision and Impeachment	192
5.2	Measures to Harden Soft Budget Constraints	193
5.2.1	Ownership Regimes: Reform of Political Geography	193
5.2.2	Liability Regimes: Alignment of Liability and Control	195
5.3	Six Reform Scenarios	195
5.4	Interim Summary: Good Fiscal Governance	197
6	The Political Economy of Fiscal Governance in Germany	198
6.1	Constitutional Change in Germany	198
6.1.1	Federal Reform Commission II	199
6.1.2	Party Positions	201
6.1.3	Reform of Federal Political Geography	201
6.1.4	Reform of Municipal Political Geography	203
6.1.5	Alignment of Liability and Control	203
6.2	Public Choice Analysis	204
6.2.1	Spatial Voting Models	205
6.2.2	The Political Economy of the Alignment of Liability and Control	206
6.2.3	The Political Economy of a Reform of Federal Geography	208
6.2.4	The Results of the Federal Reform Commission II	208
6.3	Interim Summary: Germany’s Agency Cost-Ineffective Federalism	209
	Concluding Remarks	211
	Literature	215