From unitarizing administrative quasi-federation to a genuine federal system: How demographic change will drive fiscal federalism reform as a means to improving the performance of public finances in Germany

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Germany’s escalating public debt, the demographic changes its population is undergoing, and its federal structure pose serious and mounting challenges. How the three phenomena are related, however, is not as well understood. A better grasp of their compound effect on German fiscal federalism in general and on the equalization system in particular is indispensable if effective and sustainable reform is to be realized. As it turns out, the sub-optimal performance of German public finances is intricately related to an equalization that encourages irresponsible fiscal behaviour at the level of the Länder which ends up rewarding poor fiscal performance and offering little incentive to improve fiscal performance. On the one hand, Länder enjoy greater autonomy on the spending side than on the revenue-raising side. On the other hand, their spending autonomy is severely constrained by legislative mandates that are assigned by the federal government. This dual asymmetry in German fiscal federalism has made the Länder more the dependent on transfers and hampered their adjustment to negative revenue shocks, with the effect of increasing long-term deficits. Under the perverse incentives of the current scheme, after equalization, the Länder with the lowest initial per capita fiscal capacity, end up with the highest fiscal capacity per capita whereas the Länder with the highest initial fiscal capacity, end up with the lowest capacity after transfers. As rapid population aging in several Länder, especially those in the East, causes an already unprecedented per capita gap in fiscal capacity among German Länder to widen further, the pace at which the equalization system is being overstretched accelerates and the sub-optimal performance of Germany’s public finances worsens. Yet, while there is broad agreement on the need for reform, the reform process is at a stalemate due to veto players who fear that changing the status quo would work to their detriment. The tall challenge, then, is to reform the system in a way that removes the perversions of the current system while making public finances more responsive and responsible in a way that surmount the commitment problem that has been plaguing the reform efforts.

Much of the debate has focused on a federal structure that is too entangled and insufficiently competitive. This chapter will explain why these premises for reform are essentially non-starters. To this end, the chapter first distinguishes the key concepts of federalism, federal systems, and federations, explaining that nothing prevents federations from functioning like quasi-unitary systems (and vice versa). Rather, operationalizing federalism viz. the federal idea is a composite of (1) constitutional, legal, formal, (2) institutional, and (3) societal-cultural components. The second part of the chapter argues that as a result of “the paradox of unitarization” of German federalism, entanglement and uniformity are an integral part of the German federalism and actually the
basis of its legitimacy with the German public. The third part shows how demographic change is in the process of undermining this consensus and creating the conditions for the emergence of a federal culture with the potential of facilitating reform on a more dualist trajectory with the central and subnational governments becoming more responsible for both the provision of distinct, non-overlapping goods and services and the way these are financed. The fourth part of the chapter contextualizes the current equalization system in this discussion, systematically peruses options for reform, and then positing a reform which equalizes based on per capita fiscal capacity which it contends has the potential to overcome the commitment problems encountered thus far while putting both the equalization system and public finances on a more stable and sustainable footing. The premise of the final section is that the equalization system in its current form was never intended to equalize for differentials of today’s magnitude and that the systemic crisis will be brought to a head by growing fiscal distortions and demographic bifurcation. Yet, it is the culmination of this crisis that will facilitate the dawn of new federalist age in Germany that is accompanied by the emergence and legitimation of a more genuine federal system.

Some countries that appear unitary actually function like quasi-federations. The corollary are purportedly federal countries that largely function like unitary systems. Germany is among the latter. But the end of quasi-unitarianism in Germany is looming. Owing to demographic change, the mismatch between the formal constitutional-legal apparatus and Germans’ attitudes towards their “federal” systems will grow and their perspectives on federalism will mature accordingly. As these internal strains grow, this chapter hypothesizes that they will precipitate an existentialist crisis of federalism in Germany. Yet, a more genuinely federal system is bound to emerge as a result. This has real implications for the formulation and legitimation of public policy in Germany. As fiscal federalism is likely to be the ultimate manifestation of the crisis, it also has the potential to be the harbinger of a transformed federal system.

The premise of this chapter is that the current approach to fiscal federalism reform in Germany is misconstruing the problem which makes it difficult to come up with a sustainable solution. The problem is commonly understood as follows: Germany is incurring too much public debt; the solidarity pact (Solidarpakt II) that was forged with the five new Länder is set to expire in 2019. That risks putting them into fiscal peril because spending by these Länder is irresponsible insofar as they often spend solidarity-pact funds on operational expenditures such as social programs and salaries instead of sustainable investments such as infrastructure for which they are intended. The more affluent “old” Länder in the West feel that they can no longer afford mounting subsidies of their apparently fiscally irresponsible “new” cousins in the East. Yet, this as-

1 Of course, designating solidarity-pact funds for infrastructure is a problem in itself. Rather than seizing the opportunity to broaden what constitutes infrastructure spending (i.e. beyond the “brick and mortar” conception of the Bundeshaushaltsordnung), in their consensus federal and Land politicians resorted to the “old” narrow assumptions of West Germany’s pre-reunification Basic Law. As a result, they missed a unique opportunity both to update the term’s meaning for the times and to adapt it to the unprecedented reality of reunification.
essment misses what this chapter posits as possibly the single greatest determinant of federal and fiscal dynamics in Germany over the next ten (and subsequent) years: demographics. Specifically, this chapter posits demographic change as exacerbating territorial bifurcation across the German federation thereby altering federal dynamics in Germany irreversibly. This is not just a model. It is already an empirically testable proposition. Demographic differentiation, so the hypothesis of this chapter, will reverse the unitarian trajectory that has marked German federalism over recent decades, thereby facilitating the emergence of a genuine federal society. However, any model of fiscal federalism-reform that fails to take this into account is bound to prove unsustainable.

1. **Unity in Diversity: Federalism, Federal Political Systems, and Federations**

Those familiar with the literature will recognize the subtitle of Watts’ classic article on the topic. Federalism is the referent of the federal idea in the abstract. Federation is its formal instantiation as manifest constitutionally and legally on the one hand, and institutionally on the other. The way institutions function is dynamic. Or, as Tarlton put it half a century ago:

“The federal relationship, in any realistic sense, means something very different to nearly every participant unit in the system. Among the several states in a federal union, cultural, economic, social, and political factors combine to produce variations in the symbiotic connection between those states and the system.”

William Riker observed many years ago that there is nothing intrinsically federal about a federation. For all intents and purposes, nothing prevents them from functioning like unitary systems. We know this not only from Riker but we can also observe the empirical corollary: Its unitary constitutions notwithstanding, Spain is widely recognized as functioning like a quasi-federal system. As a matter of fact, with the emergence of multilevel governance, functionally many traditionally unitary systems are exhibiting quasi-federal trends. Just like there is nothing intrinsically unitary about the way unitary systems function, so there is nothing intrinsically federal about federations.

More than half a century ago W. S. Livingston already explained why this phenomenon is possible. Right from the outset of his famous treatise, Livingston observes that federalism is not a function of constitutions but of society – or rather societies. Institutions and political action, as manifest in public policy, reflect societal reality. Quoting Livingston at length is critical here, not only to grasping the thesis of this paper as to the

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paradoxical nature of German federalism but also to understand its premise that the instrument (such as equalization) must match society and its trends:

“The essence of federalism is to be sought for, not in the shadings of legal and constitutional terminology, but in the forces – economic, social, political, and cultural – that have made the outward forms of federalism necessary. […] We are to prone to say that federal constitutions must contain a certain five or eight or ten characteristics and that all constitutions lacking any of these are not federal. Such a set of criteria ignores the fundamental fact that institutions are not the same things in different social and cultural environments. […] Federal government is a form of political and constitutional organization that unites into a single polity a number of diversified groups or component polities so that the personality and individuality of the component parts are largely preserved while creating in the new totality a separate and distinct political and constitutional unit. But the instrumentalities of federal government, like the diversities they serve, vary tremendously. […] The problem of federalism is to make the instruments fit the society beneath.”

Livingston recognized that without a federal society, there is a real and present danger that federal constitutional and institutional arrangements will acquire a unitary mould. Due to the symbiotic relationship between institutions and society, over time nothing prevents attitudes and political decision-making from becoming more centralized.

As the following section will show, German federalism has been suffering from precisely this problem. Yet, if the symbiotic nature between institutions and society is part of the problem, it is also part of the solution: As societal attitudes change, the pressure on federal institutions to change the way they function will grow. As the mismatch between societal expectations and its federal institutions grows, a crisis is bound to ensure regarding the way the system functions.

So, to understand why federal systems function the way they do, we need to distinguish among constitution, government, and society. Discerning the nature of federal systems requires scholars to distinguish among three elements: (1) the motivations and interests which necessitate political diversity on the one hand, and collective societal action on the other hand, (2) their formal constitutional-legal structure, and (3) the way governance actually transpires. Formal constitutional structures and legal framework notwithstanding, it is important not to neglect the analysis of political forces within a society and manifest political and administrative behaviour within which federal and constituent-unit governments carry out their activities. Germany is an exemple par excellence just how insufficiently a purely legalistic analysis of a constitution can be in explaining the country’s federal pattern. The two following sections below will show

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the extent to which governance of Germany’s federal system diverges from the prescribed formal legal interactions in response to societal and political demands.

The conventional distinction between federal and unitary political organization rests on structural points of reference such as the constitutional division of legislative and fiscal resources among different levels of government, mechanisms to incorporate the constituent units into the federal decision-making sphere, the role of the judiciary in interpreting and adapting the constitution, procedures to constitutional reform, and so forth.\textsuperscript{10} Their relevance notwithstanding, there is no unequivocal former marker to determine whether a system is federal (or not). Myriad exceptions and variations defy the definition of federations in this way. The basic problem is that in some federations political arrangements which in most federations correspond to federal expectations operate so as to infringe on federal norms. Even Kenneth Wheare, the “father” of the institutional approach, devotes a chapter of his seminal work on Federal Government to its preconditions.\textsuperscript{11}

Nonetheless, constitutions and the institutions to which they give rise also shape society. It is critical not to oversimplify causal mechanisms by reducing federal institutions to instruments of federal society. As the next section will show, this is of critical importance to post-World War II evolution of German federalism.\textsuperscript{12} Beginning in the United States and subsequently followed by Switzerland, Canada but also Germany, federal institutions were the cornerstone to the effective political mediation of unity in diversity.

Figure 1: The interaction of federal societies, constitutions and governments

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\end{center}

Source: Based on Watts 2008 (fn. 7), p. 22.

\begin{itemize}
\item \textsuperscript{10} Watts 2008 (fn. 7), pp. 19-23.
\item \textsuperscript{11} Wheare, Kenneth C. 1946: Federal Government, London: Oxford University Press, chapter 3.
\end{itemize}
Owing to their complexity, the causal relationships among federal societies, political institutions, and political dynamics are neither readily reducible nor static. Societal pressure is reflected in political institutions, approaches, and behaviour. This is especially true in a democracy where politicians must respond to the exigencies of the electoral marketplace if they want to get elected and stay in power. Yet, the feedback mechanisms of the interaction between institutions and society also shape societal developments and political decision-making (Figure 1).

Insofar as they need to be deemed legitimate by the citizenry, society determines the concept, design, and function of federal constitutional structures. At the same time, federal political superstructures, their patterns of interaction, and political practice influence societal loyalty, attitudes and pluralism. Federal systems are best understood as a function of the feedback mechanism between the societal foundation provided by the constitution and actual governmental behaviour and activities. On the one hand, the institutions of the system reflect its societal and political equilibrium. On the other hand, they shape the manifestation of unity in diversity (Figure 2).

Figure 2: Federal evolution through time

This interaction is reflected in the way federal systems evolve. Some federations that started out constitutionally decentralized, such as the United States and Australia, have become more integrated and centralized over time. Others, such as Canada but also India, Belgium, and even Spain, that started out rather centralized and with quasi-federal constitutions, have become decentralized, interestingly often absent a great deal of constitutional reform. In response to internal demands, some formerly unitary systems have become more decentralized and in some cases even become fully federal, such as Belgium, Spain, South Africa, Great Britain, and Italy. In each case, the development is the synthesis of the interaction between society and its political institutions.

Developments in all these cases were propelled by the search for a balance between unity and diversity. Daniel Elazar attributes this federal equilibrium to self-rule by the various constituent units and shared-rule through common federal institutions. Here-tofore the Federal Republic of Germany has suffered from a strategic imbalance in fa-

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vour of shared-rule over self-rule. The imbalance is strategic insofar as it is not accidental but deliberate. The following section will elucidate the phenomenon’s antecedents, path-dependency, and development. The subsequent section explains why the pendulum is beginning to swing the other way. And the section thereafter examines what this means for German federalism in general and fiscal federalism-reform in particular.

2. The paradox of Germany’s federal unitarization

A constitution can perform two fundamentally different functions: Either its objective is to limit government intervention. Or it empowers government and its societal intervention. While not mutually exclusive, ultimately, one of these perspectives usually trumps the other. Anglo-saxon liberal democracy tends to be in the vein of the former whereas the European continent’s “social” democracies tend towards the latter. This is the result of fundamentally different formal constitutional legal antecedents in common-law versus civil-law countries as well as different conceptions of the state and its role in society. Anglo-saxon liberal democracy tends to conceive of the state’s primary role as mediating societal conflict. By contrast, continental European social democracy conceives of the state as an instrument for steering society. Prerequisite for fulfilling this role is a much thicker moral conception of society than that found in anglo-saxon liberal democracies: The state is not relegated to mediating societal conflict, it takes an active interest in shaping “the nation”; it organizes and structures societal consciousness, channels conflicts in accordance with a strong cultural conception of justice and the common good. In Anglo-Saxon countries, the state is a composite of different nations. In continental Europe, by contrast, the state is (now) synonymous with the nation. For English-speaking Canadians, for instance, Canada is their state and their nation. For Francophone Quebecers, by contrast, Canada may be their state, but Quebec is their nation. Canada’s legal pluralism, therefore, is no coincidence: For Quebec maintains the civil code.

Thomas Fleiner thus contends that civil-law federations suffer from an internal contradiction that is intrinsic to their institutions: Reconciling the unity of law in spite of constitutionally divided powers. Fleiner explains that federalism is far more difficult to implement in the civil law tradition where government has to legitimate its own power rather than simply moderate it. That is why the civil law tradition is closely tied to the notion of the state whereas common law countries tend to confine themselves to government. The conception of the state in the civil law tradition does not really allow for a decentralization of power. There is thus a fundamental tension between federalism

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14 Of course, this was not always the case. See for example Bobbitt, Philip C. 2002: The Shield of Achilles: War, Peace and the Course of History, New York: Alfred A. Knopf; and Brubaker, Rogers 1992: Citizenship and Nationhood in France and Germany, Boston: Harvard University Press.

and the civil law conception of a sovereign, central, unitary, and indivisible state, so Fleiner’s thesis.

Common law is premised on the accumulated corpus of a continual historical development of judicial and political decisions, legislation, conventions, and constitutional principles. The legitimacy of the courts is grounded in the crown which was later replaced by the rule of law. Government never had to be recognized by the nation as the legitimate source of state sovereignty. A composite federal state in a common law framework does not call into question the legitimacy of a singular nation (because none exists). The common law tradition is not concerned with unity as the primary means of constitutional legitimation.

By contrast, the basic idea behind the French Revolution was to conceptualize the state as an instrument of societal change from a feudal into a state that manifests freedom, justice, and solidarity. The civil-law tradition thus has its roots in the French Revolution and the manifestation of sovereignty in the national assembly as the sole (or at least superior) state legislator which is preoccupied with societal salvation and well-being. It was the beginning of a new age which meant to put an end to a system where crown and courts could legislate. Legislation would henceforth be the sole purview of the collectivity of equal citizens in the form of the body of the national assembly. In this tradition, the state is not the sum of individuals or groups; it is the instantiation of the collective will of the nation of a people in the Rousseauian sense. This state is the highest source of law and justice that is accountable to no other institution. Civil law is largely premised on the legislature and a pyramidal order where higher-level law can supplant low-level law. The unity of civil law is thus not assured by judicial decision but by the unity of positive law as pronounced under the constitution. The national assembly makes the law which reigns homogeneously over the land and is merely applied by the executive and the judiciary which have a certain obligation of loyalty to the legislature.

In the German federation the unity of the civil-law state is assured through the unique institution of the Bundesrat which is neither an upper chamber in the British sense nor a second chamber in the American or Australian tradition. In the Bundesrat, the Länder forge a consensus with the federal government on legislative matters through multilateral bargaining that affect their areas of (largely administrative) competence before these can take force. That does not preclude a subsequent constitutional challenge. Yet, for a problem which in common law countries is largely resolved by the courts the German federation has a solution that is designed to preserve legislative unity.

Hence it is possible for Germany to lack a federal society as well as a federal culture of the sort that one tends to find in common-law federations. German federalism is a way of separating powers and curtailing the predominance of the central government while preserving legislative unity. This is possible because, for all intents and purposes, there is no diversity in need of reconciliation and unification, at least not to the extent as in Canada, for instance. German federalism is premised on the classic American conception of balance of powers in a framework that preserved legislative unity. It was neither set up nor intend to reconcile diversity per se which makes good sense given the country’s high degree of cultural uniformity, homogeneity, and consensus.
Table 1: Is it an advantage or a disadvantage that education policy differs from Land to Land? (in per cent)

<table>
<thead>
<tr>
<th></th>
<th>Germany</th>
<th>East</th>
<th>West</th>
</tr>
</thead>
<tbody>
<tr>
<td>Advantage</td>
<td>12</td>
<td>13</td>
<td>6</td>
</tr>
<tr>
<td>Disadvantage</td>
<td>84</td>
<td>83</td>
<td>90</td>
</tr>
<tr>
<td>Don’t know</td>
<td>4</td>
<td>4</td>
<td>4</td>
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</table>

Source: Jeffery 2007 (fn. 16), p. 67, with further references.

As Table 1 shows, the empirical evidence about the degree of unitarian consensus that reigns among Germans is overwhelming:

“Surveys in 1995 and 2004 showed that large majorities of the German public preferred uniform federal regulations on issues in education policy, law and order, social security and transport, including areas within the exclusive competence of the Länder. Where the federal system provides the possibility of variation, for example in education policy, there is clear disapproval.”16

More recent survey work by the Bertelsmann Stiftung confirms these findings.17 The proportion of citizens who identify with their Land over Germany is minuscule. They overwhelmingly reject any sense of competition among Länder; popular support for the principle of solidarity is overwhelming (Figure 3).

Figure 3: Political Levels at which Living Standards Should be Comparable (in per cent)

Question: ‘At which level should living conditions be equal for the most part?’ Figures ranked by the response ‘At the national level in Germany’.

Source: Bertelsmann Stiftung/infas.

There is widespread support for national standard in everything from education to uniform levels of taxation among all Länder and across supporters of all parties (Figure 4).

**Figure 4: Uniform Tax Rates in all German Länder (in per cent)**

<table>
<thead>
<tr>
<th>Source</th>
<th>Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Germany (total)</td>
<td>85</td>
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<tr>
<td>CDU/ CSU</td>
<td>86</td>
</tr>
<tr>
<td>SPD</td>
<td>87</td>
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<tr>
<td>FDP</td>
<td>79</td>
</tr>
<tr>
<td>Alliance 90 / The Greens</td>
<td>81</td>
</tr>
<tr>
<td>The Left</td>
<td>83</td>
</tr>
<tr>
<td>Other</td>
<td>84</td>
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</table>

Response of ‘I agree’ to the statement ‘Tax rates should remain the same in all German Länder in the future.’

Source: Bertelsmann Stiftung/infas.

As Figures 5 through 8 testify, even the most mundane policy options are met with astonishingly similar attitudes across all 16 Länder.

**Figure 5: Approval of Increased Inheritance and Wealth Taxes for Reducing Debt**

<table>
<thead>
<tr>
<th>Source</th>
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<tbody>
<tr>
<td>Berlin</td>
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<tr>
<td>Saxony</td>
<td>3.2</td>
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<tr>
<td>Thuringia</td>
<td>3.3</td>
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<tr>
<td>Brandenburg</td>
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<tr>
<td>Hesse</td>
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<td>Meck.-W. Pom.</td>
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<tr>
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<td>Hamburg</td>
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<tr>
<td>Lower Saxony</td>
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<td>N. Rhine-Westph.</td>
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<td>Schleswig-Holstein</td>
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<td>Bavaria</td>
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<tr>
<td>Rhineland-Palat.</td>
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<td>Saarland</td>
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</table>

Question: ‘Let us assume policymakers wanted to increase revenues in order to reduce public debt. I will now read you a number of sources of revenue. Please tell me whether you approve of each source or not.’ Responses for higher inheritance and wealth taxes. Mean values for responses on a scale of 1 (‘Yes, I would’) to 5 (‘No, absolutely not’). Interpretation: The lower the mean value, the greater the approval of tax increases.

Source: Bertelsmann Stiftung/infas.
Question: ‘Let us assume policymakers wanted to reduce spending in order to reduce public debt. I will now read you a number of expenditures. Please tell me whether you approve of such a reduction or not.’ Responses for reducing spending in the area of social programs. Mean values for responses on a scale of 1 (‘Yes, I would’) to 5 (‘No, absolutely not’). Interpretation: The lower the mean value, the greater the acceptance of a tax increase.

Source: Bertelsmann Stiftung/infas.

**Figure 6: Approval of Spending Reduction in the Area of Social Programs in order to Reduce Debt**

<table>
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<th>Region</th>
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<td>4.0</td>
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</tr>
<tr>
<td>Saxony-Anhalt</td>
<td>4.0</td>
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<td>4.0</td>
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</tbody>
</table>

**Figure 7: Desired Use of Increased Tax Revenues**

Question: ‘Currently the government is collecting more tax revenues than expected. Should these additional revenues be used for …’ Mean values for responses on a scale of 1 (‘Yes, absolutely’) to 5 (‘No, absolutely not’). Interpretation: The lower the mean value, the higher the acceptance of using additional tax revenues in each area.

Source: Bertelsmann Stiftung/infas.
Figure 8: Attitudes Toward Uniform National Educational Standards (in per cent)

Response of ‘I agree’ or ‘I disagree’ to the statement ‘It is the responsibility of the Federal Government to ensure uniform standards for kindergartens, schools and universities.’ Figures ranked according to the difference between agreement and disagreement.

Source: Bertelsmann Stiftung/infas.

No wonder then that right across the country, citizens’ attachment to Germany not only exceeds identification with their Land and town of residence but in 9 of 16 Länder citizens also identify more with Europe than with their Land. By and large, the Länder could not have a lower level visibility (Figure 9).

Figure 9: Identification with the Various Political Levels (responses by State; in per cent)

Question: ‘Which level do you identify with most closely: your city or town, your state, Germany or Europe?’ Figures ranked by response ‘city or town’.

Source: Bertelsmann Stiftung/infas.
It is patently obvious: Support for federalism among Germans is virtually non-existent. That explains not only the high degree of integration among parties at the local, Land, and federal level but also why none of the federal parties advocate for decentralization when appealing for votes. It also explain why economic models premised on “competi-
tive federalism” (Wettbewerbsföderalismus) and greater decentralization are rejected (see Figures 10 and 11) and why “disentangling” German federalism is a non-starter.\(^{18}\)

In Germany, federalism is the purview of elites, not the masses. This fine point the elites have failed to grasp: They have been so inculcated by the system that they fail to realize just how thin the ice is on which they are performing their pirouettes. Germany is, first and foremost, an administrative federation, not a legislative (or dual) one (which assumes that central and subnational governments are responsible for the provision of distinct, non-overlapping goods and services): Rather than dividing legislative powers, it assigns most legislative tasks to the federal government which the Länder are then left to implement.\(^{19}\) The concept of a federal division of powers as found in the USA, Canada, and Australia is inconceivable in Germany. The German federation is meant to divide power, not powers. The German state’s constitutional *raison d’être* is not to preserve individual and collective freedom by limiting power but to facilitate its exercise: The preservation of the territory’s integrity, safeguarding political stability, and ensuring a balanced economy. This peculiar style of cooperative federalism, however, comes at a price: It destroys the link between taxes and benefits and distorts accountability.

Looks are deceiving: Germany has federative elements and institutions but their purpose is to preserve the unity of the state under civil law. German federalism never calls the unity of the state into question. The Länder are mere decentralized appendages of the German people. There is neither a federal society to speak of, nor a federal culture.\(^{20}\) That system meets with the people’s expectations, in part because it is path-dependent.

According to Gerhard Lehmbruch, the principal character of the institutions of German federalism are to be sought not in the Basic Law of 1948/49 but in the amazing institutional continuity of structural elements that can be traced back as far as 1648.\(^{21}\) Today’s Bundesrat embodies the organic development of an intergovernmental institution, not a post-War break with tradition. It is the successor of the permanent Reichstag which met in Regensburg from 1666 until 1806, the Bundestag of the German Federation of 1815–1866, of Bismarck’s Bundesrat (1867–1918) and of Weimar’s Reichstag (1919–1933). The “accumulated sediment” of a path-dependent institutional maturation over centuries is reflected in the strategic repertoires at the level of actors. These are acquired through the process of political socialization and transferred from one generation to the next.

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\(^{20}\) Previous surveys – if not as systematic and comprehensive – on this topic can be found in other sources, including the Allensbacher Jahrbücher der Demoskopie (edited by Elisabeth Noelle-Neumann and Renate Köcher) as well as in *Bertelsmann Stiftung/forsa* 2003: Staatsverschuldung im Urteil der Bundesbürger, Gütersloh: Bertelsmann Stiftung.

German federalism distinguishes itself through the key role that autonomous state administrations play in the decision-making process and the implementation of directives. Vertical and horizontal intergovernmental relations are an indispensable part of this institutional logic.

In contradistinction to France, the development of the modern German state was not coupled with the formation of a nation-state. Germany is notable for the key role played by the bureaucratic executive in the development of the modern federal state. Bismarck was familiar with the diplomatic negotiating style of traditional German federalism that can be traced to the profound institutional advantages enjoyed by bigger Länder. His executive federalism facilitated a federal compromise between the interests of territorial bureaucracies fighting for the survival of their organizational structure and their linkage to territorial elites and incipient interest groups.

Bismarck seems to have learned from the failed constitutional reform of 1848/49 with an American-style senate and elected representatives of the Länder. This attempt at a modern second parliamentary chamber failed in part because of the implied loss of power for the bureaucracies of the Länder. So, Bismarck ended up leaving the implementation of the law largely up to the Länder.

The constitutional draft for the Weimar Republic again tried to replace the principle of the Bundesrat with a US-style senate. As 70 years earlier, it failed due to vehement resistance by the Länder governments and their bureaucracies. The story repeats itself during the constitutional consultations of 1948/49 when Konrad Adenauer initially favours the principle of a senate but could not surmount a coalition militating for the traditional pattern. At the time the Länder also enjoyed an unprecedented power advantage because the allies had done away with the central Prussian state in 1946. This allowed the Länder to become predominant much more than they had under the Weimar Republic. Yet, there was no broad resurgence of administrative heterogeneity. To the contrary, the Länder realized their interests through the informal and formal harmonization of standards. Their competitive advantage and the abolition of the hegemonic state thus raised the level of consensus among the Länder considerably.

So, German federalism can be attributed to the continually strengthened institutional position of intergovernmental relations. Since Bismarck intergovernmental relations have been indispensable to German politics and German federalism has been marked by strong elements of negotiation and quasi-diplomatic relations among the various federal partners. The advent of the welfare state further advanced the interdependency between federal and Länder bureaucracies, especially following the institutional reforms undertaken by the grand coalition of 1966–1969 and the 1969 renegotiation of the Basic Law which reduced the autonomous influence of the legislatures of the Länder while expanding the modus operandi of multilateral bargaining in the collection and distribution of revenue by establishing so-called joint tasks. The vastness of the administration of the Länder is most clearly reflected in the legislative role of the Bundesrat. Technically this is not a second parliamentary chamber where representatives vote freely but an assembly of the executives of the Länder whose envoys take direction from cabinets in the
capitals of the Länder and which in most committees and negotiations are represented by civil servants.

Lehmbruch refers to this strange German combination of institutional decentralization and legal-procedural centralization as “the paradox of federal unitarization.” Since they are highly dependent on one another, the sub-national actors are left with little leeway. Their institutional autonomy is curtailed by their tight integration into a multilateral system of negotiation whose raison d’être is policy homogenization. The Länder paid for creeping centralization and unitarization with a loss of autonomy.

This entangles various governmental actors without calling their sovereignty and autonomy into question. German federalism has since had a propensity for uniformity with administrative decentralization.

German federalism is unique in its aversion to policy heterogeneity. Article 72 of the Basic Law stipulates that standards and services should be the same – or at least comparable – across the federation’s constituent units. The preservation of the Länder came at the expense of pluralism, whether through centralizing legislation or cooperative harmonization. The Bonn Republic was accompanied by an unprecedented symmetric balance of power among the Länder. On top of that the allies decentralized public finances.

Yet, soon after the rehabilitation of independent political institutions the mechanisms of policy harmonization reappeared, first through informal exchanges among civil servants of the Länder and since 1948 through the Conference of the Ministers of Education and Cultural Affairs of the Länder (Kultusministerkonferenz) which is roughly functionally equivalent to a federal ministry. Thus the discovery of cooperative federalism was adapted to the German institutional tradition which reinforced cooperative federalism’s inherent executive orientation.

The arrival of 13 million migrants from the Eastern provinces and Eastern Europe after World War II coupled with the erosion of religion as a determinant of cultural identity from the late 1960s onward further catalyzed the predisposition for uniformity. The all-encompassing trends towards homogeneity were also driven by judicial decisions reinforcing the equality of all citizens stipulated in Article 3 of the Basic Law. Especially in sensitive areas of jurisdiction such as education, the prospects of decentralization that greater political autonomy of the Länder might have precipitated provoked a defensive bureaucratic strategy built on administrative formalization and uniformity. This strategy of uniformity facilitated the promotion of uniform standards of living as stipulated by the constitution.

The competencies and autonomy of the bureaucracies of the Länder were thus staved off against the impending threat of total decentralization.

22 Ibid., pp. 90ff.
23 Centralization refers to a modus operandi whereby regulation is made centrally but in coordination with the Länder. See, for instance, Hesse, Konrad 1962: Der unitarische Bundestaat, Karlsruhe: C.F. Müller. By contrast, unitarization refers to horizontal coordination among Länder or vertical coordination between the federal government and the Länder. See Abromeit, Heidrun 1992: Der verkappte Einheitsstaat, Opladen: Leske+Budrich.
Fiscal federalism is but one example. It is marked by joint decisions on fiscal supply. In the meantime all important taxes (income, corporate, and value-added) are common sources of taxation which fall under federal jurisdiction and require the consent of the Bundesrat. Even taxes whose revenue goes entirely to the Länder, such as taxes on inheritance and vehicles, are subject to federal legislation. Although this tax federalism combined with fiscal equalization undermines any inkling of fiscal autonomy, the distribution of resources requires the Bundesrat’s consent. This arrangement is the result of a bargain where the Länder traded their policy autonomy for federal financing on the condition that fiscal decisions be taken in a way that required the consent of the Länder and allowed them a joint veto.

The entanglement of German society is not to be confused with France. In the Federal Republic of Germany power is dispersed.\textsuperscript{25} The strong institutional position of the Länder facilitated the emergence of multiple centres of power. This polycentrism counteracted a spatial economic concentration of the sort found in centralized societies and their regional economic disparities. While Germany’s economic polycentrism precipitated a more equitable territorial distribution of economic activity, as the fourth part of this chapter will show, it also set the stage for an economic bifurcation between the Western core and the Eastern periphery in the aftermath of reunification. That bifurcation is compounded by demographic developments, as the following section explains.

3. Demographic Federalism

Fairly uniform economic conditions allowed unitary federalism to prevail because the degree of redistribution required was fairly small. At fairly uniform economic conditions and identical levels of taxation average per capita tax revenue was so comparable that it was fairly easy to equalize for disparities. Since reunification, however, that is no longer the case. Per capita tax capacity of the least affluent Länder is barely a third of that enjoyed by the wealthiest Länder. In March 2009, per capita debt across the Länder ranged by a magnitude of eight from 1,972 and 2,192 Euro in Bavaria and Saxony to a high of 11,808, 16,321, and 22,047 Euro in the three city-states of Hamburg, Berlin, and Bremen.\textsuperscript{26}

In other words, fiscal capacity has been diverging steadily since reunification. This is significant because per capita tax revenue and public indebtedness will be key determinants in the development of fiscal disparity across the Länder over the coming decade.

\textsuperscript{25} Elazar 1987 (fn. 13), pp. 13-14 and 34-38. Elazar insisted repeatedly that federal systems cannot have a hegemonic centre and a subordinate periphery. Only unitary states such as Great Britain which devolved competencies to constituent units such as Scotland are characterized by this relationship. In select federations, such as Malaysia (until recently) and Austria, we can, however, find almost analogous relations. Cf. Erk, Jan 2004: Austria: A Federation without Federalism, in: Publicus, vol. 34, no. 1, pp. 1-20.

The other is mounting demographic differentiation. The two are related. This relationship is about to bring German federalism in its current form to its knees.

Until 2019 the five new Länder will continue to benefit from the solidarity pact (Solidarpakt). It supplements regular equalization payments for the five new Länder. The additional revenue was meant to be invested sustainably, for instance in infrastructure and municipalities, that is, in ways that enhance their future economic competitiveness. Instead, the payments are largely going towards operational expenditures such as salaries and social programs, that is, expenditures that are not generally understood to make them more competitive. For example, despite their supplementary funds from the solidarity pact – which should, in principle, allow them to spend disproportionately more on infrastructure, thus purportedly freeing up funds to be spent on investments to enhance competitiveness, such as research and development. Nonetheless, the new Länder actually spend less of their GDP on research and development than the old Länder (Figure 12).

Figure 12: Expenditures for Research and Development

Due to its high degree of levelling, the present system provides little incentive for spenders and to cover their expenditures with their own revenue. As a matter of fact,

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the correlation of state tax revenues with state GDP has been declining which von Hagen and Hepp have interpreted as evidence of weakening state tax efforts in response to the incentive effects of equalization.²⁹ The problematic incentive structure of German fiscal federalism has a long history in the literature and need not detain us here.³⁰ Suffice it to say that its obvious manifestation is the persistence of subnational deficits and public debt but, compared to other countries, with the unique German curiosity of a system that provides incentives for fiscal indiscipline in only a minority of the federated Länder. Yet, the debt situation of the city-states is not to be confounded with that of the new Länder. The latter are in a particularly precarious position. On the one hand, they are confronting a gradual decline in solidarity-pact payments until they run out altogether by 2019. Figure 13 lays out the fiscal implications: By 2019 that translates into a 20% decline in revenue. Conversely, just to maintain current levels of expenditures the

²⁸ This is an opportune moment to refer the reader to the debate on restructuring some Länder (Länder-neugliederung) to make them more administratively and financially efficient (in effect by reducing the number of Länder, notably by amalgamating smaller, fiscally weaker ones). Without dwelling on this debate, I shall skirt it because I find it spurious for a number of reasons. First, there is no evidence to support the hypothesis that administrative and fiscal economics of scale stand to be harnessed from larger units. Empirically, for instance, experience with municipal amalgamations negates this hope. Moreover, the experience of Canada’s four Maritime provinces suggests that efficiencies that may be harnessed in particular sectors, such as post-secondary education, do not require consolidation of the actual federal administrative units. Second, while there is precedent for subdividing units, especially in India’s recent federal history, there is no precedent for fusing federal units. This should come as no surprise: Once political and bureaucratic fiefdoms have been created, institutional self-interest would militate against mergers. Third, the merger of Baden, Württemberg-Baden, and Württemberg-Hohenzollern in 1952 and the incorporation of the Saarland happened under unique historical constraints that are not given today. Baden and Württemberg-Hohenzollern had been part of the French occupation zone (in fact, Württemberg-Hohenzollern had been created in 1945 from the former state of Württemberg and the Prussian administrative region of Hohenzollern as part of the French occupation zone) whereas the northern half of Württemberg became Württemberg-Baden under American administration. Their 1952 merger was preceded by a straw poll in 1950 and a referendum in 1951. Similarly, the disputed Saar Protectorate’s status (whether to remain under French administration or return to Germany) was decided by a 1955 plebiscite whose rejection of an independent status for the Saar sealed its “small reunification” (as it is sometimes referred to) with Germany. No such popular groundswell of support for merging Länder exists in Germany, least of all in the units who would be the target of such mergers (notably the New Länder but also the greater Hamburg region).


³⁰ For an overview about this discussion see: Blankart, Charles B. 2007: Föderalismus in Deutschland und Europa, Baden-Baden: Nomos. Another way to look at this problem is a soft-budget constraint where sub-national federal units are prone to fiscal irresponsibility when the institutional fiscal constraints are not “hard”, that is, when spendthrift subnational governments can expand expenditures without facing the full cost, either because the federal level ends up having to bail out lower levels. See Rodden, Jonathan A. 2003: Soft Budget Constraints and German Federalism, in: Rodden, Jonathan A./Eskeland, Gunnar S./Litvak, Jennie (eds.): Fiscal Decentralization and the Challenge of Hard Budget Constraints, Cambridge: MIT Press, pp. 161-186.
Eastern Länder will have to increase their tax revenue by almost one-third over the same timeframe – while at the same time confronting a shrinking population and tax base.

**Figure 13: Proportion of funds financed through tax revenue versus those resulting from the solidarity-pact transfer in Saxony’s state budget (2008–2025)**

<table>
<thead>
<tr>
<th>Year</th>
<th>Proportion of solidarity-pact transfers</th>
<th>Proportion of tax revenue funding</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008</td>
<td>0%</td>
<td>100%</td>
</tr>
<tr>
<td>2010</td>
<td>10%</td>
<td>90%</td>
</tr>
<tr>
<td>2012</td>
<td>20%</td>
<td>80%</td>
</tr>
<tr>
<td>2014</td>
<td>30%</td>
<td>70%</td>
</tr>
<tr>
<td>2016</td>
<td>40%</td>
<td>60%</td>
</tr>
<tr>
<td>2018</td>
<td>50%</td>
<td>50%</td>
</tr>
<tr>
<td>2020</td>
<td>60%</td>
<td>40%</td>
</tr>
<tr>
<td>2022</td>
<td>70%</td>
<td>30%</td>
</tr>
<tr>
<td>2024</td>
<td>80%</td>
<td>20%</td>
</tr>
</tbody>
</table>


On the other hand, they face demographic challenges of unprecedented proportions where the effects of rapid population aging are compounded by the flight of younger, educated labour-market participants which stifles both demographic growth and per capita tax capacity. Figure 14 depicts the projected population development in Western and Eastern Germany.

**Figure 14: Population development in Eastern and Western Germany (2006–2030)**

Population development in East and West Germany from 2006 to 2030; figures in per cent of the population of 2006 (2006 = 100%).

Source: *Seitz* 2008 (fn. 27), p. 16.
By 2019 that, for instance, translates into a difference in average age of just under 48 in Thuringia as opposed to 45 in the West. As a consequence, after having held fairly constant since reunification, the dependency ratio, that is the population under 15 and over 65 relative to the population from 16 to 64, is about to rise from 36.9% in 2010 to 42% by 2020 in the East while remaining almost unchanged from 38.0 to 38.4% in the West. In other words, while remaining virtually unchanged in the West, the proportion of the population from 19 to under 67 years of age – the key working-age cohort – is projected to decline by 15% between 2009 and 2019 (Figure 15). That is almost twice the rate as the population decline in the East overall (which means that at least some of population group’s decline can be attributed to migration).

**Figure 15:** Development of the key working-age cohort (2006–2030)

![Figure 15: Development of the key working-age cohort (2006–2030)](image)

Figures in per cent of the population of 2006 (2006 = 100%).
Source: _Seitz_ 2008 (fn. 27), p. 18.

Neither the trend nor the rate of population decline is new. Between 1991 and 2005, while most “old” Länder registered population growth, the population of each “new” Land declined by about 10% (with the exception of Brandenburg whose decline was offset by population expansion around suburban Berlin). Note a decline of almost one percent a year among the population in the East compared to one-tenth of that projected for the West. In other words, the difference in population decline between East and West is a magnitude of ten. Not only is the proportion of women of childbearing age relative to men in the same age cohort on the wane (Figure 16) – which is indicative of an outmigration of women of childbearing age – but those women who are staying are having significantly fewer children than women in the West (Figure 17).
Figure 16: Ratio of women to men among the 18-29 cohort (2003)


Figure 17: Total Fertility Rate (2003)

Source: Kröhnert/Medicus/Klingholz 2006 (Figure 16), p. 6.
The territorial convergence of these trends is steering the fiscal-equalization system straight off the cliff. Since the new Länder are at a competitive disadvantage (if for no other than the fact that the older Länder had a head start of 40 years of entrenching themselves and local companies in the capitalist system), they should be all the more vigilant about positioning themselves competitively by spending disproportionately in areas such as infrastructure (broadly conceived) and post-secondary education. Yet, they have been doing the opposite: The new Länder are not as competitive as they could be because they have not invested their solidarity-pact payments as effectively as they could have in areas that could have made them more competitive. However, one should not be too quick to blame them: After all, as section four will show, this is partially the result of the perverse incentives of the current equalization system that actually reward Länder with poor fiscal performance. As a result, unemployment rates across the East consistently exceed the national average by more than 50% (12.9% in June 2009 in the new Länder, 8.1% nationally, 6.9% in the old Länder). At the same time, they have the lower labour-force participations rates averaging 66.4% across the East (including Berlin) as opposed to 70.1% across the West (without Berlin).\(^3\) Lower labour-market participation rates generally mean less per capita tax capacity. How much less? Average per capita tax capacity at the levels of cities, counties and Land combined is not even 3 000 Euro in the East but almost 4 000 Euro in the West. Similarly, per 1 000 inhabitants in 2005 a high of 111 works industry in Baden-Württemberg but no more than 53 across the East and a low of 23 in Mecklenburg-Vorpommern. Concomitantly, in 2007 real GDP per capita ranged from a low of 20 352 in Mecklenburg-Vorpommern to a high of 50 557 Euro in Hamburg and a national average of 27 700 EUR. The city-states of Hamburg and Bremen may be highly indebted – but they are also disproportionately productive.\(^3\)

By resorting to paying for operational expenses, declining solidarity-pact payments translate into declining operational revenue. Although the city-states are technically more indebted, considering that the new Länder had a clean slate when they were (re-) established on the occasion of reunification, they have been accumulating debt at more a rapid rate than the old Länder.\(^3\) As a result, the Eastern Länder’s deficit as a percent of revenue quickly surpassed the Western ones.

Moreover, their tax capacity is on the wane: On the one hand, population aging means fewer people of working age paying taxes; on the other hand, mis-spent solidarity pact funds accelerate population flight (especially among women of childbearing age since they tend to be more highly skilled and thus more mobile than the corresponding male cohort) because a Land failed to optimize its competitive edge and job-creation for highly skilled people. This claim is empirically verifiable: Between 2002 and 2007 personal wealth across inhabitants of the Western Länder rose from 90 724 to 101 208 Euro

\(^3\) Statistische Ämter des Bundes und der Länder 2007: Sozialberichterstattung, Tabelle D.5 „Erwerbstätige (im Alter von 15 bis 65 Jahren) in Prozent nach Bundesländern“.


\(^3\) Seitz, Helmut 1999: Where Have All the Flowers Gone? Die öffentlichen Finanzen in den neuen Ländern, paper prepared for presentation at the University of Magdeburg.
per capita (about 12%); over the same period, it fell by about 20% from 34029 to 30723 Euro across the East.\textsuperscript{34}

This outcome was not unavoidable. The largest of the five new Länder, Saxony, is in a much better position than the rest. Its per capita indebtedness is among the lowest in the country, second only to Bavaria, it has spent its solidarity-pact funds more as they were intended, and its demographic situation is better because it has the two largest population and economic centres in Eastern Germany after Berlin: Dresden and Leipzig.

**Figure 18: Development of the younger population (2006–2030)**

Figures in per cent of the population of 2006 (2006 = 100\%).

Source: Seitz 2008 (fn. 27), p. 17.

The costs of redistribution and fiscal indiscipline are becoming a source of frustration that is beginning to undermine the solidarity and cooperation that have characterized the German federal system: Bavaria and Baden-Württemberg, for instance, have aggressively challenged the equalization system in the courts and in the political process.\textsuperscript{35} In

\textsuperscript{34} Calculations by the German Institute for Economic Research (DIW Berlin), in: Wochenbericht, vol. 76, no. 4, p. 57, Table 1.

\textsuperscript{35} Rodden 2003 (fn. 30), p. 182.
a major ruling on 11 November 1999 even the Constitutional Court (Bundesverfasungsgericht) recognized that the current equalization offers almost no incentive for the well-to-do Länder either to do better or to raise additional tax revenue because almost all the additional public funds gained end up being redistributed to other parts of the country. It criticized the criteria used for distribution and the extreme redistributiveness of the equalization system. In June 2001, the Bund and Länder did agree to a new equalization law (which took effect in 2005); the system remained largely unchanged with the exception of allowing more affluent Länder to keep a larger share of the taxes they collect (but without reducing payments to poorer Länder).

**Figure 19: Proportion of foreign residents**

Over the coming decade, the demographic and fiscal cleavage between East and West is bound to widen considerably. The Western Länder generally have more sustainable population structures (Figure 18), especially in large centres such as Frankfurt, Munich, Hamburg, but also Berlin where immigrants tend to congregate (Figure 19).

As a result, both the demographic viability of the old Länder and their per capita tax capacity is much better than that across the East. As a matter of fact, because of its high per capita GDP, Hamburg actually has the highest per capita tax capacity in the country and the capacity of all old Länder is either above or approaching the national average. By contrast, that of the Eastern Länder amounts to barely 40% of the national average.
which is about half that of the old Länder with the lowest per capita tax capacity, Saarland and Berlin.

4. Squaring the circle: Fiscal federalism-reform in a maturing federal system

There are three basic options for reforming Germany’s equalization system. The first is the status quo, which is keeping the current formula and following up with a “Solidarpakt III” when the current one runs out in 2019. The official position of the Eastern Länder is that they neither need nor want a Solidarpakt III. In private, however, they are inclined not to meddle with the fundamentals of the system, fearing that reform would lead to them ending up with the short end of the stick. In negotiation theory, this is a classic zero-sum problem. Similarly, affluent Länder, which essentially pay for equalization, are not apt to complain (not officially, at least) about the current system because they were part of the consensus that created it (including its 2001 revision). Constitutionally, then, the equalization system in its current form is a legally-binding component of the way tax revenue is redistributed in Germany.

The second option is to do away with the equalization system altogether. In public-sector economics, in theory, there are at least two important rationales to forego an equalization system. The first reason is that it supposedly prompts people to vote with their feet: It optimizes labour-market outcomes by having people move to where the jobs are. The second reason assumes 100% capitalization. That is, because failure to equalize is assumed to optimize labour markets, there is no need to equalize for differences in cost-of-living because the system is presumed to equalize those costs perfectly. No advanced industrialized democracy other than the USA has gone this route. For that reason alone, it would be unlikely for Germany to abandon equalization. In light of the aforementioned survey data, it is clear that the German public has little tolerance for capitalization; and, as we shall see in a moment, neither does the constitutional court. Both the citizens and the court put a premium on comparable remuneration for similar work as opposed to leaving it up to the (labour) market to adjust for regional differences in demand and cost-of-living. This outcome was to be expected: It reflects the overwhelming desire to give priority to national solidarity across the territory and de-emphasize regional differences. However, the propensity not to capitalize is not without its problems because it essentially means that citizens in the East have, on average, a much higher standard of living: They may make marginally less but, on average, have a lower cost of living. In effect, then, by minimizing capitalization the German system ends up over-equalizing. How is one to moderate over-equalization? By equalizing for differences in GDP rather than revenue, notably representative tax-base revenue, a system can equalize for revenue while accounting for capitalization without explicitly hav-

36 There are, of course, two empirical problems with this assumption. First, it turns out that due to a variety of other intervening variables that supersede individual utility maximization, even in the absence of an equalization system labour-market outcomes are still sub-optimal. Second, equalization systems notwithstanding, we witness considerable labour-market migration and optimization across the rest of the federal world.
ing to account for need. As it turns out below, this is a critical component of any viable proposal for fiscal-federalism reform in Germany.

That leaves reform as the third option. Much has been written in Germany about reforming the fiscal-federal system.\(^\text{37}\) Commissions have repeatedly tried to sort through the problem but failed to find a consensus on how to proceed (although, to their credit, they recently agreed to hem in the ability to accumulate new debt – as of 2020). The German Research Council (DFG) provided generous funding for a multi-year research team to come up with solutions.\(^\text{38}\) The team’s public-choice approach may be perfectly rational and even appealing to some of Germany’s elites but is not politically saleable, both because it would undermine solidarity and uniformity and because some Länder, especially those in the East, feel that they stand to lose no matter what. Yet, the longer reform is pushed off, the more difficult reaching consensus will become as the fiscal and demographic situation of the Eastern Länder grows ever more precarious.

Much has been made of giving the Länder greater tax autonomy, that is, fiscal decentralization. Notwithstanding their minimal independent authority over taxation, as is so often the case in federations, they spend more money than the federal government. It is thought that this would lead to more accountability vis-à-vis the electorate and allow Länder to adapt their spending habits to their means. While proponents of competitive federalism favour this idea, there is little evidence to support it: Greater fiscal autonomy may lead to more accountability but not necessarily to more responsible spending.\(^\text{39}\) Quite to the contrary, as long as there is a soft-budget constraint of the sort where the Länder might expect that the federal government would (have to) bail them out, there is little incentive to rein in their spending. But an end to possible bailouts is also difficult to conceive. On the one hand, many of the Länder, including the city-states and the Saarland in the West, are unlikely to consent. On the other hand, in an apparent attempt

papiere der Wirtschaftswissenschaftlichen Fakultät der Universität Leipzig Nr. 6, p. 4.


to rein in the moral hazard problem it had exacerbated in an earlier decision that extended large debt relief bailouts to Bremen and Saarland, Germany’s constitutional court has ruled that a bailout request by an indebted Land may be constitutionally permissible only in the case of a “federal emergency” (bundesstaatlicher Notstand).\(^{40}\) So, an end to forcing a bailout may make sense in public-choice theory but not in practice.

Fiscal autonomy makes good sense for a whole number of reasons but, based on the evidence, increased accountability is not one of them. In theory, the value-added tax (Mehrwertsteuer) is the obvious tax to decentralize, if not in full then at least in part, since it is already the only aspect of the vertical distribution of resources in Germany that is flexible. In practice, however, decentralizing the VAT is not under serious consideration. The comparative literature on fiscal federalism actually militates against decentralizing VATs because that exacerbates inefficiencies\(^{41}\) The literature lauds a system with a uniform value-added tax rate and a centralized collection mechanism as the most efficient way possible of structuring one’s value-added tax system. The Canadian system, for instance, has the worst of both worlds: A decentralized value-added tax rate and a decentralized collection system. The inefficiencies are so considerable that the most populous province with the largest provincial economy recently was left with little choice but to reach an agreement with the federal government to harmonize its collection system to overcome severe inefficiencies hampering economic growth and competitiveness.

Of course, there is nothing to prevent an Australian solution of a uniform tax rate and collection but with revenue going solely to the provinces. This idea has some merit insofar as Australia’s highly institutionalized fiscal equalization system has resulted in the most redistributive egalitarian federation in the world. Germany is the second-most egalitarian federation. The more populous and affluent a province, the stronger its consumption, and thus the greater the revenue from the value-added tax. Although this approach rewards those provinces where consumption is strongest and encourages provinces to spur consumption, the Australian scheme shows that it can be subject to highly egalitarian equalization. In Germany, however, it would be difficult to have revenue from the VAT accrue to the Länder because it is not only a prime source of revenue for the federal government but also a key source for its egalitarian equalization.

That leaves the two other main sources of tax revenue: income and corporate (Einkommen- und Körperschaftsteuer). It is conceivable to decentralize these in full or in part as many federations have done. In Canada and the USA, for instance, the federal government as well as provinces and states set their own rates and rules of taxation in each of these two tax areas. The problem is that some Canadian provinces, for example, have agreements with the government to collect corporate and income taxes on their behalf. This works reasonably well for income taxes. For corporate taxes, however, the federal government does not have much of an incentive to enforce collection of the provincial portion since it stands to gain nothing from doing so an only incurs additional

\(^{40}\) Judgment of the Bundesverfassungsgericht, 2 BvF 3/03 of 19 October 2006.

costs applying corporate-tax rules that differ from province to province. This is why Ontario, for instance, eventually returned to collecting its own corporate tax.

Yet, the collection of these two taxes, which are uniform across Germany, is already decentralized; so, Länder have an incentive to collect corporate taxes in their jurisdiction. If, however, in the process of reform, the Länder were given the power to set their own corporate tax rate, the Canadian problem might be reversed: while keen on collecting their portion, the Länder would have little incentive to enforce the federal portion of the corporate tax. But that would further exacerbate what is already one of the gravest problems in German public finance: The Länder have weak incentives to strengthen audits and improve revenue collection. They bear most of the costs of tax administration, yet only a small fraction of additional tax revenues (often less than 10%) accrues to them. Nowhere is the problem more severe than in the most dependent Länder which derive almost no benefit from increasing tax collection efforts (for every additional Euro in tax revenue is offset by an almost equivalent reduction in equalization revenue).

To make up for lost revenue, decentralizing the corporate tax might provide an incentive for the federal government to set up its own collection mechanism, which introduces further collection inefficiencies. So, under the current collection arrangement, only a fully decentralized corporate tax would be efficient – and there is no mature democracy in the world where the federal government has abdicated taxing corporate earnings. The federal government could benefit from a mechanism that would tax back or equalize some portion of the corporate-tax revenue raised by each Land, but it would be difficult to see how this might be done. With differential tax rates, Länder would have an incentive to drive their corporate rates as low as possible so as to minimize the revenue they would have to share with the federal government and other Länder. In other words, the corporate-tax status quo seems to make ample sense.

A similar problem arises with respect to income tax. In Germany it is uniform but collection is decentralized; so, a partial decentralization of the rate might cause inefficiencies in collection between the federal and the Land portion. But those inefficiencies are relatively small compared to the inefficiencies associated with the collection of the federal portion of a partially decentralized corporate tax. Quebec, for instance, collects the federal portion of Canada’s tax on behalf of the federal government (and receives some administrative compensation in return). Presumably, the federal government would have long rescinded this arrangement if it felt that this was disadvantageous; the political fallout from collecting its federal portion of the income tax would be minimal and it already has the collection infrastructure in place for the other nine provinces for which it collects both the federal and provincial portion of the income tax.

Income, then, is the only tax source where a partial or full decentralization of the rate might make sense. But the outcome differentials would be dramatic. Affluent Länder


with resilient economies, such as Bavaria, Baden-Württemberg, and Hesse, would fare well and would be induced into lower rates to entice labour mobility in their effort to maximize the national and international competitiveness of their labour market. By contrast, owing to their peculiar population structure and relative economic weakness, less affluent Länder, such as Thuringia, Saxony-Anhalt, Brandenburg, and Mecklenburg-Vorpommern, already have the lowest per capita income-tax capacities among the German Länder. To raise additional revenue, they could raise their rates. That, however, would lower the competitiveness of their labour market and cause them to vote with their feet, thus aggravating the emigration problem as even lower-income earners might opt to move to lower-tax jurisdictions. Empirically, there is some tolerance for income-tax differentials at the sub-national level without causing undue distortions in the labour market (because individual interest is not limited to those of the assumptions behind the “homo oeconomicus”). But the growing differentials in income tax capacity among the German Länder suggests that the differences would likely end up being so large that they would lead to sub-optimal outcomes.

In the end, it does not seem to make much sense to tinker with taxation. Germany has as optimal a value-added tax system as one can find. It also does not seem to make much sense to decentralize corporate taxes. Income is the only tax for which decentralization seems to make some sense but its decentralization would have to be coupled with other mechanisms, such as equalization, to mitigate distortions. This is possible; the Canadian system exemplifies this point.

In other words, tax autonomy and decentralization in and of themselves are not the answer to reforming the German fiscal-federal system. Ultimately, that leaves changing the formula and means by which equalization is calculated. There are two basic choices here: Whether to politicize equalization or to institutionalize the system and whether to equalize for revenue, expenditure, or both.

Canada, unlike Germany, is an example of a highly depoliticized system because the federal government can change equalization unilaterally without consultation or consent of the provinces. Australia, by contrast, has the Commonwealth Grants Commission where federal bureaucrats essentially assess fiscal need on an annual basis and make a recommendation to Canberra. It is sometimes said that this type of institutionalized system only works in a fairly uniform federation such as Australia. However, that argument is belied by India, one of the world’s most diverse federations, which has adopted a similar system. On the one hand, a politicized system is not only highly democratic (because voters can vote out a government that, in their view, plays hard and fast with equalization) but also well suited to circumstances under which per capita fiscal capacity has started to diverge rapidly and is expected to continue to do so. Yet, affluent German Länder such as Bavaria are already apprehensive about the growing concentration of fiscal clout with the federal government since reunification. Ergo, the last thing on their mind is to cede more power to the federal government. A highly bureaucratized system, on the other hand, seems intrinsically appealing. It caters to the aforementioned bureaucratic instincts of German federalism. And it seems to work well under fairly uniform conditions where citizens also expect fairly uniform outcomes.
The Australian system is quite unique in another respect: It tries to equalize based on need as well as revenue. Most equalization systems – such as the German one – equalize for revenue only. Revenue is fairly straight-forward to assess; need is not. The major controversy that arises when equalizing for need is whether to capitalize (or not), meaning whether to incorporate differentials in cost-of-living and standards-of-living. For example, under the new remuneration scheme, civil servants in Germany’s new Länder earn marginally less than they do in the old Länder. Yet, in many locales in the West the cost-of-living is substantially higher than anywhere in the East. For example, the average rent paid per square metre of apartment space ranges from 4.83 Euro in Berlin to 9.90 Euro in Munich. Should equalization be adapted to take these differences into account, that is, that a civil servant in most places in the East earns less than in the West but ends up having a higher standard of living? To capitalize in this way presumes a decentralization of civil-service salaries. This process is already underway, albeit gradual. But would the constitutional court allow for capitalization to be factored into equalization? The court has ruled that civil servants are not entitled to capitalization, that is, a police officer posted to Munich is not entitled to a supplement to compensate for a higher cost-of-living. Although this is speculative, it is, therefore, questionable whether the courts would allow capitalization to be included in the equalization formula. Quite to the contrary, the legislative conditions would first have to be created. For Germany’s constitutional court has found that fiscal equalization is not meant to equalize on the basis of need. Ergo, need must not be factor into the calculus (which also explains why the police officer’s challenge failed). To forestall a (successful) constitutional challenge that would throw a new system into limbo, it is probably safer to proceed on the current basis of equalizing for revenue only. Since that is what most federations do anyway (precisely because factoring in need is inherently controversial), this would seem the most practical approach. But based on what criteria? As was demonstrated above, there are two basic approaches to equalize for fiscal capacity: revenue, GDP, or a combination of the two.

One option is to average revenue from representative tax sources across jurisdictions. A highly uniform system of taxation as Germany’s current one makes equalizing for revenue fairly straight-forward as a function of average per capita fiscal capacity in each Land. Canada averages fiscal capacity across the provinces by averaging revenue from five representative tax bases. Provinces that fall below “average” are entitled to receive equalization, provinces above are not. The “average” is inherently political as it will be based on the tax bases selected for averaging and the way it is averaged across jurisdictions. To provide stability and allow provinces to forecast revenue, the system uses a three-year rolling average with a two-year lag. This way, provinces know two years ahead of time the sum to which their equalization payments will amount.

44 Average rent per square metre as calculated based on the official Mietspiegel 2009.
45 Until recently Canada’s formula was calculated as a function of 31 representative tax bases and averaged on a five-province standard; so, there is nothing intrinsic about either the number of representative tax bases to be averaged or the number of jurisdictions based on which the average is calculated.
Since equalization payments are unconditional in Canada, they are complemented by a system of targeted transfer payments. These are calculated on a per capita basis which means that their benefits accrue disproportionately to more populous provinces. In Germany, it may also make sense to augment equalization payments with targeted per capita transfers, for instance for education. One might agree to a system whereby the nature and amount of such transfers would be subject to approval by both the Bundestag and Bundesrat.

The problem inherent to the Canadian system is its preoccupation with calculating revenue as a function of tax bases. That politicizes the system because it leaves both the tax bases and the method of averaging open to controversy and thus indirect political manipulation. Instead, a much more sensible approach to equalizing for differences in per capita fiscal capacity is to calculate equalization as a function of per capita GDP, averaged across all jurisdictions. This is about as simple a scheme as one can conceive. But that is not the primary reason for adopting it. Under the perverse incentives of the current scheme, after equalization, the Länder with the lowest initial per capita fiscal capacity, notably Bremen, the Saarland, and the eastern Länder, end up with the highest fiscal capacity per capita. Meanwhile, the Länder with the highest initial fiscal capacity, notably Hamburg, Hesse, Baden-Württemberg, and Bavaria, end up with the lowest capacity after transfer. Furthermore, rather than encouraging irresponsibility through the current supplementary transfers, it would remove this gap-filling incentive which explicitly ends up rewarding poor fiscal performance.

To make this scheme acceptable to the eastern German Länder, they would likely require a guarantee that the combination of equalization and direct transfers would not equal less than a given Land’s total entitlement including the solidarity pact and, as of 2019, its total entitlement under the current equalization scheme (but without any solidarity-pact payments since we should take the Eastern Länder by their word when they disavow the need for a Solidarpakt III). The 2001 revision of the German equalization which introduced a (relatively marginal) component to compensate for areas with low population density (Dünnbesiedlungskomponente) exemplifies an emerging recognition of demographic differentiation across the federation’s constituent units. Länder could switch to the new scheme sooner if that were to work out better for them but once they switch to the new scheme, they would forego this minimum-transfer guarantee. The Länder might even agree to a phase-out of the minimum guarantee if its horizon were sufficiently long.

An ancillary advantage of a GDP-based equalization scheme is that it might facilitate doing away with Germany’s horizontal transfer. Although the Swiss recently adopted it, it exists in no other federation and needlessly kindles a patronizing attitude between Länder which pay and those on the receiving end. Indeed, the precedent for moving away from the horizontal transfer was set in the equalization reforms of 2001 (which took effect in 2005) when the Bund replaced some of the horizontal redistribution with direct, vertical redistribution. The more affluent Länder will fear that doing away with the horizontal transfer might end up bolstering the federal government. Irrespective of those concerns, the reforms of 2001 (2005) failed to tackle the system’s perverse incen-
tives; to the contrary, they actually exacerbated the transfer dependence of the poorest Länder. It may thus prove impossible to realize, in which case equalization would continue to have a horizontal as well as a vertical component.

This concept for reform is viable precisely because it is in line with the historical sociology and institutional path-dependency of German federalism, which is marked by decentralized administrative symmetry, national policy homogeneity, and fiscal uniformity. Most propositions for reform, especially those from the public-choice school, would end up altering all three hallmarks. German bureaucracy is unlikely to relinquish administrative symmetry and, as illustrated by the aforementioned survey data, the German electorate is a steadfast proponent of policy homogeneity. Both, however, are ambivalent about fiscal uniformity: Administrative symmetry and policy homogeneity are ends in themselves; fiscal uniformity is only a means. The challenge, then, is to reform fiscal federalism without obviously compromising administrative symmetry or policy homogeneity. This concept achieves that end. Those that insist instead on public choice-inspired competitive federalism or on institutional and policy “disentanglement” fail to grasp the contingencies of German federalism.

5. The beginning of the end

Human beings have always wanted to know what the future holds. Demography is about as reliable a method that we have to this end. We do not know what politics or the economy will look like a decade hence; but we can project the demographic landscape with a fairly high degree of accuracy. In Germany, that landscape suggests growing demographic and fiscal differentiation across the territory of the federation accompanied by mounting disparities. The current system was never meant to equalize disparities of this magnitude, let alone of ever-greater disparities. Yet, there is reason to have hope.

Younger populations and older populations tend to have different political priorities. Older populations tend to be more reliant on the state than younger ones. Similarly, less affluent populations tend to be more reliant on the state than less affluent ones. If this hypothesis is correct, then we should be able to observe a cleavage in the political marketplace between older, less affluent populations on the one hand and younger, more affluent ones on the other. Ostensibly, the different electoral preferences across Eastern and Western Germany cannot be attributed to differences in political culture alone. Now consider Richard Florida’s work (however methodologically suspect) that urban populations are the driver of national economic performance because their attitudes tend to be everything from more tolerant to more creative than rural populations. Since the populations in large urban centres are consistently younger and more ethno-culturally diverse than those in rural areas, it stands to reason that their political priorities would distinguish themselves from rural ones. Now consider that with the exception of Berlin and secondary centres such as Dresden and Leipzig, there are no large urban centres in the East – or in the highly indebted Saarland, for that matter.

As demographic trends exacerbate the differences between young and old, urban and rural, diverse and homogeneous, and more and less affluent, we will witness a demographic and fiscal differentiation of unprecedented proportions across the German territory. This bifurcation is bound to precipitate a political uncoupling of the federation. Younger, urban, diverse populations which are generating most of Germany’s wealth and productivity are bound to grow increasingly apprehensive about an equalization system that externalizes the costs of public goods in several of the recipient Länder onto the paying Länder. As depicted in Figure 20, per capita the new Länder (the last column in each of the four rubrics respectively) spend systematically more on political leader-
ship and central administration, policing, culture, and primary and secondary education than the old Länder (the penultimate column in each of the four rubrics respectively).

Given demographic trends in the East with the apparent decline in children, the disproportionate spending on education by the new Länder is particular puzzling and leads to considerable distortions. For example, Figure 21 shows the discrepancy in the student-teacher ratio across East (black line) and West (grey line). Whereas between 1993 and 2005 the student-teacher ratio in the Western Länder rose from 16 to 17 students, it dropped from 16 to 13.5 in the Eastern Länder.

In 2007, five Länder paid for equalization while 11 received funds. We can expect popular resentment to emerge in those five Länder.

This is akin to the advent of Ulrich Beck’s second modernity: The critical moment of reflexivity and cognisance that a linear progression of the system is precipitating a slew of unforeseen problems. That moment is the beginning of the end of unitarizing federalism. This breaking point will kindle a consciousness about the benefit of federalism, of sub-national government that defends their interests in the federation. This is when the Owl of Minerva takes its flight. Demographic and fiscal differentiations are in the process of conjuring up unprecedented diversity across the federation. Germany’s advantage is that it already has a federal system and is thus well positioned to cope with growing federal diversity. Now it need only adapt its politics: Relinquishing some of the steering capacity of the “state” in return for more federal governance, that is, a federal system with a focus on arbitrating among competing interests rather than one preoccupied with a telos of uniformity.

This adaptation will be driven not by elites and constitutional changes but by institutional paralysis, an emergent federal society and the accompanying federal culture. German federalism has thus far been largely an elite project. Owing to demographic and fiscal differentiation it is about to become the purview of the masses. Unitarizing federalism will be buried by growing federal heterogeneity. As the federation decouples politically, the pressure to revamp fiscal federalism is bound to grow. The longer it takes for this existentialist sentiment to come to the fore, the more severe federation’s looming political crisis will be since the differences and disparities continue to widen. Yet, self-consciousness and crisis are contingent on demographic and fiscal developments. The differentiation and bifurcation they are precipitating continues apace. And so the existentialist crisis looms. The transition will be painful but we know what awaits on the other side: A federal system marked by greater political and fiscal autonomy.

These developments are bound to politicize German federalism. In the post-War period Germany’s bureaucracy responded to the impending threat of decentralization through administrative and procedural uniformity. This reaction is no longer viable precisely because it precipitated German federalism’s looming existential crisis. The trajectory towards autonomy, decentralization and a reformed fiscal federation that is responsive to the federation’s demographic and fiscal transformation is on the horizon. German’s federal system is well on its way to becoming more self-reflexive.