

**Federalism and Its Discontents:
Fiscal and Legislative Powersharing in Germany,
1948-1999**

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Abstract: The division of fiscal and legislative responsibilities forms the backbone of every federal constitution. Germany has attracted attention as one of the clearest examples of “cooperative federalism” and, recently, as a locus of debates about more competitive routes to organizing federal systems. This article examines trends since 1948 that centralized legislative competencies and heightened the sharing of financial burdens. The unidirectional dynamic in these reforms – underscored by failed attempts at devolution in the 1980s and 1990s – is explained by focussing on politics in the *Bundesrat*, the second house in the German Parliament, in which state governors are seated. “Federalism” policies position the rich states against the federal government; any majority to change the system must be built with poor states’ votes. The poor states, likely losers of competition among jurisdictions, vote for financial solidarity and centralized policymaking but against devolution. The article predicts a continuation of the problematic status quo, and concludes by contrasting two evaluations of Germany’s failure to achieve a more “competitive federalism.”

¹ This project was made possible by the Deutsche Akademische Austausch Dienst (DAAD), the Deutsche Gesellschaft für Auswärtige Politik (DGAP), and the Institute for Intergovernmental Studies (IGS) at the University of California – Berkeley. The support is gratefully acknowledged. I wish to thank for their productive comments Ernie Haas, Jonah Levy, Frank Nägele, Wolfgang Renzsch, Fritz Scharpf, Hal Wilensky, Sarah Wiliarty, Dan Zibblatt, Nick Ziegler and John Zysman. Sincere gratitude goes also to the many interviewed officials who gave generously of their time and expertise, and who remain anonymous. Faults that remain are the author’s.

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The constitutional division of fiscal and legislative responsibilities forms the backbone of every federal system. German federalism has attracted attention because it represents one of the clearest and, until recently, one of the most successful examples of “cooperative federalism:” tax resources are shared equitably between levels of government and across regions, while policy is made by the federal and state governments jointly rather than autonomously. Since unification in 1990 Germany’s cooperative federalism has been regarded with increasing skepticism in part because the poor incentives it creates for policymakers are said to contribute to the country’s lackluster economic performance. As such, developments in German federalism are related to a larger debate about “competitive” routes to organizing federal structures, a debate dominated by those who argue that cooperation among jurisdictions is the best guarantee that policies are made well and democratically.²

Despite growing dissatisfaction, attempts to transform Germany’s “cooperative federalism” into “competitive federalism” by giving lower level governments hard budget constraints and more policy autonomy have never succeeded. Recurrent tensions between the strong states (or *Länder*), weak states, and the federal government (or *Bund*), have lent a certain dynamism to the federal relationship, requiring constitutional changes in every decade since the founding of the Federal Republic. The inability of the weakest to fulfill the role reserved for them led to a centralization of fiscal and legislative responsibilities through the 1970s. The resultant centralization then received round criticism from independent academics and analysts in all the major parties. Yet all attempts in the 1980s and 1990s to translate these criticisms into concrete devolution failed, despite the seriousness of the problems and the political clout of the reform

² Barry R. Weingast, “The Economic Role of Political Institutions: Market-Preserving Federalism and Economic Development,” *Journal of Law, Economics, and Organization* 11, no. 1 (1995): 1-31; Charles M. Tiebout, “A Pure Theory of Local Expenditures,” *Journal of Political Economy* 64, no. 5 (Oct. 1956): 416-24; William H. Riker, *Federalism: Origin, Operation, and Significance* (Boston: Little Brown, 1964); Wallace Oates, *Fiscal Federalism* (New York: Harcourt, Brace, Jovanovich, 1972); Daphne A. Kenyon and John Kincaid, eds., *Competition among States and Local Governments: Efficiency and Equity in American Federalism*, (Washington, DC: Urban Institute Press, 1991).

proponents. The article explains these changes in competencies, which are discussed with the following labels: fiscal devolution (state level responsibility) contrasts with burdensharing or solidarity (pooled responsibility); legislative devolution contrasts with centralized- or joint-decisionmaking.

Most explanations for the lack of fiscal and legislative devolution in Germany center on three variables: party politics, consensus norms, and predilections for solidarity rooted in either historical memory or political culture. This paper, in contrast, focuses on the politics of the *Bundesrat*, the second house of Parliament in which each of the state governor's offices is represented. I argue that the *Bundesrat* majorities required to change laws defining German federalism cannot be built without the votes of the poor states. These states will not support devolution because they understand they are the likely losers in a competition of jurisdictions against states with greater resources. The poor states do vote for policy proposals that centralize financial burdens or those that, by standardizing regulations across the nation, prevent the richer states from outperforming the rest. In short, I argue that the only reforms to the federal system that will be approved by the *Bundesrat* are those that embrace solidarity and centralization. Section one of the paper reviews existing explanations. Sections two and three apply the argument to developments in legislative competencies and tax revenue equalization policies since the founding of the Federal Republic. The possibility that an external actor may compel *Bundesrat* decisionmakers to endorse devolution is discussed in light of the Federal Constitutional Court's 1999 rulings on the equalization policy. The conclusion presents a synthesis of current dissatisfactions with German federalism before raising the question of how to interpret, from a normative standpoint, the very likely continuation of this status quo.

Section One: Existing Explanations.

The failure of federal reform in post-unification Germany is, from the *Economist's* or the *Financial Times'* perspective, hardly surprising. Sclerotic Germany, after all, is reputedly incapable of reform: shopping is still not permitted on Sundays, the "bloated" welfare state has proven resistant to slimming attempts by both the Christian Democrats and now the Social Democrats, and employment regulations are still among

the most rigid in Europe. The lack of reform in the policies defining German federalism in the 1990s contrasts starkly, however, with policy innovations in biotechnology and venture capital promotion that have transformed Germany from a laggard to a leader in Europe.³ Similarly, the lack of federal reforms in the 1990s contrasts with the large scale reforms to these very policies in the 1950s and 1960s, and especially in 1969. These reforms increased centralization (or “joint decisionmaking”) by transferring more competencies and financial responsibilities to the federal level – to either the *Bund* or to the *Bundesrat*. The reforms increased solidarity (or “burdensharing”) by raising the level of transfers from rich to poor states and by making more and more financial obligations into joint rather than individual state responsibilities. In contrast, the reforms proposed in the 1990s were aimed at devolution and a reduction of solidarity. The puzzle emerging from the events of the 1990s, therefore, is the failure a certain kind of reform – reforms that devolve responsibilities to the *Länder* and that reduce the complicated interlocking of fiscal and legislative competencies among levels of government.

To explain the solidaristic bent to German policymaking, analysts have looked to history, to decisionmakers’ individual and collective memory of the tragedies that have occurred in Germany when economic disparities were too great. Germans have learned through suffering to value solidarity, it is argued, so that in the postwar period they continue to support, even at considerable expense, the sharing of burdens.⁴ Yet it is difficult to make a compelling case for the causal role of historical lessons. The Germans also learned lessons about the dangers of centralization during the Nazi years, yet these lessons seem not to impact current policy decisions. Without this careful analysis of the structures anchoring specific lessons to outcomes, “memory” seems a less than convincing causal explanation for developments in federal relations.

Another common explanation for the success of reforms in the 1960s and their failure in the 1990s is party politics. The Grand Coalition of the 1960s, it is argued, made

³ Karen Adelberger, “Semi-Sovereign Leadership? The State’s Role in German Biotechnology and Venture Capital Growth,” *German Politics* [forthcoming, 2000].

⁴ Michael Mertes, “Germany’s Social and Political Culture: Change Through Consensus?” *In Search of Germany*, eds. Michael Mertes, Steven Muller, Heinrich August Winkler (New Brunswick: Transaction Publishers, 1996), pp. 6-8. Intelligent essays to explain German foreign policy with memory include Thomas Banchoff, *The German Problem Transformed: Institutions, Politics, and Foreign Policy, 1945-1995* (Ann Arbor: University of Michigan Press, 1999); and Andrei S. Markovits and Simon Reich, *The German Predicament: Memory and Power in the New Europe* (Ithaca: Cornell University Press, 1997).

possible agreement on thorny reforms, agreement that was blocked by the gridlock of divided government in the last period of the Kohl government. It makes sense to argue that, when the opposition controls the *Bundesrat*, difficult reforms become nearly impossible. Yet there have been other periods when both houses of Parliament (meaning in practice the *Bundesrat* and the federal government) were governed by the same coalition. Consider, for example, the Christian-Liberals' dominance during parts of the 1980s and again during parts of the 1990s. Yet reforms to the federal system proposed first by the federal government and then by the *Länder* at these times failed.⁵ They failed because, even when united by a national party, decisionmakers may be divided by economic and institutional interests. On some issues, particularly those that redistribute responsibilities among governments, the *Bund*, the strong *Länder*, and the weak *Länder* will have divergent preferences, regardless of the party composition of the government at their helm.

Consensus decision making is perhaps the most common explanation for solidaristic and centralizing outcomes in German policy. Analysts argue that in decision arenas governed by consensus rules, negotiations to change policy must continue until all participants are satisfied in order to prevent vetoes. As a result, attention is paid to all decisionmakers, and not only the strongest coalition's wishes. And in decision arenas that include both the federal and the state governments, it is very often the federal government that extends financial incentives to secure the consent of the otherwise unsatisfied, leading to a centralization of both expenditures and decisionmaking powers.

The trouble with this explanation is empirical: does a norm of consensus exist, and does it have enough force to shape policy outcomes as predicted? Analysts divide on what exactly generates the consensus rule. Roland Sturm considers the norm of consensus to be culturally generated: Germany is a consensus-seeking society.⁶ Peter

⁵ Charlie Jeffery and John Yates, "Unification and Maastricht: The Response of the *Länder* Governments," *German Politics* 1 (Dec. 1992), pp. 58-81 at p. 64 examine the federal government's attempt in the 1980s to devolve the Joint Tasks back to the *Länder*. Wolfgang Renzsch, *Finanzverfassung und Finanzausgleich. Die Auseinandersetzung um ihre politische Gestaltung in der Bundesrepublik Deutschland zwischen Währungsreform und deutscher Vereinigung (1948 bis 1990)* (Bonn: Dietz, 1991), at p. 224 writes that in 1969 debates on the Joint Tasks, lines of conflict divided politicians of the same party based on their affiliation with the federal or state governments.

⁶ Roland Sturm, "Continuity and Change in the Policy-Making Process," *Developments in German Politics* 2, eds. Gordon Smith, William E. Paterson and Stephen Padgett (Durham, NC.: Duke University Press, 1996), pp. 117-132, esp. p. 120.

Katzenstein observes that in some cases, the norm is embodied in law, for example in Federal Constitutional Court mandates about decisionmaking in the “Joint Tasks” as enumerated in Art. 91a of the Basic Law. Wolfgang Renzsch and Fritz Scharpf maintain that a consensus norm (at least among the *Länder*) emerges as rational actors reiterate games: the *Länder* realize unanimity is in their interest, for only united can they counterbalance the *Bund* in decision fora in which the federal government and states are joined.⁷

In the decision arena in which changes to legislative competencies and the financial equalization arrangement are adjudicated, however, consensus decisionmaking is neither necessary nor normal.⁸ These policies are made in the country’s most important joint decision arena, the *Bundesrat* or second house of Parliament in which each of the states is represented by its governor or minister president. Only a simple majority in the *Bundesrat* must agree with the federal government to pass bills into law; two-thirds majority is necessary to amend the constitution. That majority and not consensus is the operative voting rule is clear from the attention paid by party strategists and political pundits to *Land*-level elections determining the majority party in the *Bundesrat* – even though straight party voting only sometimes occurs (the Minister Presidents represent their *Länder*’s specific interests which may contradict national party platforms). In short, *Bundesrat* decisions need only a simple majority, yet they too yield policies that are centralizing and solidaristic. Something other than the mechanism of consensus decisionmaking must therefore account for these outcomes.

As a final alternate explanation, the constitutional requirement that policies achieve an equalization of living conditions throughout the country deserves mention. By itself, this requirement cannot explain the solidarity-enhancing and centralizing tendencies. The income differentials tolerated within the definition of “equalized”

⁷ Peter J. Katzenstein, *Policy and Politics in West Germany: The Growth of a Semisovereign State*. (Philadelphia: Temple University Press, 1987), p. 52; Fritz W. Scharpf, “Die Politikverflechtungs-Falle: Europäische Integration und deutscher Föderalismus im Vergleich,” *Politische Vierteljahresschrift*, (1985), pp. 323-356; Wolfgang Renzsch, “Einheitlichkeit der Lebensverhältnisse oder Wettbewerb der Regionen?” *Staatswissenschaften und Staatspraxis* 8, no. 1 (1997): pp. 87-108. Renzsch also argues that because *Bundesrat* representatives are higher-ups in national parties, they need to find policies that are vote-getters across the country, moderating what might otherwise be more pronounced regional self-interest.

⁸ During the 1970s, the *Länder* fairly successfully abided by an informal consensus norm. In the 1980s and 1990s, as economic discrepancies widened, the norm eroded. The *Länder*’s (varying) adherence to consensus decisionmaking simply cannot explain the constant direction of reforms across time.

conditions is politically determined, and increased burdensharing has occurred because the *Bundesrat* adjusted the definition, repeatedly, upwards. Further, the proposed reforms in the 1990s failed because they were unable to secure a majority among the *Länder*, and not because of a threat of a challenge by the Federal Constitutional Court (*Bundesverfassungsgericht*). In fact, a late 1990s Federal Constitutional Court decision may compel lawmakers to reduce equalization policies, a possibility considered below. The Constitutional Court's equalization requirement does not cause solidarity, but it does limit the range of acceptable solutions.

I argue that three propositions about *Bundesrat* politics shape federal reform in Germany, accounting for the trend toward ever more burdensharing and centralization. Before stating these propositions, however, their applicability needs to be bounded. First, they apply to policies made in *joint decision arenas* governed by majority rule in which all the state governments as well as the federal government are seated. The best example are laws requiring *Bundesrat* consent. Second, the propositions apply to *policies* of only one type – those that redistribute a fixed array of responsibilities and benefits among decisionmakers. Policies of this type create mutually exclusive preferences for the *Bund* and the strong *Länder*, defined as *Länder* with above average financial capacity. For example, the strong states and the federal government want to maximize the areas of legislation in which they are permitted to be active – but, as the federal government's role increases, the areas in which the states can act autonomously decrease, and vice-versa. The weak states, those with below average financial capacity, are not committed to states' legislative autonomy: they are happy to share decisionmaking authority with the federal government to secure financial assistance. Elsewhere, I examine policies adjudicated in other types of decision arenas (unilateral decision arenas), and policies of other types, such as those that distribute joint resources to non-decisionmakers (e.g. subsidies to the private sector). These kinds of issue areas are characterized by different politics, and lead to different outcomes including devolution (as opposed to centralization) and meritocracy (as opposed to solidarity).⁹

⁹ Karen Adelberger, *Structuring Innovation: Decisionmaking Arenas and Economic Policy Reform in Germany*, Dissertation, UC Berkeley, Berkeley, CA: forthcoming.

My approach focuses on the construction of majorities in the *Bundesrat*. The argument has three elements. First, policies defining the federal system always position the strong states against the federal government. For example, the strong states and the federal government want to maximize the areas of legislation in which they are permitted to be active – but, as the federal government’s role increases, the areas in which the states can act autonomously decrease, and vice-versa. In contrast, the weak states are not committed to states’ legislative autonomy: they are resigned to share decisionmaking authority with whichever level of government extends financial assistance. In short, the federal government and the strong states have conflicting preferences, and meet in a decision arena – the *Bundesrat* – requiring a majority.

The consequence, my second point: small states play a kingmaking role. As a result of regional disparities creating more weak states than strong, neither the federal government nor the strong states can build a majority for their legislation without the support of the weaker states. Reforms to the federal division of fiscal and legislative rights must therefore satisfy the weakest states.¹⁰

My third argument is that weak states support burdensharing and, less obviously, centralization. Centralization, or nationally standardized policies, stands for uniformity in outcome across the country. Devolution, in contrast, implies a competition among regions, or at least permission for the strong states to excel by pursuing policies only they can afford. Thus, given the kingmaker role of the small states, devolution and decentralization are unlikely. In short, I argue that on decisions that re-adjust shares of financial and legislative responsibility, the *Bundesrat* will only initiate and approve changes from the status quo that increase legislative centralization and financial solidarity. For devolution to occur, lawmakers will either need to be compelled by an outside actor (such as the Federal Constitutional Court) or, a much more difficult challenge, they will need to re-consider their socially constructed understandings of the consequences of “competition” and “differentiated outcomes.”¹¹

¹⁰ On issues that do not create mutually exclusive preferences for different levels of government, party politics become much more important. For example, in education reforms, party politics and not level-of-government structures lines of conflict and coalition.

¹¹ I thank Charlie Jeffery for reminding me of this possibility.

Section Two: Division of Legislative Competencies.

The politics of the division of legislative competencies is not, unexpectedly perhaps, driven by a desire of the various levels of government to avoid costs. A return of lawmaking competencies to the state governments will not directly raise their expenses: in Germany's "functional" federalism, the states and not the federal government are obliged to implement – which means paying the costs of – both state and federal laws. Almost all federal laws are unfunded mandates,¹² so regardless which level of government legislates, the states pay. Devolution does not directly affect the financial obligations of the states. The politics of re-dividing legislative competencies revolves instead around competition between *Bund* and *Länder* over the power to legislate policies that help win elections, and disagreement between the strong and the weak *Länder* about the price worth paying for *Land*-level autonomy.

In 1948, the Minister Presidents of the German states met to sign a Basic Law creating a federal government in the tri-zone. These Minister Presidents represented states with functioning governments legitimated by existing constitutions, and had no interest in drafting away a majority of their rights to the federal government they were creating. Moreover, they worked under the watchful eyes of the Allies, intent on preventing a strong national government from arising on the ashes of Nazi Germany. The drafters of the Basic Law thus granted wide-reaching legislative prerogatives to themselves. All powers not expressly given to the federal government were reserved for the states, or labeled areas of "concurrent jurisdiction" in which the *Bund* might legislate only if federal law were demonstrably necessary to achieve uniformity in markets and living conditions (note that, unlike "concurrent jurisdiction" in the United States, in Germany only one level of government may legislate on these issues).

The *Länder* were not equally capable of accepting these considerable responsibilities. The devastation of war left all states fairly weak, but the ensuing territorial re-division created states of very unequal resources. As a result, the 1948 division of legislative competencies proved hard to maintain, as can be seen in a brief

¹² There are two (limited) exceptions: (1) when federal laws extend grants to the *Länder*, they may be funded in part or entirely by the *Bund*, and (2) when the states act as *formal* agents of the federal government in carrying out laws the *Bund* may pay (the *Länder* usually implement all laws but with enough

overview of the research promotion policy – a story mirrored in areas from regional economic promotion to the construction of hospitals.

The basic law reserved research promotion for the *Länder*, with a role for the future federal government only in very large science requiring specialized, expensive apparatuses. The states thus had to fund the existing research infrastructure: several independent labs, nationally linked institutes such as the Max Planck Society, and the German equivalent of the National Science Foundation, or the *Deutsche Forschungsgemeinschaft*. With the 1949 “Königsteiner Accords,” the *Länder* committed themselves to paying, individually, for those labs within their borders, except for those belonging to the national societies, which were to be financed by the *Länder* cooperatively (largely according to population). The agreement – expensive for the populous *Länder* – was reached relatively easily as a result of their desire to leave no opening for the *Bund*’s involvement. The Accords also explicitly forbade institutes that received state funding from receiving federal money.

In the 1950s, the “economic miracle” blessed some states more than others, while the *Bund* benefited greatly from the upswing in its revenue from consumption taxes. The *Bund* became interested in steering the research promotion agenda in the institutes financed and directed by the *Länder*. In 1952, the federation introduced a bill meant to clarify – read “enlarge” – its role in research promotion. The states objected, as they did in 1954 to the Max Planck Society’s suggestion that the federal government become a co-financier. Despite their general opposition to the *Bund*’s involvement, however, the weaker *Länder* were interested in sharing some of their research-related expenditures with the federation. Particularly tempting was the federation’s DM 7 billion “Juliusturm” fund accumulated to pay for a continually delayed rearmament. Although the constitutionality of the *Bund*’s role was questioned by the courts, the *Länder* pushed for federal support. The richer states hoped to prevent a “fire sale” of their competencies by the poorest, yet were unwilling to provide comparable financial support. Instead, they decided their best approach was the creation of joint decision forums: joint decision forums would force the *Bund* to bargain with all the states over policy changes in those

latitude that they are also expected to finance them). An example of (2) is the building of freeways – although even here administrative costs of managing freeways are borne by the states.

areas in which it was becoming financially involved. This strategy was formalized in the 1964 Administrative Accords between the states and the federal government. Once the *Bund* achieved an official voice in research policy, the larger *Länder* quickly realized it made no sense continuing high levels of cooperative funding – the incentive of preserving state policy competencies no longer existed. Instead, the *Länder* began viewing the *Bund*'s participation as a route for reducing their budgets.¹³

A similar pattern was evident in regional policy, and to a certain extent hospital construction, agriculture, and coastal protection. The *Länder*'s ability to resist federal encroachment was only as strong as the weakest's commitment to autonomy, resulting in a strategic preference for joint decision fora. These decision arenas institutionalized the *Bund*'s participation, giving federal decisionmakers a 50 per cent vote in exchange for federal funding for at least half the policy's total costs. They also ensured that future negotiations between state and federal governments would not occur bilaterally, but at one table giving the *Länder* a counterbalance to the organizational and financial dominance of the *Bund*.¹⁴ In 1969 constitutional reforms transferred decisionmaking power up to joint arenas by creating Joint Tasks (Articles 91a and b) – although in far fewer areas than originally proposed by the *Bund*.

The rest of the 1970s brought no significant changes in constitutional division of legislative competencies. Yet centralization continued, driven by two other trends. The *Bund* made full use of the “necessary clause” in areas of concurrent legislation – the areas of law reserved for the *Länder* unless a clear federal role were necessary to achieve standardized living and market conditions across the country. Within a few decades, federal legislators had succeeded in turning all de jure concurrent legislation into de facto *Bund* competencies, because – and this is crucial – once the *Bund* legislated, the *Länder* were no longer entitled to enact *Land*-level solutions. The imbalance between the *Bund*'s competencies and the *Länder*'s became even larger as European integration quickened in the 1980s. The transfers of domestic policymaking to Brussels, often in

¹³ Hans-Willy Hohn and Uwe Schimank, *Konflikte und Gleichgewichte im Forschungssystem: Akteurkonstellationen und Entwicklungspfade in der staatlich finanzierten außeruniversitären Forschung* (Frankfurt/Main: Campus Verlag, 1990), pp. 43-4, 102-132, 144-5.

¹⁴ On the Joint Tasks, see Fritz W. Scharpf, Bernd Reissert, and Fritz Schnabel, *Politikverflechtung: Theorie und Empirie des kooperativen Föderalismus in der Bundesrepublik* (Kronberg/Ts.: Scriptor Verlag, 1976); Renzsch, 1991, pp. 223-227.

areas of *Länder* jurisdiction, meant that the federal government became responsible for defining Germany's preferences on several *Land*-level issues.

By the 1980s there existed clear dissatisfaction with the centralizing trend. The states – including the weaker – complained bitterly about the reductions in their areas of legislative competencies. And independent analysts criticized the consequences. Joint decision arenas were said to restrict policy outputs to the *status quo* (the default solution if no “consensual” alternative can be found¹⁵) or to those changes made acceptable to all parties, often through special line-item “bribes” to the dissatisfied. The policies emerging can rarely be the most appropriate responses to changing real-world problems. Yet, because they have committed themselves to joint responses, individual *Länder* have forfeited the right to legislate solutions for their own *Land* that would be more appropriate. Caught in a “joint decision trap,” they are unable to exit this suboptimal policy world.¹⁶ The centralization also undermined the democratic prerogatives of the state parliaments, as more and more laws were made by the federal government, or by the states' executive branches via the *Bundesrat*.¹⁷ While federalism should provide the benefits of diversity and dynamic competition, in Germany, it produced a narrower and narrower range of regional variation.¹⁸

By the late 1980s, the states began an effort to “roll-back” and “rein-in” the federal government.¹⁹ They aimed to regain competencies “colonized” by the *Bund* in concurrent domestic law and EU policy, to (re)create a clearly defined catalogue of competencies which would be reserved for the *Länder*, and to bolster co-determination procedures by which the *Länder* help shape federal and European policy. Their approach

¹⁵ Consensus is, however, neither necessary nor normal in the *Bundesrat*.

¹⁶ Scharpf, 1985.

¹⁷ Heinrich A. Große-Sender, ed., *Report of the Commission “Erhaltung und Fortentwicklung der bundesstaatlichen Ordnung innerhalb der Bundesrepublik Deutschland – auch in einem Vereinten Europa”* (Düsseldorf: Landtag Nordrhein-Westfalen, 1990); cf. Heiderose Kilper and Roland Lhotta, *Föderalismus in der Bundesrepublik Deutschland: Eine Einführung* (Opladen: Leske & Budrich, 1996), pp. 151-203.

¹⁸ Renzsch, 1997, p. 93 calls this a “paradox” of German federalism.

¹⁹ Good overviews include Jeffery and Yates, 1992; Richard Deeg, “Germany's *Länder* and the Federalization of the European Union,” *The State of the European Union, (vol. 3), Building a European Polity?* ed. Carolyn Rhodes and Sonia Mazey (Boulder, CO: Lynne Rienner, 1995), pp. 197-220; Charlie Jeffery, “The Territorial Dimension,” *Developments in German Politics*, 2, ed. Gordon Smith, William E. Paterson, and Stephen Padgett, (Durham, N.C.: Duke Univ. Press, 1996), pp. 76-116; Hans-Peter Schneider, “German Unification and the Federal System: The Challenge of Reform,” *Recasting German Federalism: The Legacies of Unification*, ed. Charlie Jeffery (London: Pinter, 1999).

centered on strengthening the *Bundesrat* legally and procedurally.²⁰ They were unable to build majorities in support of devolution, but they all could agree to enhance the *Bundesrat*'s voice in German policy. The initiatives were spearheaded, however, by the strongest states – in particular Northrhine-Westphalia, Baden-Württemberg, Hesse, and Bavaria.²¹

By the late 1990s, what had become of the *Länder*'s “roll-back” and “rein-in” agenda? Those proposals intended to augment the *Länder*'s *collective* legislative rights vis-à-vis the *Bund* have been successful. Those intended to return responsibilities to the *individual* states have failed. By 1992, the states had secured a veto over further transfers of sovereignty to the European Union, and had more-or-less subjected Germany's European policymaking to the same procedural checks that obtained domestically. In fact, the *Bundesrat* can even provide the German national negotiator at certain bargaining tables. The states succeeded in large part because they made their ratification of the Single European Act and the Maastricht Treaty contingent on the success of these proposals. But the *Länder*'s ability to agree amongst themselves on a clear agenda was also necessary. Divided, their threat not to ratify the treaty would have been neither credible or practicable. Because the agenda emphasized cooperative rather than individual *Land* responsibility for policies, it presented a strategy that was as unobjectionable to the weak as to the strong. It achieved greater rights for the *Länder* without pursuing devolution, and provided the foundation for their common front vis-à-vis the *Bund*.

The *Länder*'s domestic lawmaking agenda met with more limited success. Potentially divisive issues like doing away with the Joint Tasks and identifying policies for return to individual *Land* jurisdiction – proposals the poor states felt would disadvantage them – were left off the dockets or postponed for a subsequent reform attempt. But lacking the leverage their threat to withhold ratification gave them over European issues, the states were unable to extract any but the most modest of

²⁰ The *Länder* also emphasized the value of European integration, requested that a Committee of Regions be formed at the EU level, and that the subsidiarity clause be strengthened. While the Committee was created, its impact has been slight; and the *Länder*'s solidarity clause preferences were largely ignored.

²¹ For the *Länder*'s initial preferences, see Kommission Verfassungsreform des Bundesrates, *Bericht: Stärkung des Föderalismus in Deutschland und Europa sowie weitere Vorschläge zur Änderung des Grundgesetzes*. (Bonn: *Bundesrat*, 1992).

compromises from the *Bund*. They were able to make it slightly harder for the *Bund* to justify its activities in areas of concurrent legislation by tightening the “necessary clause” (Art. 72, 2; Art. 93, 1, 2). And they formalized a procedure by which the states could call back areas of concurrent legislation to state level (Art. 72, 3; Art. 125a2).²²

The latter turned out to be a meaningless victory. The states have proven unable to find a majority supporting the return of any law to state competencies, from hospital financing, to construction law, welfare (*Bundessozialhilfegesetz*), gambling, and company incorporation and registration (*Grundbuchordnung*). In fact, after two years of discussion, a draft of a bill – sponsored by Bavaria – to “call back” competencies to the *Länder* was killed in committee. The official reason was that “national solutions remain more appropriate,” because they standardized procedures and outcomes across the *Länder*, and prevented duplication in administrative costs. The political reason was that a majority of states in the *Bundesrat* are poor and regard differentiated policy regimes as more disadvantageous than the *status quo* even when the reforms were anticipated to enhance efficiency.²³ Regardless whether the opposition was motivated by substantive or self-serving concerns, the contradictory behavior is clear. While all the states complain their rights have been usurped by the *Bund* and federalism distorted, a majority of the *Länder* yet opposes concrete proposals to devolve competencies and permit more state-level autonomy in policymaking.

In sum, fifty years of reforms and failed reforms reveal the following patterns. The *Bund* and the strong states are each interested in (acquiring and) keeping what were initially the *Länder*’s legislative areas. The *Bund*, bringing greater financial resources to the bargaining table, can almost always buy its way into legislative responsibilities poorer *Länder* cannot meet. The price the *Länder* seem to have extracted in exchange for

²² The *Länder* also successfully limited the *Bund*’s micromanaging of their administration of federal law by reforming the *Bund*’s “framework legislating competencies.” On the 1994 reforms, see Heinz Laufer and Ursula Münch, *Das föderative System der Bundesrepublik Deutschland* (Bonn: Bundeszentrale für politische Bildung, 1997), pp. 96-100; Rüdiger Sannwald, “Die Reform der Gesetzgebungskompetenzen nach den Beschlüssen der Gemeinsamen Verfassungskommission von *Bundestag* und *Bundesrat*,” *Die Öffentliche Verwaltung* 47:15 (Aug. 1994), pp. 629-637; Wolfgang Rensch, “‘Mit blauem Auge’...’ auf Grund gesetzt.’ Über den Zusammenhang von Staatsmodernisierung und Grundgesetzreform nach der deutschen Einheit,” *Politische Bildung* 28: 2 (1995), pp. 7-27.

²³ The proposed amendment is published as *Bundesrat Drucksache 77/98* (Jan. 1, 1998) “Entwurf eines Gesetzes zur Umsetzung des Artikels 125a2 des Grundgesetzes.” Information about committee decisions from interviews B081398.1, L090898.1, and an unpublished *Bundesrat* document, on file with author.

“letting the *Bund* in” is a multilateral forum in which they meet the federal government *en masse*, thus shaping the path to centralization. In contrast, the opposition of the weakest *Länder* and the *Bund* to devolution has prevented any meaningful return of lawmaking prerogatives to the individual states. The furthest devolution is likely to go is to recall competencies from the *Bund* and return them to the *Bundesrat*.

Section Three: The Burdensharing Arrangement, or The Fiscal Equalization Scheme.

Germany is the only federal country in which fiscal disparities among states are ameliorated by transfers from richer states as well as the federal government. Currently over 75 percent of national tax income is shared between the federal and the state governments, prompting frequent and fractious bargaining over federal and state shares, and about how states’ incomes will be redistributed to bring each to at least 99.5 percent of the nationwide average per capita tax revenue. The equalization policy has been repeatedly criticized by independent economists including the OECD: it creates mammoth incentives for fiscal profligacy and none for good budgeting; it has failed to improve the long-term financial position of the states (only Bavaria has moved from recipient to payer status). And yet, although the policymakers concede the flaws, and only the weak states have a direct interest in the policy’s continuation, it has never been voted down or even scaled back. Instead, the “equalization” target has been raised every time it has been changed. From an initial target of 88.75 percent in the 1950s it has been raised to 99.5 percent, and with the rapid increase of federal transfers, many of the poor states’ coffers are filled to 120 percent of the average of all states. Even the expensive incorporation of five poor eastern *Länder* in 1995 – a moment of openness that many hoped would be used for fundamental policy reform – did not lead policymakers to reduce solidarity and joint decisionmaking.

From an American perspective, continued unquestioning support for financial equalization is puzzling if not bizarre. It would be as if Connecticut each year transferred millions of dollars of tax surplus to Mississippi and never once questioned the arrangement, only requested adjustments at the margin. In Germany, however, state and federal politicians take for granted that burdensharing is necessary. Because the *Länder*

must bear the costs of implementing federal as well as state laws, they have considerably less than full control of their outlays. Compensation for state-level civil servants (*Beamten*) is set nationally, for example. Moreover, the *Länder* lack the right to set their own tax levels. While the Constitution reserves for them the *income* from specific taxes, in most cases the rates must be set nationally (Art. 105). States in Germany thus lack full control over both their revenues and outlays; laws not of their own making force *Länder* into debt. The remedy is fiscal equalization: in 1995, for example, ten percent of total tax revenues was redistributed from rich to poor *Länder*, with an equal amount distributed from the *Bund* to the poor *Länder*.²⁴

Federal systems have twice been weakened in Germany because levels of government had insufficiently autonomous revenue sources to remain independent. In Bismarckian federalism after 1871, the *Reich* was dependent on the *Länder*, while during the Weimar Republic the *Länder* were dependent on the *Reich*.²⁵ Thus the Minister Presidents of the *Länder*, while drafting the Basic Law in 1948, pursued a clear division of resources between the federal government and the states. The *Länder* were given taxes with effects on localized regions – taxes on real estate, vehicles, inheritance, corporations and personal income. The *Bund* received the VAT and consumption taxes, and taxes with extra-regional effect including freight taxes and customs. Because many of the *Länder*'s taxes were relatively stable income sources, but the VAT and consumption tax revenues fluctuated with economic cycles, the Basic Law also gave the *Bund* the right to request shares of the *Länder*'s income and corporate taxes to cover essential expenditures. As a result of large differences in the *Länder*'s needs and revenues, a small degree of solidarity across *Länder* was also introduced, outside the Basic Law.

The states' commitment to financial independence was challenged in the 1950s. The *Bund*, regaining sovereignty, made requests for increasing amounts of the *Länder*'s

²⁴ *OECD Economic Surveys 1997-1998: Germany*, (Paris: OECD, 1998), p. 85, p. 87; Dieter Vesper, "Sind die Finanzprobleme in Ostdeutschland durch die Neuordnung des Finanzausgleichs gelöst? Zur Finanzlage der ostdeutschen *Länder* und Gemeinden," *DIW-Wochenbericht* 17 (1996: internet version), at tables 1-3. For an English-language overview of the current arrangement, see Arthur B. Gunlicks, "Financing the German Federal System: problems and Prospects," presented at the German Studies Association, Atlanta, GA, (Oct. 7-10, 1999).

²⁵ Ursula Münch, "Ergebnis deutscher Geschichte und mögliches Modell für Europa: Der Bundesrepublikanische Föderalismus," *Föderalismus und Zentralismus: Europas Zukunft zwischen dem deutschen und dem französischen Modell*, ed. by Günther Ammon, *et al.* (Baden-Baden: Nomos Verlagsgesellschaft, 1996), pp. 54-75 at pp. 58-62. pp. 54-75

revenues to cover its expanding agenda. At the same time, the states – especially the poorest – found the costs of implementing federal laws to be a growing burden. To take advantage of this, the *Bund* extended several categorical grants directly to the weaker *Länder*, linked to their support on other of the *Bund*'s bills in the *Bundesrat*.²⁶

Against the not infrequent cooperation of the *Bund* and the four poorer *Länder* (Lower Saxony, Rhineland-Palatine, the Saarland, and Schleswig-Holstein), the stronger *Länder* and Bavaria (not yet rich but deeply committed to states' rights) found their best strategy to be preemptive solidarity – to support financial burdensharing among the *Länder*. In 1955, not without self-interested bickering, the *Länder* expanded their financial equalization scheme to guarantee each at least 88.75 percent of the average per capita tax. It was a purely horizontal, or inter-*Land*, arrangement. Vertical payments (from the *Bund* to the *Länder*) had been considered and rejected, because the *Länder* anticipated the *Bund* would demand more of the *Länder*'s taxes to cover the transfers.²⁷

Over the next ten years, the congruence between the *Bund*'s expansive agenda and the poorer *Länder*'s financial need continued. It yielded a series of ad hoc federal spending bills in programs of interest to weaker regions, created inefficient competition for scarce private investment among these various *Land*-level programs, and increased the financial obligations borne by the *Bund* prompting perennial arguments about its share of the *Länder*'s taxes. By the mid-1960s, all parties were interested in a reform to the financial constitution. An apolitical commission under the leadership of Heinrich Troeger spent several years considering a workable reform to the financial articles of the Basic Law. It recommended that the revenue richest taxes (income, corporate, and VAT) become “Joint Taxes,” shared between the *Bund* and the *Länder*; that “Joint Tasks” be created in several areas of *Länder* competencies; and that the financial equalization scheme be revised. But questions about specifics remained.²⁸

²⁶ Rensch, 1991, Chap. 4, and esp. p. 128.

²⁷ Rensch, 1991, 130-169, esp. p. 150.

²⁸ The report is Kommission für die Finanzreform, *Gutachten über die Finanzreform in der Bundesrepublik Deutschland* (Stuttgart: Verlag W. Kohlhammer, 1966). An English-language overview of the reform process is Robert L. Rothweiler, “Revenue Sharing in the Federal Republic of Germany,” *Publius* 2:1 (Spring, 1972): pp. 4-25. Rensch, 1991, pp. 170-260, provides a perspective sympathetic to the *Länder*; (Federal Finance Minister) Franz Josef Strauss, *Die Finanzverfassung* (Munich: Günter Olzog Verlag, 1969) offers history from the federation's perspective at pp. 33-52; 68-158. See also *Stuttgarter Zeitung*, “Finanzschwache Länder...”, (May 31, 1969); *Frankfurter Allgemeine Zeitung*, “Bund und Länder streiten...” (May 31, 1969); *Stuttgarter Zeitung*, “Die Länder erhalten...” (13 June 1969).

Disagreement began over division of the VAT. The *Bund* claimed it needed 75 percent in the first year; the *Länder* claimed to need at least 31 percent or 32 percent. The *Länder* also disagreed amongst themselves about how much of their VAT should be redistributed to eradicate financial differences. After it became clear that the poor states lacked the two-thirds majority necessary to get need-based redistribution of all the VAT, they demanded bilateral federal transfers freed from any requirement for co-payments. The negotiations were deadlocked until the federal government offered vertical transfers without requiring matching contributions from the *Länder* (Art. 104) in exchange for the *Länder's* agreement to a smaller, 30% share of the VAT.²⁹

The *Länder* then agreed to a three stage equalization scheme (see Figure One). They would distribute a quarter of their VAT to bring all states to 92% of average per capita strength, then transfer tax “surplus” to bring the weakest to 95%, and finally permit federal transfers to the poorer states for particular needs.

In the final version of the reform, the *Bund*, which received less of the Joint Taxes than it wanted, did receive more stable revenue sources, to be adjusted according to need. Most importantly for the *Bund*, its active involvement had been officially sanctioned in areas of the *Länder's* competencies, through the Joint Tasks as well as the federal supplementary transfers. The richer *Länder* were able to keep a ceiling on their burdensharing obligations, and secured nearly as much VAT as they initially demanded. While the poor did not get the equalization they wished (of 97 to 99 percent), they did considerably better after the reforms than before. The equalization target was raised to at least 95 percent (from 91 percent); obstacles to receiving federal transfers were removed; and although only a quarter of the VAT was to be distributed by need, the redistribution of the remaining 75% on a per capita basis favored them (turnover tax revenues are lower in low-growth, poorer regions). In all, the outcome was remarkably favorable for the poorer *Länder* even though they were, at the time, in the absolute minority – the consequence of the *Bund's* interest in expanding its influence, the richer *Länder's* decision to accept some centralization in order to minimize increases in the financial obligations they assumed, and the need to secure a two-thirds majority in the *Bundesrat* to change the constitution.

²⁹ *Stuttgarter Zeitung*, “Die Länder erhalten...” (13 June 1969).

Figure One: The Stages of the Burdensharing Scheme in the FRG

Stage	Mechanism	Measure of financial strength	Goal and 1995 transfers.
One: horizontal	Redistribution among <i>Länder</i> of 25% of <i>Länder</i> 's share of VAT.	Per capita tax income, Excludes: VAT income, local governments' income, city-state population weighting.	All <i>Länder</i> should reach 92% of average income. Transfers: DM 16.5 billion
Two: horizontal	Cash transfers from richer to poorer <i>Länder</i> .	Per capita tax income, Includes: VAT income, 50% of local governments' income, and city-states' population weighted at 135%.	All <i>Länder</i> should reach 95% of average income. Transfers: DM 11.45 billion
Three: vertical	Cash transfers from <i>Bund</i> to poorer or needier <i>Länder</i> .	As in Stage Two.	Distribution of 1%-2% of <i>Bund</i> 's VAT until 1993; thereafter, all <i>Länder</i> guaranteed at least 99.5% of average income. Transfers: DM 4.8 billion
After the Equalization: vertical	Cash transfers from <i>Bund</i> to poorer or needier <i>Länder</i> .	Ad hoc determination of need.	Varies. Transfers: DM 20.3 billion, with nearly 2/3s going to eastern <i>Länder</i> , the rest to poorer western <i>Länder</i> .

Source: computed from Vesper, 1996, tables 1-3, and *Finanzbericht 1998*, p. 146.

This burdensharing arrangement remained essentially unchanged³⁰ in the period 1970 to 1995, not because all participants were satisfied, but because the *Länder* were unable to agree on the specifics of a reform, and the default option absent majority agreement to change policy was a tolerable fallback on the *status quo*. As economic fortunes diverged, the larger, richer *Länder* began to balk at the “confiscatory” level of transfers, at the yearly “tax” on doing well. Of particular irritation were the bloated population weightings for the city-states that give rich Hamburg and Bremen large net transfers each year. The fact that another perpetual recipient, Lower-Saxony, did not have to report its revenues from oil and natural gas extraction in the burdensharing calculations also caused friction, especially when the revenues ballooned after the 1973 jump in oil prices. The richer *Länder* repeatedly proposed changes that would have scaled back overall transfers. Negotiations among the *Länder*'s Finance Ministers never yielded a majority for a reduction in solidarity. Frustrated, in the 1980s the richer *Länder* sought to force change to the system by appealing to the Federal Constitutional Court,

which unleashed a round of self-serving lawsuits by several states. The Court's rulings in each case underscored the prevailing principle of solidarity among the *Länder* and brought no essential changes.³¹ The string of lawsuits emphasized, however, the *Länder's* inability, in decision arenas governed by majority voting, to devolve responsibilities and reduce solidarity. In contrast, they did build cross-party majorities leveraging additional contributions from the *Bund* in the late 1980s.³² After several years during which the *Bund's* contributions approximated 60% of the *Länder's*, by 1992 vertical transfers had become larger than horizontal. (The eastern *Länder*, it should be noted, were not incorporated into the burdensharing arrangement until 1995.)

It was clear as soon as Germany unified that adding five very poor *Länder* to the burdensharing arrangement would be extremely expensive. The question was, for whom? Both the federation and the rich states sought in 1993 to secure the weaker *Länder's* votes for proposals that would spare them from the burden. Federal Finance Minister Theo Waigel proposed that the new *Länder* be incorporated on particularly generous terms, financed to 75 percent by (some of) the western *Länder*. Moreover, the federal government's 25 per cent would be included as "essential expenditures," such that the coverage quota calculations would then require the *Länder* to give five percentage points of VAT back to the *Bund*.³³ The richer states then countered two months later with a Bavarian proposal that offered the poor states at least as much as the federal government had, but forced the federal government to absorb 90 per cent of the cost. (The western *Länder's* share of the net total costs generated by unification turns out, by one estimate, to be as large or larger than the *Bund's* when the perspective is broadened to include funding commitments made before the Solidarity Pact as well as changes in tax laws and public transfers.³⁴)

³⁰ Early in the 1970s, federal payments in stage 3 increased quickly from a very low level, as the *Bund's* ad hoc contribution was formalized at 1.5% of its VAT. This level remained stable until the late 1980s.

³¹ Michael Burchardt, "Die Praxis des aktuellen Länderfinanzausgleichs und das Problem der Integration der neuen Bundesländer," *WSI Mitteilungen* 45:9 (Sept. 1992): 577-590 at p. 578 n. 3; Ulrich Exler, "Financing German Federalism: Problems of Financial Equalisation in the Unification Process," *German Politics* 1:3 (Dec., 1992): pp. 22-37 at pp. 23-7.

³² Kilper and Lhotta, 1996, pp. 191-2; Rensch, 1991, pp. 262-73.

³³ Interview with one of the *Länder's* 1993 negotiators (L012798.3); Razeen Sally and Douglas Webber, "The German Solidarity Pact: A Case Study in the Politics of the Unified Germany," *German Politics* 3:1 (Apr. 1994): pp. 18-46 at p. 25.

³⁴ Wolfgang Rensch, "Die Finanzierung der deutschen Einheit und der finanzpolitische Reformstau," *Wirtschaftsdienst* 78:6 (June, 1998): pp. 348-56.

The Bavarian proposal, pushed by a cross-party tandem of CSU (Bavaria) and SPD (Northrhine-Westphalia), gained unanimous support from the *Länder*. It required the *Bund* to give the *Länder* eight per cent more of the VAT revenues, with which money the eastern German *Länder* could then be included in the existing financial equalization scheme. Two stages of horizontal distribution would then be followed by vertical distribution (federal grants), guaranteeing the poorest at least 99.5% of average per capita income, with additional “perks” tailored to attract small eastern and western states. The outcome: at a time when states with but roughly 35% of average per capita taxes were included in the system, equalization was raised to at least 99.5%, but in practice 120% for the eastern *Länder* and 190% for the city-state Bremen when including stage three federal transfers (see Table One).³⁵

The *Länder*’s ultimate unity rested on compromises that reproduced longstanding points of contention. The most important compromises occurred between the eastern and richer western *Länder*. The eastern *Länder* agreed not to challenge the reallocation (*Zerlegungs*) mechanism for corporate and personal income tax, and retracted demands that local governments’ strength be fully included in calculations of a *Land*’s financial strength. In exchange, they received guarantees that for the next ten years they would receive nearly 100 per cent of the average income across *Länder*.³⁶

These compromises, however, made the west’s burden look larger than it is. The *Bund*’s VAT contribution meant to assist the eastern *Länder* became labeled as VAT belonging to all the *Länder*. Thus, the large transfers of VAT from west to east appear ridiculously generous when in fact much of the revenue the western *Länder* are transferring was never “theirs” in the first place. Similarly, the decision not to weight local governments’ strength at its full value masks the western *Länder*’s relative financial capabilities. In 1997, were the local governments’ financial capabilities included at 100 per cent rather than deflated to 50 per cent, the payer *Länder* would have been obliged to

³⁵ *Spiegel*, No. 50/1996, p. 76, as reproduced in Laufer and Münch, 1997, p. 174.

³⁶ On the reforms see Michael Hüther, “Reform des Finanzausgleichs: Handlungsbedarf und Lösungsvorschläge,” *Wirtschaftsdienst* 73:1 (Jan. 1993): pp. 43-52; Charlie Jeffery, “The Non-Reform of the German Federal System after Unification,” *West European Politics* 18:2 (April, 1995): pp. 252-72; Wolfgang Renzsch, “Der Föderalismus in der innerdeutschen Bewährung: Der Kampf um die Neuregelung des Finanzausgleichs,” *Föderalismus in Deutschland: Neue Herausforderungen*, ed. Uwe Andersen (Schwalbach/Ts.: Wochenschau Verlag, 1996), pp. 39-54; Sally and Webber, 1994; and Exler, 1992.

pay an additional five billion DM to the recipient *Länder*.³⁷ These compromises exacerbated simmering tensions.

Table One: *Länder* Financial Strength as Percentage of *Länder* Average, 1995, Across Stages of Equalization

<i>Land</i> c = city-state w = west e = east	Tax receipts, <u>real per capita</u>	Financial strength as measured in stage 1	Financial strength after 3 stages of equalization, as measured in stage 3	Financial strength after federal transfers, in <u>real per capita</u> terms
Hamburg (c, w)	236 %	157.5 %	102.2 %	120 %
Hessen (w)	132	118.7	103.4	89
Bremen (c, w)	125	111.7	99.6	197
Northrh.-W. (w)	120	114.2	102.3	91
Baden-Würt. (w)	116	115.7	103.0	90
Bavaria (w)	112	113.8	102.5	90
Berlin (c, e/w)	98	93.3	99.5	141
Schleswig-H. (w)	91	106.8	101.2	94
Saarland (w)	90	83.5	99.5	135
Rhineland-P. (w)	86	95.7	99.8	94
Lower Sax. (w)	83	96.2	99.8	91
Brandenburg (e)	43	56.4	99.5	120
Saxony (e)	40	50.3	99.5	117
Saxony Anhalt (e)	36	44.5	99.5	121
Mecklen.-V. (e)	36	47.0	99.5	122
Thuringia (e)	35	43.7	99.5	120

Sources: Per capita tax receipts, and financial strength after federal supplementary transfers, from *Spiegel* 50/1996, p. 76, reproduced in Laufer and Münch, 1997, p. 174. Original financial strength: Vesper, 1996, table 2. Financial strength after three stages of burdensharing, Federal Ministry of Finance, Referat VA 4 internal document (on file with author).

After the 1993/1995 reforms, the politics of burdensharing returned to normal. The richest states again complained about the high levels of transfers and the distortions produced by the arrangement. The poorer *Länder* again refused to negotiate until the current arrangement expired, in 2004. Thus three of the rich, Bavaria, Baden-Württemberg and Hesse, filed suit with the Federal Constitutional Court.³⁸ They argued

³⁷ Dieter Vesper, "Länderfinanzausgleich: Neuer Verteilungsstreit zwischen West und Ost," *DIW-Wochenbericht* 65: 7 (Feb. 12, 1998): pp. 133-141 at Table 4.

³⁸ See *Süddeutsche Zeitung* "Absurde Übernivellierung" (Sept. 9, 1999), *Süddeutsche Zeitung* "Sankt Martin und die dicken Kinder" (Sept. 24, 1999). The Bavarian reform proposal Bayrisches Staatsministerium der Finanzen, *Der neue Finanzausgleich: einfach – föderal – gerecht. Das Modell zur Neuordnung* (Munich: Bayrisches Staatsministerium der Finanzen, 1998).

the current policy (modeled on the 1993 Bavarian proposal!) had unconstitutionally high redistribution, a point they made by highlighting the outcomes as measured in the far right column of Table One which reflects real rather than weighted per capita transfers and a wider range of federal grants. Traditionally, following Federal Constitutional Court interpretations, lawmakers have measured outcomes as in the second to right column. And once again, the absence of agreement among the *Länder* to devolve responsibilities and reduce solidarity has led to a yearly reproduction of the *status quo* by the *Bundesrat*.

However hypocritical Bavaria's suit against what was its own proposal may seem, the dysfunctions criticized by the rich *Länder* are real. The system has nearly completely failed to reduce long-term inequalities among *Länder*. Between 1970 and 1990, only one *Land* (Bavaria) moved from recipient to payer status; the dispersion of real GDP among *Länder* hardly changed; and the dispersion of unemployment rates remained roughly constant. The system creates disincentives for *Länder* to support economic growth, since the transfers create effective tax rates of between 70 per cent (for the weak *Länder*) and 90 per cent (for the payer *Länder*) on each additional Deutschmark in tax revenue raised.³⁹ The system also creates truly labyrinthine transfer patterns: Bremen has the second highest per capita income of any *Land* in Germany and is the fifth richest region in the EU. In the 1995 burdensharing process, however, Bremen received the highest per capita transfers of the western German *Länder*, in part because the taxes earned in the city by firms and workers resident outside its borders were transferred out of the city according to the reallocation principle – income losses for which Bremen was then compensated through the city-state exception that artificially inflated its population to augment its per capita transfers.⁴⁰

By itself, the *Bundesrat* was unable to ameliorate these inefficiencies because reforms would necessarily disadvantage the recipients over the status quo. However, in November 1999 the Federal Constitutional Court returned a not unfriendly ruling on the rich *Länder*'s suit. The ruling compels the *Bundesrat* and *Bundestag* to revise the burdensharing scheme by 2003, within parameters that appear to constrain current levels of transfers. The Court – under the leadership of Paul Kirchhof (who represented well-

³⁹ OECD, 1998, p. 81, 84.

⁴⁰ Renzsch, 1997, p. 93.

to-do Baden-Württemberg in its equalization cases before the Court in the 1980s) – endorsed most of the current practice including high transfers to the eastern states. But it did admonish lawmakers to evaluate the appropriateness of the city-state privilege and the 50% weighting of local governments’ financial capacity; to consider lowering the equalization target below 99.5% to allow for “appropriate” but not complete equalization; and to restrict but not eliminate the federal supplementary grants that distort the “performance order” (or give rich states lower revenues than the poor after the equalization process). In other words, the Court requires legislators to revisit the long-standing points of contention in the policy, while reaffirming the general approach. It is likely that the new policy will slightly reduce city-state privileges, while continuing generous federal transfers for special needs – transfers to which all states, including the city-states, are entitled. If the *Länder* can unite around this plan, more of the total burden will shift from the richer states to the federal government: again, the politics of the *Bundesrat* will drive centralization rather than devolution.

Section Four: Conclusions

Despite popular conceptions that Germany is incapable of reform, significant changes to the federal division of fiscal and legislative responsibilities have occurred since 1948. The clear division of tax revenues and lawmaking authority between the states and the federal government has been repeatedly muddied, so that today almost all important policies are decided jointly. The weakest *Länder* precipitated centralization and increased burdensharing by declaring themselves unable to meet existing obligations. The strong *Länder* and the *Bund* responded with proposals for reapportioning the responsibilities – each seeking to maximize their own decisionmaking authority. For the *Bund* with its larger budget, this meant using direct subsidies to create “golden leashes” and “buy” policymaking authority. For the strong *Länder*, often unwilling to prevent the *Bund*’s involvement by assuming full costs for supporting poorer *Länder*, this meant containing federal influence with arenas that forced the federal government to bargain with the states collectively. The strong *Länder* and the *Bund* thus had mutually conflicting preferences, and they needed to rely on the votes of the weaker to translate their preferences into law. Not surprisingly, the weaker states time and again supported

centralization and solidarity, but not devolution, as they gave their votes to policies changing the federal system in Germany.

Reforms to the division of both fiscal and legislative responsibility are possible in Germany, but typically only in one direction. Is this dynamic a problem? To a certain extent, it is more of a problem today than in the 1960s and 1970s. While “we [were] all Keynesians now” and economic performance was thought to be heightened by active central government steering and spending, the dynamic dovetailed with economists’ advice about the national pursuit of prosperity. More recently however, a belief that efficiency requires local level responsibility has become ascendant. Neo-liberal insights have penetrated even social democratic Third Way thinking. When economists and advisors prescribe devolution and differentiation, the dynamic of German federalism appears much more dysfunctional.

Three elements of German federalism are responsible for almost all of the current dissatisfactions. The first is, for lack of a better term, *disconnectivity*. In too many areas decisionmaking is disconnected from its consequences, creating moral hazards. The federal government passes laws but doesn’t have to pay for them – the states do. Similarly, states that make substandard budgetary decisions don’t have to pay for these – their richer counterparts do. The divorce of actions from their consequences is problematic from both an efficiency and a democratic standpoint.

The second problematic characteristic is the almost complete *eradication of Land-level autonomy* in taxing and spending decisions. In some policy areas, such as regional policy, the *Länder* retain autonomy in their choices about how to implement nationally standardized programs. But in other areas – tax policy, hospital financing, company incorporation and registration – the *Länder* are not permitted to pursue independent implementation strategies. Solutions tailored to local problems and preferences cannot be translated into local policy. Moreover, the *Länder* have incomplete control over both the income and outlay sides of their balance sheets, and cannot be expected to remain “in the black,” which fairly well necessitates continued burdensharing.

The third element of the German federal system creating perpetual tensions is the current *territorial division*: the large discrepancy in the size and economic strength of the federal system’s constitutive units. The city-states and other small *Länder* have

generated much of the total costs of the burdensharing transfers through population weighting (city-states) and repeated temporary assistance for budgetary crises (Bremen and Saarland). If the small states are only able to survive with repeated subsidies from their larger counterparts, the question arises of whether territorial boundaries should not be re-drawn to create fewer but stronger and more equal territorial units. The creation of more economically similar *Länder* would reduce pressure on the financial equalization arrangement, ameliorate imbalances in *Länder* influence and dependency that have led to centralization, and give nationally standardized policies a better chance of meeting the needs of regions across the country. The problem of regional differentiation has become ever more serious over the past forty years, as economic trajectories diverged in the smokestack north and silicon south, and as eastern Germany joined the Federal Republic.

What are the chances that these three problems will be addressed? What possible ways out exist? The chances of simultaneous fiscal and legislative reform need not be over estimated, especially after unification when such a large proportion of the *Länder* are poor. It has simply become much harder for any national party to endorse a program that would be unattractive to the voters in so many *Länder*.

A second option is territorial reform to create fewer, more equal states – a frequent and serious proposal.⁴¹ The trouble is that the citizens appear to have grown attached to the states created just 50 years earlier. The politicians and bureaucrats in the states suggested for fusion are not at all interested in being made redundant. And the constitution makes only those considering a merger, but not those who finance the lack of a merger (i.e. taxpayers in third party states supporting the “weaklings”), entitled to decide (Art. 29). Thus, although the constitution has a clear procedure for fusion, it has only been used successfully once, in 1951 when Baden-Württemberg was created from three southwestern states. Amalgamation most recently failed when voters rejected a Berlin-Brandenburg merger in 1996.

⁴¹ Adrian Ottndad and Edith Linnartz, *Föderaler Wettbewerb statt Verteilungsstreit: Vorschläge zur Neugliederung der Bundesländer und zur Reform des Finanzausgleichs* (Frankfurt: Campus Verlag, 1997) at pp. 175-192; and literature review in Uwe Leonardy, “German Federalism Towards 2000: To be Reformed or Deformed?” *Recasting German Federalism: The Legacies of Unification*, ed. Charlie Jeffery (London: Pinter, 1999), pp. 285-311, at note 12.

The third and most modest reform option would be an embrace of the “Sinatra Doctrine” in which the *Länder* separately “do it their way.”⁴² The poor could continue to seek close financial and legislative cooperation with the federal government, while the richer could pursue, on their own budgets, a broader and more specialized array of policy priorities. In fact, this strategy has already been followed in some policy areas, such as technology promotion policy.⁴³ However in broad areas of law including unemployment policy, civil servant law, and most tax policies, individual *Länder* are precluded from passing their own policies because national law already exists. For Sinatra federalism to work, the *Bund*’s role in concurrent jurisdictions would have to be further rolled back. Because it raises the specter of a “two-class federalism,” and because it weakens the *Länder*’s ability to present a united front vis-à-vis the *Bund*, it is not clear that a “Sinatra” approach would find majority support in the *Bundesrat*.

The chances of radical renewal of the federal system – through territorial reform or a thoroughgoing revision of legislative and financial competencies – are close to zero. Because a continuation of the *status quo* is the most likely outcome, it is worthwhile to think briefly about its costs and benefits. Most of this article, concerned with attempts to reform the existing system, has reviewed its costs: efficiency is harmed, democratic responsiveness and accountability are reduced, and the strongest states are fettered, reducing GDP and employment growth for the nation as a whole.

But the current system also has clear benefits. The expensive investment in solidarity means that differences in citizens’ quality of life – across regions and across social classes – are smaller in reunified Germany than in many OECD countries. Poverty is very low, public schools are uniformly good, publicly funded healthcare is commendable. As a result, Germany avoids the costs of high crime as well as preventing crime. Germany avoids the costs (monetary and non-monetary) of having a significant number of children fail to become productive members of society, of urban decay, of insufficient maintenance in infrastructure. Solidarity is expensive; but so, less directly perhaps, is the absence of solidarity.

⁴² Jeffery, 1996, pp. 94-95.

⁴³ Richard Deeg, “Economic Globalization and the Shifting Boundaries of German Federalism,” *Publius* 26:1 (Winter, 1996): pp. 27-52.

In the “first” or original federal country, the United States, the preference for cooperative federalism inaugurated with Progressive era reforms in the 1890s solidified into a practical consensus at least by the time of New Deal. But this preference has slowly eroded, in academic discourse, to a new consensus that competitive federalism – the *process* of competition among jurisdictions via the mobility of “voters/consumers” – offers the best guarantee of policy responsiveness and efficiency.⁴⁴ Germans, especially in the strong states and conservative parties, have also embraced the idea of “market-preserving federalism.” Yet nothing like a consensus exists in the normative debates about federalism in Germany, because against this *procedural* justification for competitive federalism exists a *substantive* argument for cooperative federalism. This argument rejects competition as the *raison d’être* of federal systems (units need not unite if their only object is to compete), and rejects the assumption that as long as the process is sound, outcomes will be good. Instead, the substantive approach begins by defining the *outcomes* desired: that citizens in poorer, or more poorly administered, *Länder* have equal access to public spending; that labor have no incentive to be mobile (migration is destabilizing); and that policymakers have no incentive to engage in “races to the bottom” – races whose outcomes are collectively irrational (or at least diverge from these advocates’ conceptions of the common good).⁴⁵ The process for guaranteeing these outcomes, then, is a continuation of nationally standardized policies and financial burdensharing.

Thus far decentralizing reforms in Germany proposed by the strongest governments have been blocked by the weakest. Ultimately, to overcome this opposition, the political class would need a broad belief in the benefits of change. Keynesian centralization garnered this broad support – because it was believed to provide both procedural and substantive improvements over the *status quo* for all concerned. In contrast, neo-liberal ideas informing the suggestions for a more competitive federalism today focus on procedure, leaving inadequately answered substantive questions about distributive justice given a competition among regions. From a substantive perspective, it

⁴⁴ Daphne A. Kenyon and John Kincaid, “Introduction,” in Kenyon and Kincaid, eds., 1991.

⁴⁵ See (current Federal President) Johannes Rau, “Bewährt oder erstarrt? Unser föderatives System auf dem Prüfstand,” Opening speech at *Bundesrat* Conference “Fifty Years Herrenchiemseer Constitutional Accords” (Kloster Secon, Germany, Aug. 19, 1998).

is perhaps not a bad thing that the politics of the *Bundesrat* make any significant switch to competitive federalism unlikely.