

FISCAL (DE)CENTRALIZATION IN POST-UNIFICATION GERMANY, 1990-2019

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Abstract

The given paper addresses the issue of fiscal federalism and its centralization in the post-Unification Germany. The research is thus aims at answering the question of how the need to cope with increasing disparities resulting from Unification has affected and transformed the German fiscal federalism design. The research hypothesis was in spite of a significant degree of centralization, which is one of the hallmarks of German federalism, this centralization and redistribution of revenues was necessary to manage Unification.

To test this hypothesis, the historical institutionalism approach was applied. Owing to this method, it has become possible to identify the key features of the German federal design that considerably influenced fiscal federal arrangements in the Federation. These three features – cooperation, centralization (or unitarism), and symmetry become more pronounced and enforced by the federal government when there is a necessity to confront serious challenges to the economic well-being of the Federation, or political stability. As soon as the need for such consolidation decreases, the states tend to support policies that are more competitive.

Overall, despite many tensions between the rich and less well-off states, centralization during the post-Unification period significantly eased the incorporation of East Germany to the Federal Republic. Starting from 2020, the equalization scheme will cease to function, and the states will have to rely on themselves and maintain balanced budgets, which may serve as a confirmation that the German fiscal federal system enters its less ‘cooperative’ phase.

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Introduction

The Unification of 1990 became the major challenge the German federal system had to cope with, and indeed its impact on the German fiscal federal system has been even more profound as it has exposed many areas of critique. The long-established practice of German federalism, its nature based on searching for consensus was questioned amidst the difficulties brought by Unification and its consequences. In this regard, the fiscal federal system became the most affected one, carrying the burden of the economic, financial, and social integration of the new Länder into the Federal Republic of Germany. At the same time, while there is no shortage of works exploring the international stage at the time, or historical significance of Unification for the German history, the issue of the Unification's impact on the system of fiscal federalism in Germany and how German federalism sustained such a challenge tends to be neglected.

This paper will concentrate on the state of German fiscal federalism after Unification and the impact it has had on the symmetrical design of the German federation, since the necessity to address the increased economic and social disparities has stimulated the German government to introduce reforms and specific programs affecting the well-established fiscal system. The **research hypothesis** tested is that German model of federalism provide favorable and feasible conditions for post-Unification reforms.

As for the method, the paper uses the historical institutionalism approach to demonstrate how fiscal federalism in Germany evolved, and how the dynamics of intraregional fiscal relations developed. The way institutions were constructed historically is crucially important in order to understand how the federal state responds to pressures for change, as once a system of federal institutions was set up and shaped in a historical sequence, path dependence heavily impacts its consolidation and development over time (Broschek 2012: 663). Combined with normative theoretical approaches to fiscal federalism and fiscal decentralization, historical institutionalism will help to explain why implementing a full-fledged fiscal decentralization was not possible in

Germany in the post-Unification period, though the basic conditions for it seemed to be favorable.

Historical development of German fiscal federalism after Unification, in this case, can be considered as the case combining stability patterns influenced by path dependence and gradual change, which was directed towards greater fiscal centralization of Länder policies. Even when fiscally strong and stable Länder changed their preferences and decided to opt for more authority in fiscal matters, they proved to be unable to do so because of the institutional restrictions. These Länder found themselves incapable of escaping the “joint-decision trap” (Scharpf 1988) without sacrificing a part of their competencies in return.

In the framework of this approach, special attention will be paid to examining the historical development of German federalism and features which allowed the federal system to sustain significant transformations in the fiscal relations among the Länder. To trace the impact of Unification on the German fiscal federal arrangements the author will analyze constitutional reforms and reforms targeting the German fiscal constitution of 1969, Stability Pacts I and II. Generally, this analysis was built upon careful consideration of official documents and programs concerning fiscal reforms and redistribution as well as the Basic Law and amendments that were made to this document.

The paper’s structure is organized the following way. Chapter I presents theories of fiscal federalism and fiscal decentralization. Chapter II deals with German federalism, its main features – cooperation, centralization/unitarism, and symmetry, and the interaction of federalism with the Social Market economy and the welfare state. This chapter is set to demonstrate that despite the fact that German federalism as a concept has never been set in stone, its key elements provide stability to the system, though at different stages of history their relative weight can vary. Chapter III introduces theoretical background on fiscal federalism in

Germany and presents the scholarly debate about the state of art concerning fiscal federalism in Germany. Finally, Chapter IV investigates the process of Unification and the reforms it triggered as well as the contradictions that arose as a result of these reforms, with special attention to the fiscal federalism reforms. Moreover, the chapter aims to analyze the changes proposed by Unification reforms, their achievements and shortcomings. The chapter concludes by indicating points for reforms of the current fiscal federal system in the coming years in order to preserve the stability of the system that greatly contributes to the securing of the ‘equivalent living conditions’ – one of the key purposes of the German fiscal federal and federal systems.

As for the contribution, the paper may help create different solutions for countries not willing to implement a full-fledged fiscal decentralization but aimed at economic growth. It may also be used to understand the difficulties of increasing decentralization, for example, in Austria in which federal units also lack fiscal autonomy.

Chapter 1. Theoretical Background

In this chapter, for the purpose of the study, there is an overview of Fiscal Federalism theories, and the main components of fiscal federalism which, in turn, have their impact on decentralization levels. Fiscal federalism is mainly concerned with the issues of revenue collection and tax policies, and as a public economics concept, it is not tailored to the states with federal systems only. Here, attention is paid to the following components of fiscal federalism: expenditure assignment, revenue assignment, intergovernmental transfers as well as the problem arising as a result of imbalanced fiscal policies. This will be of particular importance regarding the discussion of the state of fiscal federalism in Germany after Unification.

1.1. Federalism and Fiscal Federalism

Federalism is a form of territorial organization that enhances the legitimacy of the national and sub-national governments by making each of them directly elected and making accountable to their own electorates, and controlling the amount of power and competences delegated to each level of decision-making within the polity. In other words, in economic terms, federalism is thought to be more responsive and adaptive to preferences of the citizens in heterogeneous societies (Kincaid 2010). This goes in accordance with normative economic theory of federalism that postulates that in federations, citizens enjoy the opportunity to ‘vote with their feet’ and consequently, can choose those jurisdictions in which tax burden is less heavy and where they are more satisfied with the quality of goods and services delivered (Ostrom 1972). However, this is more correct regarding federations with strong decentralization component, which, in its turn, is not a distinctive feature of German federalism in general and fiscal federalism in particular.

1.2. Fiscal Federalism Theories

As a concept related to public economics, fiscal federalism is primarily concerned with “understanding which functions and instruments are best centralized and which are best placed in the sphere of decentralized levels of government” (Oates 1999: 1120). In other words, it is the issue of how spending, revenue raising and tax collecting authorities are allocated between different levels of government. Here, as Oates points out (1999: 1120-1121), it is important not

to wrongfully associate fiscal federalism with fiscal decentralization as an element of federal states only. In political science studies ‘federalism’ is used to describe a state system that is based on power-sharing and that has a constitution, which enshrines the autonomy and division of power at the federal, regional and/or local level. At the same time, in economics, all state systems are federal since they involve different levels of authority that are involved in decision-making procedures. Besides, ‘fiscal’ federalism does not touch upon only budgetary issues, it also concerns matters belonging to the vertical structure of the public sector (1999).

The literature on fiscal federalism makes a distinction between two approaches. First Generation Fiscal Federalism (FGFF) built on Tiebout (1956), Musgrave (1959, 1969), and Oates (1972, 1977) concentrates on studying the performance of decentralized systems administered by benevolent social planners and focuses on issues of horizontal and vertical equity. Considering the benevolence of the social planners, FGFF assumes that the goal of authorities at each level is to maximize the citizens’ social welfare within their responsible jurisdictions. FGFF adopts Musgrave’s three basic functions of fiscal federalism: allocation, (re)distribution, and stabilization. The normative aspect of FGFF postulates that these fiscal responsibilities should be applied when designing the optimal structure of state’s fiscal institutions especially in the context of welfare maximization. From the general perspective of FGFF, decentralization and fiscal autonomy of the sub-units of the central government are required in this case.

Second Generation Fiscal Federalism theories (SGFF) developed mainly by Besley & Coate (2003), Diaz-Cayeros (2006), and Weingast (2014) diverts from the FGFF in the sense that second generation theories consider social planners are not benevolent, but face political (e.g., re-election) and fiscal incentives which encourage them to plan their work accordingly. Generally, SGFF builds on FGFF, but also assumes that political actors have goals induced by political institutions and these goals do not always include maximizing citizens’ welfare. SGFF

addresses the concerns the FGFF ignored, namely self-enforcing federalism. This is how federal systems are bound together given various negative incentives for federal systems to dissolve or move towards greater centralization (Weingast 2014). SGFF also touches upon such issues as the compatibility of decentralization and democracy. Finally, it investigates how various political constraints may impede economic growth, thus again emphasizing the link between fiscal structure and decentralization.

Both theories, FGFF and SGFF, address the issue of decentralization, which in recent years has become a trend in policy-making. In the 1990s and at the dawn of the XXI century, developed and developing countries actively sought to introduce fiscal decentralization in attempts to lessen central governments' monopoly in fiscal policy planning (World Bank 1999). Fiscal decentralization aims at improving public administration system and the provision of public services, and this objective serves as a chief rationale for the central government to transfer part of its competencies and responsibility to lower levels. Such position was elaborated owing to prominent political economists of the time beginning with Tiebout (1956) and his well-known model. Specifically, it implies that perfectly informed and mobile residents are able to 'vote with their feet' and thus choose the jurisdiction in which they could fulfil their preferences to the most optimal level possible. This incentivizes jurisdictions to compete for taxpayers, and the equilibrium is reached when nobody wants to move. Stigler (1957) advocated decentralization as the measure which makes it possible to meet the preferences of local residents. Similarly, Musgrave (1959), in his groundbreaking study of the public finance theory, proposes that the center should allow the subnational units to have more room for maneuver to provide their residents with public goods of a good quality. Elaborating on Stigler and Musgrave's line of arguments, Oates (1972) formulated his well-known decentralization theorem that postulates that "each public service should be provided by the jurisdiction having

control over the minimum geographic area that would internalize benefits and costs of such provision.”

According to the World Bank, fiscal decentralization can take many forms, but generally, it includes the following measures (2019):

- **Expenditure Assignment** (assigning some expenditure and/or revenue authority to subnational entities of government). It is important here to make a distinction between cases in which subnational or local governments determine the structure of expenditures, and in which the central government assigns the necessary level of expenditures and subordinate levels merely operate within it.

Theoretically, unitary and federal governments have different capacities regarding expenditure independence. At the first glance, federal systems seem to offer more room for subordinate levels of government, because the latter are usually protected by the constitution. In practice, however, federalism does not guarantee wider decentralization than unitary systems. For example, in fiscal terms, Belgium and the Netherlands are equally decentralized, though the former is a federation and the latter is a unitary state.

- **Revenue Assignment.** Generally, governments tend to employ a common list of taxes applying to the same overlapping bases in order to reduce incentives for tax evasion or tax fraud. For instance, general sales taxes, payroll taxes, and income taxes rely on such considerably overlapping bases. The problem is that while it is relatively plausible to transfer some expenditure authority to subnational governments for the purpose of improvement of public services provision, but there are few taxes (especially, high-revenue ones) that could be levied at the subnational level without creating intergovernmental distortions. In addition, decentralized taxing system may create perverse incentives for the subnational entities to pursue the so-called beggar-thy-

neighbor redistributive policies favoring well-off residents and punishing low-income one. Therefore, if subnational governments decide to introduce state taxes, these are usually taxes on immobile factors (Boadway 2017) (e.g., property taxes) and/or cost recovery charges (e.g., frontage taxes – tax per linear front foot of property).

- **Intergovernmental Transfers** may serve as an important source of revenues not only for developing countries, but for poor sub-states in developed countries as well (Germany, the UK, Spain, and Italy). Kennen (1969) argues that fiscal transfers among the regions can have a positive stabilization effect by harmonizing regional aggregate demand and employment levels as well as redistributing income between sub-states prone to asymmetric cyclical shocks (Athanasoulis and van Wincoop 1998, European Commission 1977, Goodhart and Smith 1993, Hagen 1992). With respect to the purpose of a grant or transfer, these can be generally classified into two groups: *non-matching* and *selective matching*. As Bahl and Lihn (1992) argue, this category of transfer is appropriate, which largely depends on the transfer or grant's objective.

Non-matching grants can be classified into selective (conditional) or general (unconditional). Selective non-matching grants are a fixed amount of funds that are not tailored to a particular regional/local program but that should be spent for a certain purpose. In this case, conditionality will make certain that the recipient subunits will spend on the needed program as much resources as they have been provided with.

Unconditional (general) non-matching grants in their turn do not put any constraints on how the sub-governments should manage them. In contrast to conditional grants, the central government issuing the grant does not set any expenditure limits in any area. Therefore, the grant could be used as an additional source for financing public goods and services or easing tax burden on local residents.

Selective (Conditional) Matching grants/transfers involve purpose-oriented spending, plus the recipient has to match the given funds to some extent (World Bank). The results of selective grants/transfers are such that (1) sub-national units have more resources, and some of them could be used to gain additional goods and services; (2) price or substitution effect: the subnational units gain more for a given budget because the provided subsidy from the center decreased the relative price of services. Consequently, selective transfers and their effects encourage expenditures on the assisted programs or projects.

Overall, the economic arguments for transfers and grants provision assume that they could come handy (Brennan and Buchanan 1980, chapter 9; Sachs and Sala-i-Martin 1992) when a government's fiscal federal system has to deal with such challenges, as:

- **Fiscal gaps or “vertical imbalance”** (an imbalance between the two tiers of governments, upper and lower, e.g. the central government versus states or provinces) (Gruber 2007).
- **Horizontal imbalance** occurs among the states at the same level, and to fix there is a need for equalization transfers (Sharma 2011).
- **Fiscal inequity** (in a decentralized state, subnational governments can possess their own expenditure, taxation responsibilities and thus are able to provide their residents with goods and services of different quality. This may lead to distortions in horizontal equity, namely equal treatment of all citizens across the country).
- **Fiscal inefficiency.** The inefficiency of a tax system depends on the extent to which taxed units adopt their behavior to avoid taxation
- **Fiscal harmonization** (to the extent the central government is interested in resource redistribution; in any case, the center has to deal with a trade-off between the benefits of a centralized system (free and unrestrained flow of goods and services) or a decentralized one (innovation, efficiency, and accountability) (Boadway 2004).

Based on these measures, fiscal decentralization may serve as a set of tools enlarging the power and competences of sub-central units via the devolution of power and resources. It differs from administrative de-concentration, when the center delegates functions to sub-central or local agents but maintains decision-making control (Faguet et al. 2014). In this regard, the German fiscal federalism and its degree of decentralization case is of interest, because it combines devolving elements, as Germany is a federation, where sub-central units possess vast administrative powers, and a significant degree of centralization, because Länder do not have large decision-making competences. Finally, as we will see later, sometimes centralization is needed to provide for a more or less smooth transformations and changes made within fiscal federal system.

Chapter 2: German Model of Federalism and Its Key Features

This chapter deals with German federalism and its development throughout history, with special attention paid to the XX century. Analyzing the works of scholars on federalism and building on them, I highlight and elaborate on the most important features of the German federalism – cooperation, centralization/unification, and symmetry, as they allow to explain the centralization of the German fiscal federal system (see Chapter III). Taking into account that federalism does not exist on its own, rather it is a part of Germany's political system and economy as well, I discuss the interaction between federalism and the Social Market economy, and federalism and the German model of welfare state (Sozialstaat). The German federal system grounded on the principles of consensus, uniformity, and symmetry serves as a good framework for implementation of a well-developed social security system and economic system, as for their smooth functioning Länder's assistance is necessary.

2.1. German Federalism in Scholarly Literature

While scholarly literature on, for example, European federalism and the EU federal project is extensive, its arcane and abstract language tends to describe federalism as an administrative and technocratic solution to the Union's problems, which is perceived by some (e.g., the UK) as an attempt to impose an overly bureaucratic European super-state (Haseler 2004, Morgan 2005). In German political science literature, federalism, in Umbach's words, is employed to signify the balance between diversity and unity with an emphasis on devolution (Umbach 2002). Also, in line with American, Austrian, and Australian scholars, German students of federalism deal with the issues, such as efficiency, effectiveness, accountability and allocation of competences between upper and lower tiers of government (Erk 2007: 264). In contrast, Belgian, Canadian, Spanish, and Swiss students of federalism tend to concentrate on the ethno-linguistic divisions (2007), which are more relevant for their countries, though this 'geographic' classification of federalism studies is not always precise.

In this regard, "German Federalism: Past, Present, Future" by Umbach (2002) is one of the major works about federalism in Germany. The book presents federalism as one of the key embodiments of German history, and though the authors do not wish to fall into 'historical determinism,' the analysis of federalism's place in history is an important feature of this work. In the book's chapters, experts investigate the nature of German federalism, its meaning and

development through centuries. Despite the fact that their contributions are listed chronologically, they do not fall into ‘narration’ of German history of federalism. Instead, Umbach and his colleagues applied different approaches – cultural, political, linguistic, and constitutional, in order to analyze the phenomena of German federalism at key stages of its development.

Umbach et al. explain the success of the German federal project by referring to the ‘separate histories’ of the German states which allowed federalism to root deeply in their day-to-day practices. Moreover, they emphasize that German federalism is a success story due to fairly vague and flexible nature of German federal system. Although federalism is usually not seen as a driving force of German political system due to its relative inactivity, in turning points of history, federalism was necessary when dramatic political challenges needed to be accommodated. Last but not least, in Umchach’s opinion, not only ‘vagueness’ (the absence of a clear-cut political meaning) did help German federalism to survive and adapt to challenging circumstances but also its pragmatic rhetoric, which was appealing to German electorate regardless of its party affiliation in most cases. Overall, Umbach and other contributors to the book come to the conclusion that studies on German federalism cannot be done ahistorically, in other words, one cannot analyze German *Föderalismus* separately, without taking into account historical implications (2002: 10-13).

Historical institutionalism’s approach to federalism dominates the work of Broschek who employs it to demonstrate how various forms of relationships between upper and lower tiers of governments become institutionalized and then self-enforcing. He concentrates on Canada and Germany as models for his case study because the federalist design in Canada and Germany is idiomatically distinct from each other. Broschek’s historical analysis leads him to conclude that the well-developed dualistic sharing of political authority is the founding feature of Canadian federal system. Consequently, it allowed Canadian provinces to massively engage in the

process of province building, namely use their institutional capacities to implement far-reaching reforms in such areas, as public service, agriculture, healthcare and education. In contrast, in Germany, Länder (provinces) did not address the central government when they wanted to act independently within their own area of competence (Broschek: 562). Instead, they turn to the federal level when they attempted to initiate political changes, and indeed, Länder participation in legislation at the federal level in the form of Bundesrat is one of the key characteristics of the German federal system. On the downside of this, Broschek argues, the high level of interdependence and cohesiveness, which allows for a smooth functioning of the Bundesrat, pushes German provinces to engage in the joint decision making procedures, though it often leads to the “joint decision trap,” the concept that was initially developed by Scharpf (1988). Broschek in line with Kropp (2010) and Scharpf (2009) emphasizes that the joint decision-making impedes real cooperation, which becomes a rare occasion in German constitutional setting, and unilateralism tends to resurface.

Similarly, German scholars are also keen on studying federalism through historical lenses. Nipperdey (1980) analyzing the role and place of federalism in German history concludes that federalism is not normative term, but historical one, an integral principle of German political system. In his opinion, German federalism is not a result of benevolent planning or careful consideration of politicians, it was a result of federalism’s own development during different stages of history, beginning from the Middle Ages and continuing today (Nipperdey: 545). Deuerlein (1972), Hartung (1963), and Huber (1957-1978) present a very well-structured works on historical evolution of German federalism. They differ regarding the time when federalism became a prominent feature of German political system: Deuerlein occupies himself with the XIX century, when the German states and principalities created their customs union, and then joined the Prussia-dominated Empire. Hartung sees elements of federalism in the Holy Roman

Empire, while Huber is interested in finding the federalist traits in German principalities and states starting from 1789 – the beginning of the Great French Revolution.

While many scholars are interested in investigating the relationship between federalism and democracy (Benz and Sonnicksen 2017, Lane and Ersson 2005, Weinstock 2001), the issue of conjunction between federalism and the welfare state remained mostly overlooked (Manow 2004). Maximum the explanations would often not much divert from the point that federalism lacks efficiency when it comes to providing welfare benefits (2004). In his turn, Manow (2004) seeks the linkage between German federalism and the welfare state, another deep-rooted feature of German institutional design. He shows that despite the ‘conventional’ wisdom that federalism hinders the growth of welfare state and prevents its expansion, German federalism peacefully co-exists and, even more, contributes to one of the most generous welfare system in the world. Manow’s answer to this peculiarity of the German case is cooperative nature of German federalism.

At the same time, along with Auel (2014), who investigated intergovernmental relations among German regions, Manow admits that cooperative federalism makes the respective regions to search for consensus, while the problem of externalizing costs persists. Auel, however, conducts her analysis relying on data on party polarization, party incongruence, as well as outlines the dynamics of territorial and financial conflicts between different German regions. She also draws attention to the reform log jam (*Reformstau*) which only adds more pressure on the intergovernmental relations, especially after Unification in 1990, when the relative number of poor regions increased, and hitherto economic disparities became more significant. In line with Gunlicks (2005), Auel emphasizes the need for reforms of the current federal arrangements, though admits that any changes leading to greater autonomy of Länder might complicate the more or less symmetrical economic development of German regions after Unification. Plus, reforms are not much likely considering the fact that poor regions possess the

majority of seats in the Bundesrat and constitutional reforms have to be approved by a two-thirds majority in Bundestag and Bundesrat (2014: 29).

Based on the review of scholarly works about German federalism, one may argue that most studies prefer to view German federalism relying mostly on a historical approach, as in the German case it started to play a prominent role even before Germany became a state. German scholars tend to occupy themselves with the issues of historical relevance of federalism, necessity of federalism, and, especially in the last 30 years, the issue of reforming federalism and reconsidering the relations among the regions has become increasingly acute. However, admitting that reforms are necessary (Auel 2014, Manow 2004), they state that ‘big’ reforms are highly unlikely to take place because of the opposition mounted by poorer regions and the central government whereas small reforms are not able to address the existing problems entirely, especially those related to the problem of fiscal decentralization.

2.2. Historical and institutional development of the German federal system

It has always been quite a perplexing task to find a proper place for German federalism in a taxonomy of states with federal systems (e.g., Riker 1964: 123-124), especially when German federalism is referred to as a unitary federalism (Hesse 1962). Due to the adherence of German states to a high level of equivalency concerning living and socio-economic standards and their relying on the center on issues of political governance, one may assume that Germany even resembles more a decentralized unitary state than a federation. However, if one takes a closer look at the areas in which Länder have autonomy, it will be clear that one of the key elements of decentralization – fiscal decentralization does not manifest itself at the regional level. In financial matters, German states are closely tied to the central government while in such policy areas, as education and culture, they enjoy almost unlimited authority. Here it is worth mentioning that Germany has never experienced ethnic or linguistic divisions as strongly and intensively as in Belgium, Canada, the UK or Spain (the last two are the classic examples of

decentralized unitary states), and regardless of the centralism of the German state in the 1930s-1940s, proto-federal institutional arrangements had existed in German history for centuries.

Historically, Germany had a long practice of power sharing among governments and federal arrangements that existed for centuries, even before Germany became an empire in 1861 and then a republic in 1918. This tradition of power sharing and consolidated decision-making gave rise to German federalism represented by the Imperial Diet (or Reichstag) in the Old German Empire. After the Empire was dissolved in 1806, the Diet maintained its existence as a council of states' representatives. The Weimar Constitution, along with introduction of parliamentary democracy, institutionalized this type of 'intragovernmental vertical interlocking' (Benz 1999) by creating the Federal Council (Bundesrat) that continues to be an integral element of Germany's political system.

Importantly, the Weimar Constitution in 1918 and then the Basic Law in 1949, also institutionalized the so-called cooperative form of federalism by requiring the states (Länder) to coordinate their policies under the joint-decision making procedure. This procedure should apply to the legislation that in domain of the states as well as to policy areas that might have an impact on achieving equal living conditions across the country (but not living standards). In 1990, unification had as a result the joining of five former GDR provinces the Federal Republic of Germany which posed the biggest challenge to the well-established German federalism. Until this, never had there been such a wide gap between economically developed and poor regions within the federal system.

What demonstrated this cleft the most vividly were skyrocketing levels of unemployment in the eastern regions of the former German Democratic Republic that were obviously higher than in the western regions. The fact that during the time of the GDR an extensive welfare state was its trademark only added more strain in the interregional relations. As a result, the relations in the

chain “Federal Government – Länder – municipalities” have been repeatedly reviewed and reconsidered in order to strike a reasonable compromise. The reforms of the federal systems in 1994 and 2006 attempted to bring more balance in the existing federal system and improve policy outcomes without increasing the gap between western and eastern Länder (see Chapter II). Importantly, in spite of the ongoing criticism of the reforms introduced, there is mostly an agreement in the scholarly literature that these reforms have achieved a needed balance between excessive centralism and ‘federal particularism’ (Radke 2005:21).

The German state rests on three integral principles, which are necessary to provide for equivalent living conditions required by Articles 72 and 106 of the Basic law. These are *Sozialstaat* (social or welfare state), *Rechtstaat* (the state of law), and *Bundesland* (the federal state) (Basic Law, Art. 20, para. 1). At the federal level, German Bundesrat is the key institution that is responsible for the representation of the executive branches of the each Land and is one of the central players in creating common federal legislation (Schmidt 2015). The place of this legislative chamber in German political system is often contested: although English-speaking scholars and experts on Germany refer to Bundesrat as the upper house, it is not exactly correct. As Gunlicks (2005) defines it, Bundesrat is ‘a unique chamber that represents the Land governments (cabinets) – not the parliaments – roughly on the basis of population (each Land has from three to six votes, which must be cast *en bloc*). It is not therefore a popularly elected body, which German constitutional experts consider to be a prerequisite for a true “house” of parliament.’

All laws touching Länder’s interests have to be agreed with and approved by the Bundesrat. For instance, if the Basic Law is amended, there needs approval from a two-thirds in the Bundestag and in the Bundesrat; Bundesrat’s majority is required for the approval of *Zustimmungsgesetze* (consent bills). Besides, bills do not require the Bundesrat’s consent

(Einspruchsgesetze) can be prevented from entering the legislation by a majority of the Bundesrat, namely two-thirds (Grundgesetz, Article 77, paragraph IV).

2.3. Federalism and Social Market Economy

In a strict sense, the term social market economy describes the economic concept introduced in 1948, which created the basis of the post-war West-German economy and was regarded as the economic miracle, especially during the time of Ludwig Erhard and his ‘economic miracle’ (Quaas 2005: 393-395). In a broader sense, the term is used to define economic policy of the Federal Republic of Germany in general (post-war and post-Unification) regarding its form and defining features.

The German Constitution did not envisage a particular economic system, but the Article did provide for a democratic rule and free market economy, but with regard to creating equivalent living conditions.’ That is why social market economy has become an embodiment of such provisions, having combined in itself a free market economic system and broad and far-reaching social policies that contributed to fair competition both in economic and welfare policies. The social market economy achieved a balance between state and Länder participation in the provision of welfare, efficient functioning of the federal and municipal tiers of government regarding economic and social liberties, social security; guaranteed private property, established competition laws and workers participation, and full convertibility of German currency, Deutsche mark (Schlecht 2002: 401-406).

The interaction between federalism and social market economy has proved to be mutually beneficial as it managed to break the patterns common for market economies (Radke 2005: 21-22). Full-fledged market economies are prone to regional imbalances, and in unitary countries, these imbalances tend to increase benefitting those who has saved huge political and economic capitals. It is fraught with a risk of increasing economic distortions, tension in interregional relations and on the vertical “region-center.” In this regard, federalism is the key reason why

this adverse tendency did not root in Germany, since the above-mentioned overriding aim of the German federalism – uniformity of living conditions had expressed itself in the following political practice: the public goods provision, namely infrastructure, education and cultural institutions, is operated in almost the same manner in all the Länder. As Radke admits, such a unique system has managed to orchestrate a very well balanced system stimulating economic growth and protecting the achievements in the welfare area (2005: 21).

2.4. Federalism and the German welfare state

In the case of welfare provision, German federalism contradicts conventional wisdom that federalism prevents welfare state expansion and impedes redistribution. This is mostly because throughout its history, the German welfare system developed on the grounds of subsidiarity principle, one of the building blocks of the German Basic Law. Even after the welfare state reforms, known as Harts reforms, introduced in the early 2000s, which heralded the retreat of the federal government in many welfare areas, the federal government was able to create a strong and well-developed legislative framework on local and case-based provision of welfare. As a result, the central government, the Länder and local governments with the help of civil society organizations as well have maintained and solidified a robust system that enabled them to serve as providers of welfare policy and provide a basis for action at the municipal level (Droste et al. 2010:5).

The German federalism case demonstrates that this logic of interaction between federalism and welfare is subject to changes. Within German federal structures, which necessitate a certain degree of redistribution due to the provisions in the Basic Law, political actors both at the federal and regional level conduct and support redistributive policies by imposing national taxes and transferring revenues from richer regions to poorer ones. This creates incentives for shifting responsibility and dividing costs between the federal government, regions and welfare system, and this system generates quite an opposite effect. Instead of exerting restrictive influence on

the welfare state expansion, German federalism with its significant reliance on joint decision-making, symmetrical provision of equivalent living conditions and a considerable degree of centralization encourages almost unrestrictive spending dynamic combined with a low degree of fiscal discipline, stimulated by the absence of hard budget constraints imposed from the center to the Länder. Considering that Länder enjoy a powerful veto concerning joint taxes legislation that makes up approximately 70% of total tax revenue (Manow 2004: 34).

Established with the purpose of deepening national unification, the German welfare system has greatly contributed to strengthening to steady provision of the welfare while implementation of the federal tax system prevented a ‘race-to-the-bottom’ economic competition among the regions. However, there were proposals from the Länder, especially those in the south, to change the existing system of redistribution, not only in the field of collecting taxes and education, but also welfare system, and in the 1990s, they have become more vocal (Münch 1998, Papier 1995, Pitschas 1994). Supporters of this idea consider that such a reorganization would introduce more experimentation and learning into German federalism, the so-called ‘laboratory federalism’ which became quite common for Canada (Broschek 2012) but was unknown in German tradition of federalism because of extensive fiscal balancing and fiscal equalization schemes imposed by the center¹.

Nevertheless, political support for these changes and welfare devolution (introducing more welfare competences for the Länder) remains weak and unstable. Besides, there is no unanimous support for more devolution among the Länder, especially considering that Eastern states and less affluent states in the West will not benefit from such rearrangements. Therefore, even if German federalism does not strictly prevent welfare decentralization, major structural reforms are difficult to accomplish because of the well-established practice of consensus that

¹ This absence of ‘laboratory federalism’ practice lead to policy experiments and learning conducted outside the traditional social welfare system, especially in the area of social insurance (e.g., local care for the elderly, local assistance to socially unprivileged groups). (Schmid 1990, Alber and Schölkopf 1999).

should be maintained among regions and between the regions and the federal government. As a result, Germany's "grand coalition state", as Schmidt names it (Schmidt 2002), as consensus is required among parties as well (mainly Christian Democrats and Social Democrats), does not provide many alternatives to changes, except those negotiated between upper and lower tiers of government (Manow 34: 2004).

2.4. Key elements of the German federal model

The following features of German federalism – cooperation, unitarism/centralization, and symmetry have shaped federal practice in Germany, provided for its interaction and 'co-existence' with Social Market Economy and *Sozialstaat* (welfare state). In many respects, these features allowed German federalism to stand numerous challenges during tumultuous periods of history – the creation of the German Empire and its collapse, post-World War I economic and political shocks, and Nazi's rule. In many respects these elements (cooperation, unitarism/centralization, and symmetry) contributed to the creation of the federal system Germany possesses today, but they never existed in vacuum: they changed their relative weight, developed, and evolved in compliance with the tasks and assignments the whole federation needed to perform at different stages of history.

2.4.1. Cooperation component

With the Basic Law of 1949 heralding a new chapter in German federalism, its cooperative component was only strengthened in order to perform two important functions (Börzel 2001). Firstly, it established vertical separation of power with a considerable power reserved for the regional level in order to avoid the re-creation of a strong centralized state (Hesse 1962). Secondly, the implementation of the *Sozialstaatprinzip* (welfare state principle) (Art. 20 I of the Basic Law) required the federal structure to provide for a certain uniformity regarding social welfare of the citizens. This may sound paradoxical, but in Germany, as Sturm claims (2018),

the century-long tradition of German public to rely on the central state as a chief provider of welfare has much contributed to the idea that the most efficient federalism is one which encourages equal treatment of each citizen. Sturm labels this belief as misleading, driven by the wrong interpretation of the Article 20 of the Basic Law, which enshrines a social and welfare state (*sozialer Bundesstaat*), and party politics, as for them promising more social welfare came to be beneficial in terms of winning the electorate.

Originally, the adoption of the Basic Law firstly gave rise to the German phenomenon of ‘executive federalism’ and ‘functional federalism’ because the legislative power is predominantly exercised by the federal level, and the administrative functions lie within the competence of the Länder (Karpen 2007). The emergence of “cooperative federalism” became the next element, as the center was also able to encourage or sometimes enforce formal and informal coordination of the states’ activities. At the beginning, ‘cooperative federalism’ may sound as a pleonasm since federalism itself involves a certain degree of cooperation between federal center and sub-federal units. In Germany, this term has its own connotation which describes that the federal government and Länder participate in designing “joint tasks”, planning, finance issues and implementation. By the mid-1970s, cooperative federalism had attained its distinctive features (Jeffrey 2002):

- ‘Functional’ federalism: division of powers between federal and Länder legislative and administrative bodies;
- Bundesrat actively participates in the decision-making process at the federal level;
- Länder and the federal government commit themselves to securing consensus regarding policy design and implementation that is enforced via mechanism of coordinating committees;
- The increasing bureaucratic complexity (*Politikverflechtung*) of the upper and lower levels of government;

- Relative marginality of the few remaining exclusive competences still exercised by the Länder and their legislative assemblies (Landtage);

The consequences of cooperative federalism system were thus two-fold. On the one hand, cooperation encourages accomplishment of the common goal – achieving the uniformity of living conditions, which became even more desirable after Unification. On the other hand, such a vast system of interlocking competences and long negotiations may lead to a lack of transparency and a “joint decision trap”.

However, since the late 1980s but especially in the 1990s, the achievement of the common goal has become a highly debated goal. While joint achievement of common goal provides for improvements at the federal level and helps to bridge huge gaps between affluent and impoverished regions, it cannot force sub-federal units into having common interests. The notion of joint decision-making via cooperative federal framework in order to achieve common goals implies that some Länder will have to sacrifice their interests as well as part of their revenue for a ‘common good and well-being.’ It resulted in that such regions as Bavaria and Hesse, for example, started questioning the purpose of this mechanism.

Since the 1990s, the ‘spirit of cooperation’ was in decline compared to the pre-unification period or the first post-war years of the Federal Republic, when the need to rebuild economy and demonstrate its prosperity to the socialist German Democratic Republic used to ‘encourage’ both the center and regions to strive for a common goal (Jeffrey 2002). Moreover, policy differentiation among the Länder is gaining pace, and the Länder began pursuing policies responding to their interests: Hessen in air transport, Brandenburg in its relations with the Eastern Europe, and Bavaria in agricultural field. Deepening Euro integration of Germany has also added up to this tendency, as German regions became more interested in ‘going it alone’

approach in their relations with EU institutions whilst loosening their coordination and consolidation within 'home' federal structure (2002).

Nevertheless, despite these trends and the 2006 constitutional amendment, which reduced the number of joint tasks shared between federal and sub-federal levels, cooperative federalism remains an important feature of German federalism. Initially, it stems from the federal nature of German federalism that, depending on the situation, encourages or compels the representatives of central and regional governments to come to an agreement and negotiate consensus concerning the tasks they have to accomplish together. Moreover, the Basic Law does not restrict itself to distinguishing between the competences at the federal and regional levels only, it also differentiates between a wide array of policies and assignments that involve cooperation, co-decision and a division of workload regarding policy implementation between federal and regional (Länder) levels (Benz and Sonnicksen 2017: 15-16). Besides, as parliamentary democracy is building block of German political system, it has an impact on the cooperative federalism's mechanism as well: the letter and spirit of German parliamentarism necessitates the negotiating authorities to consider the will of parliament, plus the authorities have to take into account the logic of party competition which makes the ruling and opposing party antagonists.

2.4.2. Centralization/unitary component

When it comes to German centralization or unitarism, centralized policies in the German case mean that the central government sets the guidelines and standards which should be met by the Länder when they perform administrative assignments. The phenomenon of high centralization of German federalism arises from a long-lasting tradition of concluding a huge variety of cooperative arrangements and treaties concerning public law, military and economic issues, e.g., trade, custom services (Schesinger 1998: Chapter 4). Until unification of German states in 1871 and the creation of the German Empire, more than 20 German city-states, principalities

and states mostly ruled by Hohenzollern and Hapsburg royal dynasties were parties to this kind of treaties. Subsequently, it laid down the foundation for the following continuous disjunction in German federalism: whilst political and economic arrangements were to a certain degree fragmented and left much room with regards to their implementation, German states indeed possessed a common language and culture, though there were significant distinctions between Protestant states in the north and Catholic South.

The drift towards centralization was not implemented in the blink of an eye, it evolved and continued during the Weimar Republic. Under Article 9 of the Weimar Constitution, the federation had the power to overrule Länder's decisions regarding domestic affairs and welfare provision in cases of a 'need for unified direction' (Schlesinger 1998: 103). Aiming for restriction of the Länder's powers, the framers of the Constitution provided the federal government with significant competences allowing for greater centralization of the federal system, and at the beginning of the 1930s, Germany appeared to have many features common for a unitary state. Quite interestingly, that even Hitler's capture of power did not curtail federal and administrative systems. Although at the time, Länder did not have any political independence, they were important providers of Nazi policies in their respective domains. After the World War II, the Allies, who controlled West Germany and were aware of the unsuccessful federal experience of the Weimar Republic, insisted that the federal model should be maintained and the centralist tendencies of the federal government-to-be have to be constrained with the help of an institution representing the interests of the states – the Bundesrat.

However, despite these efforts, since the 1950s, the growing degree of centralization has become a distinct characteristic of the German federalism. It would be wrong to say that this centralization was forcefully imposed, quite the opposite: it was encouraged due to a strong sense of aiming towards common purpose and well-being through rebuilding the country. Besides, the Basic Law proclaims Germany to be a 'federal social state', and judging by the

development in German politics over the last century, it is also a ‘party state’, but interestingly, with a significant degree of policy diversity (Schmidt 2015: 2).

Actually, with the adoption of the Basic Law, Germany’s federalism began its way of shifting to a greater centralization or more ‘unitary’ federalism meaning that the federal government gained more power, and sometimes this power was excessive, with regards to setting policy objectives, living conditions, and coordinating cooperation between sub-federal units, formal and informal. What eased this process is that the people’s identity at the time was more national one than regional (Karpen 2007), except probably Bavaria, where regional identity had always been persistent. Additionally, the gradual erosion of the territorial divisions also played to the benefit of greater centralization. In contrast to the Weimar Republic, where the activities of political parties were more tailored to the territorial divisions within the country, in the Federal Republic of Germany, party politics became increasingly nationalized; the same parties competed for mandates both at the federal and regional levels. Soon the two leading parties – the Christian Democrats (CDU/CSU) and Social Democrats (SPD) became Volkspartien (people parties) as they addressed people in the whole country, rather than appealing to a particular group living on a particular territory.

Despite the fact that centralization was criticized in the 1980s, and nowadays German federalism is less centralized than once it was in the 1950-1980s period, it is indeed still centralized, though more competitive (McKay 2001: 22-24). Nevertheless, centralization remains an extremely important feature considering the provision of equivalent living conditions, enshrined in the Basic Law, and centralization’s role will be even more evident when the German system of fiscal federalism will be analyzed.

2.4.3. Symmetry component

In the studies on federalism, Germany is often referred to as one of the most symmetrical federations in the world on par with Australia, Austria, Canada, and Switzerland (OECD 2019:

86). The symmetry component in the design of federations is essential to understand the pattern of relations between the federation units and the central government, and among the units themselves. Ideally, as Tarlton (1965: 867-868) points out, symmetrical federation is comprised of political units of equal territory, population, cultural and social patterns, without significant social and economic disparities. There is also no major differences regarding the issues of concern for the units, but the most important aspect of symmetrical federalism is the same relation of a political unit or subnational government to the central government. This is accompanied by such elements as equal representation for each subnational government, same political mechanisms in each subnational unit, and equal distributional policies and support to the units' activities from the central authority (1965). Consequently, symmetrical model of federalism assumes that as a result these arrangements would generate no critical economic, social or political imbalances which would require preferable treatment, targeted assistance, and special protection or representation.

In this regard, based on the above-mentioned criteria, until the 1990s Germany presented a 'paradigmatic case' of a highly symmetrical federation (Bird 2014: 43) strongly committed to uniform treatment and searching for consensus. Combined with strictly symmetrical division of competences, sharing of responsibilities and resources among the Länder and between the Länder and the central government, this well-established system provided for smooth operation of German federalism (Auel 2014: 422). However, since Unification and the subsequent incorporation of the former German Democratic Republic into the Federal Republic of Germany, the time-proved system has been under considerable strain, and it was fiscal federalism component which balanced functioning has been severely damaged (Jung 2005). The incorporation of the five new Länder did not only increase the number of regions in the federation but also resulted in considerable economic disparities and intensified conflicts over

financial issues between rich regions and ‘have-nots’ regions, mainly Eastern ones, as well as between rich regions and the center.

In the post-Unification period, there were heated debates over the necessity to introduce more fiscal authority to the sub-national units, but the scheme continues to persist regardless of a considerable number of shortcomings testing the durability of German fiscal federalism (Rodden 2003). Germany presents itself an interesting case because constitutionally it has a formula-based fiscal equitation mechanism that has much in common with the like of unitary states. As in Canada, but not in the US, for example, this mechanism reallocates tax revenues among the states and the federal government (Hepp & Hagen 2010).

2.5. Conclusions and Discussion

German federalism has never been the same throughout the history of its existence, but its vagueness and flexibility made it a success story. During Imperial times, or post-war periods, when the federal union could broke apart, it many ways helped to reconcile the state whilst adjusting to the tasks the federation needed to perform. But in spite of being ‘vague’ as Umbach labels it, or, in other words, not exactly defined, federalism was and remains one of the constituent and founding forces of the German political system.

The development of federalism in Germany was closely tied with the culture of consensus, which was deeply rooted in German political tradition since the Holy Roman Empire. German federalism was continuous and enduring that could be confirmed by a chain of events, from the creation of the German Empire to Unification of 1990. Although not all political regimes in Germany were federal and not all federal regimes were democratic and welfare state-oriented, federalism has never entirely disappeared from political canvas. While, for example, being little able to constrain the expansion of undemocratic tendencies in the 1930s, federalism nevertheless demonstrated its full potential when there was a need to rebuild the economy. In this regard, it is worth considering the German’s attitude to federalism: if in the late 1940s,

federal model was not popular among the ordinary Germans as well as among the Social Democrats (SPG) and communists (KPD). Back then, it was the Allies (the USA, the UK, and France), who pushed the federalist agenda (Umbach 2002: 5-6). At the same time, the separate histories of the German states were not the direct cause of the successful re-introduction of federalism into the German political system, but it were the positive results that provided federalism with an enthusiastic attitude to in in people collective memory (2002: 6). In the German case, therefore, federalism thus can be considered as one of the founding principles on which the German state rests. Although it is not always much dynamic and might seem ineffective, it is ready to be invoked should so require political circumstances.

What provided such a reliability and sustainability for German federalism were its defining elements: cooperation, centralization/unitarism, and symmetry. Interacting with one another, they provide for the ability of the German federate model to cope with political challenges and any kind of disparities that need to be absorbed. In the same fashion as German federalism itself, which is not always active or efficient, these three elements do not exist in the vacuum. They are adaptive according to the circumstances, as it were in the 1950s, when the high degree of cooperation and centralization of competences was required to accelerate the pace of the German economy and rebuild the country.

The combination of cooperative, centralist, and symmetry motives in the German federal model assisted in the successful implementation and development of the large welfare state (Sozialstaat) and the Social Market economy, which success would be unthinkable, had it been not supported by a proper implementation of welfare and economic postulates by the Länder. It is, nonetheless, important to consider the circumstances in which these principles operated. Certainly, it was less problematic for the Länder to cooperate when income and wealth inequalities among them were less striking, and the territorial inequalities were absent which sweetened the pill of the necessity to accept, for instance, such provision of the Basic Law, as

‘uniformity, or later, equivalence, of the living conditions’ (Article 20 of the German Basic Law).

To sum up, it is worth saying that German federalism can be more or less pronounced and this is not a weakness, but rather a strength of the German federal model, since despite some of its vices (which we will elaborate upon later), it has always been pragmatic. It combines such complicated things as the sense of cultural belonging and national identity with a highly sophisticated model of government that accommodates both centralist and devolving elements. This is why German federalism lived through many dramatic moments, and the ability to address people from different backgrounds has stood the test of time: the ability that not all classical and brand-new ideologies possess.

Chapter 3: Fiscal Federalism in Germany

This chapter provides insights into the German fiscal federal system. Starting with the scholarly analysis of fiscal federalism in Germany, the chapter continues with the theoretical and constitutional framework. Special attention is given to the fiscal equalization scheme which is one of the most controversial aspects of German fiscal federalism. Also, because of its complexity, this system cannot generate a strong link between taxation and spending, which is of crucial importance for the states' budgetary systems. Based on the literature analysis and constitutional foundations of the German fiscal federalism, the conclusion can be drawn that it is rather fiscal arrangements that generate much tension within the German system of government, than it is federalism to blame.

3.1. German Fiscal Federalism in scholarly literature and debates

Considering the state of fiscal federalism in Germany, there exists broad literature that mainly focuses on intraregional relations and the negotiations over the (re)distribution of tax revenues (Renzsch 1989, 1991; Selmer 1994, Benz 1999, Watt 2000, Ziblatt 2002). Among all, Selmer expressed most concerns regarding the reform of fiscal patterns of the German tax redistribution system. In his view, the reform of fiscal equalization was quite a questionable attempt to add the compromise concerning the contributions of the federal and the state governments to the transfers flowing from Western German regions into East Germany.

There are also several quantitative studies investigating the effects of revenue redistribution as a chief measure of fiscal equalization in Germany (Lenk 2004, Lenk and Birke 2000, Pitlik 2004, Pitlik and Schmid 2000). The authors of these papers concentrate on analyzing positive and negative effects of fiscal equalization as well as the gains and losses acquired by the states, and linking them to the level of bargaining power the regions (sub-states) have in the negotiation process with each other and with the federal government. Their main conclusion is that those states benefit from fiscal harmonization and fiscal equalization, which possess a relative majority of seats in the Bundesrat (chamber of the regions). In their turn, the 'underrepresented' regions appear to have contributed significantly more for the common cause than 'overrepresented' regions having more seats in the second chamber.

Additionally, a number of studies are preoccupied with the overall design of the German fiscal system and problems plaguing it. The study by Rodden (2006) highlights the shortcomings of German fiscal federal arrangements by examining the fiscal disputes between the subunits and the absence of rigid budget rules or hard budget constraints that encourages the subunits to overborrow money and wait for the federal government to come to their rescue. Jochimsen (2008) points out at the wrong incentives as the main negative effect of the centralization of the fiscal policies in Germany, and stresses the need for deep reforms, at least for the most pressing issues. Reflecting on the nature of federalism and its virtues, Sturm (2007) is concerned with the increasing asymmetry of the German federal design to which unequal patterns of fiscal arrangements have also added up.

German fiscal federal design features in comparative studies on fiscal federalism and decentralization. Admitting that nowadays, both more and more unitary and federal countries introduce some forms of decentralized governance, Bosch and Duran (2008) address the issue of finding the right balance between effective autonomy of sub-national units and their responsibility for how they raise and spend revenues. In the study, Germany referred to as a historically federal country with a well-established system of financing regions, which prioritizes redistribution of revenues and fiscal equalization (Buettner, Chapter 6). However, in contrast to Canada, which fiscal federal system is more decentralized, the positive effects of the German fiscal system are offset with disincentive effects caused by overreliance on the redistribution and equalization mechanisms.

In another comparative study, Braun (2007) develops a model of efficiency-enhancing fiscal federalism, which was in line with the second wave of fiscal federalism theories (SGFF), and then applies this model to Germany, Australia, and Switzerland. While self-enforcing fiscal federalism arrangements are the most far-going and far-reaching in Australia, Germany and Switzerland, in Braun's view, have a long way to go in order to increase the efficiency of their

fiscal systems. In addition, in line with Buettner (2008), Braun puts the blame on the long-lived tradition of bailing out which hurdles competitiveness between the Länder and reduces incentives for the Länder to be more fiscally prudent and autonomous.

In a similar fashion, being interested in the role of the center in decentralized federations and acknowledging the importance of the proper design and tools of fiscal federalism systems, Virkola (2014) investigates empirically fiscal policy framework of four federal countries: Canada, Germany, Switzerland, and the United States. His main conclusion is that even in highly decentralized countries, the role of the federal government is large. According to Virkola, this might be caused by the presence of ‘passive insurance’ support mechanisms, which are in place in all countries observed: being hit by economic instability or economic crisis, as it was during the Great Recession, households tend to rely on the direct support programs funded by federal transfers such as unemployment benefits or health insurance (2014).

3.2. Institutional Design and the “Financial” constitution of the German fiscal federalism

The German system of fiscal federalism in many ways follows one of the basic provisions of the Basic Law, which is the provision of equivalent living conditions across the country (Article 20). In this regard, German fiscal federalism was constructed in the way to accommodate such different concepts as diversity and unity by employing a federal system, but taking into account the common well-being goal (uniform or equivalent living conditions).

The general wisdom behind this constitutional provision was that regardless of people’s place of living, they have quite the same preferences and expectations regarding social-economic well-being and living conditions (Watts 2000:8). Hence, uniformity or at least pursuing uniformity has become a powerful notion affecting the actions and policies undertaken at the both levels of government, regional and federal. In this regard, German federalism is much in

contrast with the US federal model which places higher value upon the autonomy of the states and individual's initiative.

This equivalence of living conditions is achieved and maintained through constitutional provisions, amendments to the constitution, intergovernmental relations, and judicial review. The most important amendments increased the Länder's financial and legislative competences (these were approved in the 1967-1969 period) and introduced more provisions on redistribution (the 1990s period). As it was mentioned before, the German fiscal federal system, as well the German federal system overall, is directed towards the achievement and maintenance of the equivalence of the living conditions. Article 72 of the Basic Law (Concurrent legislation of the Federation) postulates:

- (1) On matters within the concurrent legislative power, the Länder shall have the right to legislate so long as and to the extent that the Federation has not exercised its legislative power by enacting a law.
- (2) The Federation shall have the right to legislate on these matters if and to the extent that the establishment of equal living conditions throughout the federal territory or the maintenance of legal and economic unity renders federal legislation necessary in the national interest.

The federal government in Germany has more legislative powers than in the US or Canada (Watts and Hobson 2000), though the states also possess wide legislative competences. All laws considered at the federal level need to be approved by the majority of the Bundesrat. Regarding other legislative acts, the Bundesrat can also use a suspensive veto. Länder governments are independent when it comes to performing administrative tasks and dealing with budgetary policies, and they bear responsibility for dealing with their assignments effectively (The Basic Law of Germany, Articles 29, 30 and 31).

However, the necessity of the states to assure 'the equivalence of living standards throughout the territory of the federation' (Article 72(2), para 3, and Article 106(3), para 2) imposes the need for the states to engage in the joint decision-making procedures. In their turn, the rich

states have also to part with a share of their income which would later be used to finance poor-performing states. In the late 1960s, under the flag of achieving uniform living conditions, first substantial fiscal reforms were introduced. They aimed at deepening cooperation among the states and centralization of the tax system. For some (see Abromeit 1992, Sturm 2007) this was a step to such a high degree of unitarism that afterwards it was almost impossible to distinguish between unitary federation and the unitary state.

States' expenditures are financed via tax revenues, federal transfers, and debt, and basically, the Länder are allowed to borrow. Until 2015, there existed a 'golden rule', namely a nominal rule-based borrowing threshold for the federal and state governments, but it was widely criticized for being ineffective, so in 2015, the new debt brake system was introduced (see Chapter IV). In contrast to possessing vast expenditure and borrowing authority, the states' tax autonomy is much restricted (Federal Ministry of Finance 2009, Watts and Hobson 2000).

Taxes in Germany are divided into four categories: federal, state, local and shared taxes (subcategorized into the value added, corporate and income taxes). Shared taxes and the revenues generated from them are placed in the Basic Law under article 106(3) since it involves constitutionally mandating sharing, which should be organized on the respective principles:

1. The Federation and the Länder shall have an equal claim to funds from current revenue to cover their necessary expenditures. The extent of such expenditures shall be determined with due regard to multi-year financial planning.
2. The financial requirements of the Federation and the [Länder] shall be coordinated in such a way as to establish a fair balance, to avoid excessive burdens on taxpayers, and ensure uniformity of living standards throughout the federal territory.

3.3. Fiscal equalization

Firstly, the shared taxes are allocated according to the agreed formula, between the federal and state levels. Income tax revenues are distributed among the individual states based on the principle of permanent residence principle (revenues belong to the state in which the taxed

persons reside). The states' portion of the corporate taxes revenues is distributed according to the permanent establishment principle (Thöne and Bullerjahn 2018), namely, tax revenues generated from the taxation of a company or firm's commercial unit belong to the state in which the given unit is placed. Approximately 75% of the VAT-generated revenues are allocated according to the per capita basis, and the remaining one-quarter goes to finance those states whose per capita revenues are below average (this is processed after the revenues from the state and shared taxes are allocated). In this sense, this procedure can be regarded as the first step in the equalization procedure, because value added tax (VAT), or the revenues generated from the VAT; to be more precise, are employed to equalize revenues among the states (Bundesministerien der Finanzen).

The basic rule of the German equalization system is that the Länder with above-average per-capita revenues transfer a part of their revenues to the Länder with below-average revenues (Gunlicks 2000, Larsen 1999). As soon as fiscal transfers were made during the stage of the primary distribution of tax revenues, intergovernmental transfers are forwarded to explicitly balance the states' fiscal capacities, with the special priority given to the weak states. This stage is called Länderfinanzausgleich, or horizontal equalization, because so far the federal government does not participate in the procedure. Originally, the definition of a fiscally weak state is fairly ambiguous, but generally, these states are fiscally strong, whose per-capita revenues after the primary allocation of tax revenues are above-average and vice versa (Baskaran 2011: 117).

Secondly, at the next stage, fiscal equalization involves different vertical transfers forwarded from the federal government to the states. Initially, all states that are considered as fiscally weak receive unconditional, or general-purpose funds with the purpose they will be able to boost their fiscal capacities. Additionally, the federal government reimburses those fiscally weak states that experience special expenditure needs.

Lastly, the federal government provides explicit bailout transfers to render highly indebted states from their excessive debt burden. Formally, this transfer can only be made after the Federal Constitutional Court considers that a particular state is indeed in a state of a serious budgetary crisis, and only after the sanction from the Court the federal government can issue the transfer. Such a procedure was enacted with regards to two states, Saarland and Bremen, which relied on the bailout transfers in the 1994-2004 period after the respective ruling of the Constitutional Court in 1992.

3.3. Conclusions and discussion

In the German fiscal federalism model, the allocation of powers between the federal government and the states demonstrates that the Länder, despite having few exclusive legislative powers, are nonetheless important players in German political system. Possessing vast administrative competences, they are able to shape policies within their respective territorial domains, implement policies at the sub-federal level, and protect their political interest via Bundesrat.

However, if the German federal system is duly regarded as a very symmetrical one and capable of overcoming serious challenges, the design of the Federal Republic' fiscal federal system is more questionable. Having analyzed its system of fiscal equalization, it become clear that the main vice of the German fiscal system is breaking the connection between taxation and spending which is of great importance for a well-balanced budgetary system (Rodden 2006). The Länder enjoy significantly generous expenditure autonomy, they do not have the same autonomy when it comes to collecting and raising their own revenues. This is a direct consequence of the institutional design of the German fiscal federalism: whilst most expenditure and policy implementation procedures take place under the Länder's responsibility, the federal government decides upon the revenues. Consequently, local residents, for example, cannot fully grasp what happens with their taxes, which tier of the federation taxes particular

goods and services, not saying that voters usually do not possess not capabilities nor the desire to track and monitor these fiscal operations.

Finally, German fiscal equation model appears to be complex, which might be caused by quite a challenging provision of the German Basic Law requiring that equivalent living conditions should be maintained throughout the federal state as a whole. While aiming towards the provision of equivalent living conditions and thus easing the tensions among the states, this system nevertheless creates perverse incentives for moral hazard and obstruction of the fiscal rules, and consequently it leads to new tensions among the states (this will be more discussed in the chapter on Unification). Considering the fact that the federal government could use its financial authority to bail out overdebted states, this again contributes to fiscal profligacy and demonstrates that the problem of the existence of soft budget constraints continued to trigger intergovernmental fiscal relations in the Federal Republic. Actually, this problem was solved only after the debt brake system was introduced to deprive the fiscally unstable states to rely on the government should they run into heavy debts, thus laying down the foundation for the functioning of the hard budget constraints.

Chapter 4: German Unification and Its Impact on Fiscal Federalism

The fall of the communist regime in the German Democratic Republic and the Unification with Western Germany that followed have changed the pattern of German federalism and fiscal federalism in particular, having unleashed huge contradictions between the rich states of the West and their less well-off counterparts in the east. Despite being quite a controversial measure, fiscal equalization and other reforms driven by Unification helped to cope with huge socio-economic disparities, however, at the cost of greater centralization and redistribution from the more well off states, especially in the first years after the Unification Treaty entered into force.

4.1. Historical background

The fall of the Berlin Wall surprised many political observers, but for Germans on the both sides of the Wall it was a surprise as well. At the time, it was a common wisdom that the USSR, even ruled by reformist Gorbachev, would not be willing to give real independence to the GDR, which was the Soviets hard-won trophy after the Second World War (Gunlicks 1994: 81). And, certainly, the sheer thought of the German Democratic Republic reuniting with West Germany would be considered ridiculous back then. It is indeed true that the decline of the USSR's power was expected, but quite a few, if any political analytics, would dare to predict the collapse of the Soviet Union, altogether with the dissolution of the Warsaw Pact, an economic community of the Soviet satellites, and the overwhelming fall of the communist regimes across Central Europe.

At the beginning, political establishment of West Germany was not confident pursuing its plans on reuniting with its neighbor, as the reaction of the Soviet Union was much unpredictable, plus Great Britain and France were not encouraged by the possibility of a stronger and bigger Germany. That is why, given the unpredictable response from the USSR and lingering fears of Britain and France, the West German government was planning unification very cautiously. In 1989, on November 28, Germany's Chancellor Helmut Kohl initiated a ten-point plan, where unification, but to be more precise, joining of East Germany to the West Germany was the

ultimate goal (Kohl 1989). Among these steps, three were of utmost importance regarding unification and German federalism. First of all, Kohl engineered that the Federal Republic of Germany and the German Democratic Republic would build a “contractual community” thus forcing mutually beneficial cooperation in such fields as science, technology, the environment, and culture. Secondly, Kohl proposed the establishment of confederate structures in order to ease the unification process and transformation of East German regions within a new polity. Thirdly, the Chancellor deemed it vital that unification should ‘crown’ the small efforts leading step by step to a federation.

By this time, it was not a secret that united Germany should be a federation. Article 79 of the West German Basic Law, or constitution, required so, and additionally, long history of federalism stemming from the imperial times and successful development of West Germany based on the federal structure made it clear that East Germany would be joining a federation (Gunlicks 1994). However, even Kohl and his the most optimistic supporters could not imagine that the chain of events would develop much faster. Every day, around 2,000 people were fleeing to West Germany from the GDR, and being incapable of prevent it, GDR authorities decided to move up the date of the first free elections from May to March.

Subsequently, unification was ‘scheduled’ to take place in 1991 or 1990, but the latter seemed to be almost impossible. Immediately, after the fall of the Berlin Wall, people in the GDR began to claim the re-establishment of the East German Länder that were created in 1947. These Länder existed for a relatively short period, because they were abolished in 1952, with the founding of the German Democratic Republic which turned these Länder into administrative units within a centralized unitary state (Gunlicks 1992). Interestingly, regardless of the fact that three of the five Länder had little or even no federal practice at all, people in East Germany developed a close identification with these Länder, much closer than with the GDR (Gunlicks 1994: 82). Providing a positive response to these claims, GDR prepares a bill

(*Ländereinführungsgesetz*) amending the constitution of the GDR and returning into being five Länder: Brandenburg, Meklenberg-West Pomerania, Saxony, Saxony-Anhalt, and Thuringia. The bill went through three readings, passed into law, and on October 3, 1990, the new Länder were proclaimed. Besides, the law of 22 July solidified the creation of the sixth Land, Berlin. Formally, the unification procedure was conducted in the form of accession of the GDR to West Germany. Hence, the GDR decision to accept the Basic Law of West Germany was sovereign and unilateral, since such an initiative was allowed by the then present article 23 of the West German Basic Law. During the negotiations it was already clear that Unification would not remain a merger, as the ‘outcome’ was not a new state, as it would be should the unification procedure be made in form of merger. Rather, East Germany ceased to exist, and its five Länder were incorporated in the West Germany’s federal system. In the same fashion, East and West Berlin were joined together and also became absorbed by the Federal Republic as a federal City-State. Therefore, this model of unification played to the advantage of West Germany, which grew to 16 Länder (enlarged by 5 states of the former GDR and the newly unified Berlin). In legal terms, the GDR ceased to exist having joined West Germany whereas the legal existence of Federal Republic of Germany remained untouched since it was established in 1949.²

The negotiating process between West Germany and the GDR regarding East Germany’s accession to West Germany resulted in the German reunification treaty (commonly known in Germany as *Einigungsvertrag* – Unification Treaty, or *Wiedervereinigungsvertrag* – Reunification Treaty) signed on 31 August 1990 by the governments of West and East Germany. Article 1 of the Treaty proclaims that East Germany agreed to join the Federal Republic of Germany under the provisions of the Article 23 of the Basic Law, under which

² The German Unification did not also produce a new constitution and this again confirms the notion that GDR was ‘absorbed’ by West Germany. The Basic Law was amended after the former GDR joined the FRG, but not replaced by any other document. Its provisions still permit the adoption of a constitution by the German people.

“other parts of Germany” could join the Federal Republic as well. To calm the fears of Poland and the Czech Republic, who suspected that Germany might wish to return the territories it used to have prior to the World War II, Article 4 of the Unification Treaty abolished and added five new states in the Basic Law’s preamble. This was made to demonstrate that no other former territories possessed by Germany would accede to the Federal Republic and Germany no longer maintained any military aspirations.

Of equal importance, if not greater, was the agreement of the Four powers, victors in the Second World War – the Soviet Union, the United States, the United Kingdom, and France permitting the two Germany’s to reunite, though originally there was a strong opposition to the unification project from the UK and France (Binyon 2009, Knight 2009, Volkery 2009). The Two-Plus-Four negotiations provided a positive background for unification at the international stage, and the following conclusion of the treaty (Treaty on the Final Settlement with Respect to Germany) greenlighted the creation of unified German state thus allowing a united Germany to enjoy full sovereignty³.

4.2. Constitutional changes to German federalism

Changes of a constitutional character were made from the outset of the unification process. The most obvious and visible transformation – the addition of five reconstituted Länder to the Federal Republic, and the number of German Länder increased from 11 to 16. Less visible in quantitative terms but no less important was the constitutional change in the Bundesrat that followed. Among the five newly joined Länder, none was able to match in terms of size, economic potential, and population the ‘big four’ Länder in Western Germany: Baden-Württemberg, Bavaria, Lower Saxony, and North-Rhine Westphalia. These heavyweights

³ According to the Potsdam Agreement, most of Germany’s eastern territories were awarded to the USSR and Poland. These agreements were provisional, as the Potsdam Agreement postulated that this process had to finished with “a peace settlement for Germany to be accepted by the Government of Germany when a government adequate for the purpose is established” (Potsdam Agreement 1.3.1.)

feared that with the acquisition of the Eastern states, the new Länder would enter a coalition with small-, medium-sized and poorer Länder in the West and thus would outvote the ‘big four’ pushing forward fiscal equalisation programs favoring redistribution and other costly financial assistance programs. However, the ‘big four’ managed to push through a new legislation regarding allocation in the Bundesrat which gave each of them six instead of five votes in the ‘upper chamber.’

As the number of Länder increased, so did the number of votes casted in the Bundesrat overall, from 41 to 69. Taking into account that for constitutional changes the majority needs to win two-thirds of the vote in the Bundestag and Bundesrat (Merkl 1994), the four largest Länder having 24 votes could secure their interests from the possible attempts of the smaller and poorer states to impose more redistribution responsibilities on them. Nonetheless, the five new Länder had benefits as well: comprising just about one-fifth of the population (18 per cent) they now had approximately 28 per cent of the vote, or 22 per cent of the population and 33 per cent of the vote (Berlin included). Such over-representation that did not match not geographical neither population criteria played to some advantage of the Eastern Länder in the Bundesrat. It was also evident that the West German division between two large Länder in the north and the other two in the South ceased to exist, as the relative weight of smaller states increased (Gunlicks 2002).

In 1991, the Bundesrat created a Commission on Constitutional Reform whilst working on the Unification Treaty. Apart from debating the provisions of the treaty-in-the-making, federalism became the hot topic of discussions among the politicians and political experts. In the recent years, prior to the Unifications, the representatives of Western Länder, especially from Bavaria, voiced their concerns regarding shrinking competences and powers of the Länder and the growing involvement of the federal government in the states’ affairs (Klatt 1989). However, the constitutional changes were fairly subtle and modest; they did not change the core provisions regarding the division of powers between the federation and the states. For example,

Article 72 regulating concurrent powers was reviewed to in a stricter sense. Now, if the federation wanted to interfere and take concurrent powers of a Land under its guidance, it needed to demonstrate that it was ‘essential’ or ‘required’ instead of just stating that there was a ‘need’ to act this way. Such controversial phrase as maintaining ‘uniform living conditions’ in the whole federation was transformed to securing ‘equivalent living conditions’. In the light of financing new Länder, which were economically stagnant and underdeveloped, ‘equivalency’ would be an easier goal than expensive ‘uniformity,’ especially taking into account huge disparities concerning economic development and living conditions in the West and in the East.

More important were changes made to Article 24 that now guarantees the Länder the right to transfer (with the approval from the federal government) certain ‘sovereign powers to trans-frontier institutions in neighboring regions’ (The Basic Law). This provision was of great use for the Länder, as they were actively involved in many cross-border projects, which actually blossomed after the EU enlargement (reference). Nowadays, German Länder actively participate in many cross-border projects, especially in the field of healthcare and education, with the regions and provinces of Austria, the Netherlands, Denmark and France (reference).

Meanwhile, the Unification process and constitutional reforms to the Basic Law provided a stimulus for the lawmakers in the Länder to contemplate upon constitution for the states as well. Since the Basic Law was enacted in 1949, almost no attention was drawn to Land constitutions (Gunlicks 2002). Some modest amendments and technical corrections had been made during the next forty years, but at the end of the 1980s, the calls for Länder’s constitutional reforms became increasingly vocal. The Schleswig-Holstein constitution of 1990 pioneered many innovative changes, such as direct democracy (referenda and initiatives), the provisions on which would be added to the constitutions of all other states by 1997. Apart from successful attempts of Schleswig-Holstein to reform its constitutional foundations, the mere fact of five

Länder joining the Federal Republic incentivized constitutional reforms at the sub-federal level. Increasingly, the direct democracy issue became a topic of fierce debates soon after Unification. Whilst the attempts of the left parties with regards to introduction of the direct democracy at the national level were not victorious in 1993 and 1994, nevertheless, the left succeeded in implementing the direct democracy provisions in the texts of the Länder constitutions.

4.3. Reforms in the Fiscal Federalism System

4.3.1. Solidarity Pact I (1993)

Amid many changes brought by Unification, the reforms related to fiscal federal design have had the most profound impact and also generated numerous discussions about the necessity to review the fiscal federal system. The provisions in the Basic Law regarding the uniformity of living conditions were not much likely to bridge the huge gap existing at the time between economically developed Western Germany and underdeveloped East. It was evident that financing public services and infrastructure and reforming the budget system of the new Länder would be the most formidable challenge for the Federal Republic. Besides, it was apparent that the ‘old’ Länder would not be over-enthusiastic sacrificing a substantial part of their revenues in order to improve the economic prospects for East Germany.

The German system of fiscal equalization, precisely its redistribution aspect, according to which fiscally well-performing states have to transfer a part of their revenues to their poor-performing neighbors, had been an apple of discord long before the Unification. This controversial system had already led to multiple tensions between the well-off and ‘poor’ states in the West, and with Unification prospects for even greater redistribution, this system threatened to explode. In the first half of the 1990s, various temporary arrangements were concluded in order to ‘prepare’ Eastern Länder before letting them join the West German system of fiscal equation, including \$100 billion transfer (Gunlicks 2002: 140).

As a consequence of these pressures, the Länder's finance ministers negotiated a compromise financial plan under the name of the 'Solidarity Pact.' Since 1993, the Pact established that annually, DM 56 billion should be transferred to the East, with loans amounted to a billion spent on housing, infrastructure, environment, and business-friendly policies. To assist in financing these funds and loans a special 7.5% (in 1997, reduced to 5.5) 'solidarity surcharge' was introduced and placed on income taxes. As compensation for the five Länder joining the horizontal equalization scheme, the federal government increased the VAT shares for the Länder from 37 to 44% (49.5% in 1996). Overall, the Solidarity Pact proved to be costly not only for the 'old' Länder but above all for the federal government (Gunlicks 2003).

The Solidarity Pact left many discontented with the current state of affairs and increased the overall dissatisfaction with the reforms and adjustments made in the 1990s. The tensions between the rich and the poor states carried over to the 2000s, but they peaked in 1998, when Bavaria, Baden-Württemberg, later joined by North-Rhine Westphalia filed a suit to the Constitutional Court. They demanded changes in the fiscal federal system that would allow the rich states to leave their revenue shares within their jurisdictions. The Court ruled that the Bundesrat should consider which reforms would be necessary. Moreover, the Court stated that the regular payments made under equalization scheme should not exceed 95% in contrast to 99.5% of the average revenues paid (Gunlicks, 2002, Gunlicks 2003, Ziblatt 2000). Hence, after the equalization procedures take place, the revenue recipients cannot be ranked higher financially than the revenue providers.

4.3.2. Solidarity Pact II (2005), the 2006 Constitutional Amendment, and the 'sunset' of the Fiscal Equalization, 2017-2020

Following the need to reform the Solidarity Pact I, several changes were made to ease the burden of the 'big four' states, the biggest of which related to the decrease in transfer payments, so the Länder were able to save 12.5% of their revenues (Gunlicks 2002). By 2005, the Länder

prime ministers came to an agreement concerning the Stability Pact II. Under this Pact, the Eastern states would continue to be beneficiaries of heavy transfers and subsidies. The Federation concluded that the two-thirds of the DM 306 billion would be provided to the Eastern states in the 2005-2019 period, after 2009, the installments paid would be gradually reduced. In 2020, the assistance is scheduled to cease, but until that, the solidarity measures continued to be widely unpopular (Klatt 1997).

To smooth the implementation of the new solidarity package, cope with the fast development of the European market and respond to the claims of the Länder demanding more competences and less joint decision-making obligations, there was established a Joint Commission of the Federal Diet and the Federal Council in order to renew the German federal system. The overall result of the 2006 Amendment was a slight reallocation of the legislative competences in favor of the Länder (Benz and Sonnicksen 2018). Another demand of the Länder was also taken into account, and the number of consent areas was significantly decreased.

Moreover, the 2006 amendment reduced the amount of joint Federal/ Länder assignments, or “joint tasks” that concerned higher education, regional economic responsibilities, and coastal preservation (Article 91a, b of the Basic Law). These joint tasks were originally introduced in 1969 by the federal government, and at the time, the power of the purse was in favor of the center. In 2000, Länder became more substantial financially, and the central government agreed to reduce the common planning and financing tasks. The most noticeable example – education and culture: they were devolved to the states due to the reform.

The constitutional reform contributed to lowering the pressure of fiscal federalism changes that still imposed huge costs for the federation and well-off states. The reforms contributed to greater transparency regarding the allocation of competences at the federal and state level, therefore such problem, as ‘merger of authority’ was avoided. What is also important, for

Länder there have become fewer incentives to obstruct the federal government policies, as they gained the competencies they wished (Karpen 2007).

At the same time, the constitutional reforms of 2006 did not touch upon the equalization system, which had long been the subject of debates between the Länder governments. With the exception of Switzerland, Germany remained the only federation in which equalization was achieved through horizontal equalization (from richer to poorer states) instead of transferring funds and finances from the center (Karpen 2007). However, in 2009, there were undertaken important steps bringing more fiscal prudence to the system and discouraging indebted states to borrow more. Germany's golden rule, easy to outfox, was replaced by the debt brake rule, or officially, constitutional rule on federal indebtedness that has been in operation since 2011. It aims for balanced budgets and sets the maximum permissible net borrowing – 0.35% of GDP (Federal Ministry of finance 2015).

Finally, in 2017, the German Bundestag approved a bill amending the Basic Law and abolishing the VAT pre-equalization and horizontal fiscal equalization. As a consequence, all the Länder shall meet the requirements of the debt brake 2020 (Thöne and Bullerjahn 2018: 18). For Eastern Länder it will mean that the federal government will no longer provide the East with vast supplementary grants. From 2020, they will be replaced by 'generally available grants for low-tax communities' (2018), but in fact, most of these communities belong to the East.

4.4. Discussion of the results

It could be seen from the reforms conducted that the federal government pursued the policy of achieving equivalent living conditions within the federation. Prior to the Unification, this system of cooperative federalism encouraged by the federal government and less well-off Länder used to bring its benefits. In its turn, the Unification, while symbolizing the triumph of the Cold War's end, had been a cold shower for the Western states, after they came to realize at what costs necessary fiscal transformations would be made.

In this sense, a certain degree of centralization was desirable, as the economic and living standards between Western and Eastern Germany were strikingly different, and introducing wide fiscal decentralization, which was a trend in the 1990s, was not possible for a federal state which strives for symmetry in welfare provision and uniformity of living conditions was always its “trademark”. Given these circumstances, it appeared to be logical that with heavy patronage of the central government, and support from the poorer states, the reforms driven by Unification were directed towards a cooperative path.

In the State of German Unity annual report (2018), the government acknowledged the stable progress made regarding the convergence of living standards. Positive changes were apparent in the quality of infrastructure and the environment, healthcare provision. Nowadays, the East German industry generate higher than the EU-average proportion of gross value added. At the same time, the report said that the economic power of East German states is “only very slowly” approaching the levels achieved by the export-oriented states of Western Germany. In 2017, GDP per inhabitant in Eastern states was 73.2% of that in the West.

Mainly, it was fiscal federalism design, especially, fiscal equalization scheme that was a subject of considerable criticism, while after the 2006 amendments to the Basic Law the federal design, in general, has been supported by the states. In this regard, considering that decreasing the number of joint tasks for the states improved the functioning of the sub-central level, having made the allocation of competences between the center and the states more transparent. It might be plausible that with the expiration of the Stability Pact II and abolition of the equalization scheme, there will be more room for the states to perform their tasks more effectively. Nevertheless, without a certain degree of centralization, which historically characterized German federalism, it would have been more troublesome to incorporate new eastern states into the Federal Republic. Apart from centralization, such distinct elements of German federalism,

as symmetry and cooperation have also significantly provided for easing the tensions between the states within the Federation.

Conclusion

This study investigated whether centralization of fiscal federalism policies may helped the newly joined Eastern Länder and the federal state of Germany to cope with challenges presented by unification, especially huge income, environmental, and living standard gaps. In order to conduct an analysis, German historical tradition of federalism was studied as well as key elements of the German federal model. These elements – cooperation/ centralization/unitarism, and symmetry in many respects provided for an integration of the eastern states into the Federal Republic. After the federalist structure of Germany was analyzed, the German fiscal federalism system was considered, especially its place in scholarly debates on equity, equality, and redistribution.

Overall, the research helps answer the question of why after Unification, German fiscal federal system was more centralized, especially in the first 20 years. Later, as the reforms have demonstrated, there has begun a gradual drift towards a more competitive federalism model, which does not mean that cooperative federalism in Germany has ceased to exist. Rather, it has become less pronounced, which is not surprising, as throughout its history, especially in the post-Second world war period, the need to consolidate the efforts of the states to achieve boosting economy, the well-functioning welfare state, or equivalent living conditions enforced the cooperative nature of German federalism.

Considering the further application of the study, it might be of relevance to consider German fiscal federalism in the frame of EU fiscal policy prospects, as with the creation of the EU the federal structure has become more complex because of the establishment of the supranational tier of governance. Fiscal accountability issues remain important for the EU since it plans to move towards fiscal union as well, and in this regard, it might be helpful to investigate how ‘home’ fiscal federalism structures may ease or complicate this accession process.

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