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Reforming Federalism German Style

A First Step in the Right Direction

The German version of federalism, often called "cooperative federalism", has been identified by many as one of the root causes of Germany's becoming Europe's new sick man. Now, a number of changes in the institutions defining the relationship between the federal, the state and the local level have been passed. This contribution describes the most important changes and evaluates them from the point of view of fiscal federalism. It concludes that the changes are only a first step in the right direction, but a number of important steps have yet to follow.

For a number of decades after World War II, Germany was a sort of European "wunderkind". It enjoyed virtually full employment and high growth rates, and fiscal policy was sound. This has substantially changed: unemployment has been around ten per cent for a number of years, Germany's growth rates have been consistently the lowest among all members of the euro area, and Germany has not complied with the deficit criteria of the Maastricht Treaty for four consecutive years. At least as alarming: its medium and long-term prospects seem to be pretty dim if one accepts the evaluation of the PISA studies concerning the quality of Germany's education system. Although all this is common knowledge in Germany, very few of the necessary reforms have been brought about and the question is: why?

Many argue that Germany's particular form of federalism, often called "cooperative federalism" is one of the root causes of the German disease. In practice, cooperative federalism means that reforms can only be brought about if the relevant actors at both federal and state level agree on reforms. This has been coined the "joint-decision trap"[1] and explains the incapacity to pass necessary reforms. Many of the current economic and political problems in Germany can be interpreted as a consequence of a less than satisfactory allocation of competences among the various levels of the federal system. The system as a whole contains numerous faulty provisions which distort both (political as well as economic) competition and decision-making, and hence cause lasting damage to the operation of federalism and democracy in Germany. Often, the benefits and costs of political decisions no longer accrue at the same level. Small wonder, then, that the reform of the underlying institutions is often named as the most important single reform, in a sense "the mother of all reforms".

The "grand coalition" currently ruling Germany has just passed a first federalism reform. Its implementation will lead to changes in a number of articles of the German Constitution (the "*Grundgesetz*"). This contribution describes the most important changes and offers first evaluations of their likely effects. It concludes that the changes are only a small first step in the right direction, but additional ones need to follow suit. Before describing the changes, two preliminary steps will be taken: the basic notions of fiscal federalism are very briefly summarised; these notions then serve as a normative benchmark for the evaluation of both the current institutions and the proposed changes. Secondly, the institutions constituting German federalism

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[1] F. W. Scharpf: The Joint-Decision Trap: Lessons from German Federalism and European Integration, in: Public Administration, Vol. 66, 1988, pp. 239 f.

are briefly described and criticised on the basis of the criteria of fiscal federalism.

Fiscal Federalism

The economic theory of federalism is concerned with the optimal allocation of tasks to the various possible levels of provision.[2] A very simple criterion is used as a benchmark: what allocation allows citizens to have their preferences best satisfied? Assuming that preferences concerning the provision of public goods can vary from region to region, a regional provision seems best suited to satisfy citizen preferences. This insight has been transformed into a general rule, namely the subsidiarity principle, which starts from the assumption that a decentralised provision of public goods ought to be the rule. If ever there are arguments against a decentralised provision, it is the higher, more centralised level, that carries the burden of proof. Other arguments in favour of a decentralised provision point to a dynamic aspect: *ex ante*, the "best" ways to provide public goods cannot be known. If this insight is taken seriously, then simultaneous attempts to find good institutional solutions can induce a better average quality of institutions by way of non-central innovations.

Of course, citizens would be best off if they could consume a high quantity of excellent public goods without ever having to pay for them. Unfortunately, such an arrangement is not sustainable. It is, hence, important to take the citizens' willingness to pay for public goods explicitly into account when deciding on their provision. The rule that those who consume a public good should be identical with those who pay for its provision and who decide upon its provision is called the principle of institutional congruence in public finance. Fiscal equivalence as introduced by Olson[3] into public finance is a direct consequence of that principle. The principle of institutional congruence implies another principle, namely that of autonomy. The relevant actors ought to have the right to decide autonomously on the goods with which they wish to be provided (after all, they also pay for them). "Joint tasks" are, hence, incompatible with the principle of institutional congruence.

So what are the arguments in favour of centralisation? The most important single argument is the presence of externalities or spillovers. If activities in state A negatively affect citizens in state B, there is some need for coordination between the two states. Representatives of traditional public finance have therefore argued that provision at the next higher level at which both benefits and costs accrue simultaneously would be warranted. Alternatively, and based on Ronald Coase,[4] it has been argued that decentralised coordination can be welfare-maximising given that some initial endowment with rights exists and that the costs of coordination between the states are sufficiently low. Assuming that coordination costs between 16 states are not huge, there is still a role for the federation even in this more decentralisation-friendly view of the world as it is the federation that would have to define the initial rights endowment. Economies of scale are another argument, according to which centralisation might be warranted if per unit provision costs are lower, if the good is provided at a higher, rather than a lower, level of government. These insights from the economic theory of federalism are the benchmark against which both the current institutions of German federalism, as well as those that will be the valid ones after the reform has been implemented, are measured.

Federalism German Style: the Cooperative Version of Federalism

The starting-point of all competence is art. 30 of the German Constitution[5] (the "Grundgesetz" [GG]) which allocates the exercise of governmental powers to the states (the "*Länder*"). Deviations from this general rule need express provision or permission at the level of the constitution. Consistently, the basic principle with regard to legislative competence is that all competence is with the states (art. 70). The areas in which the federal level has exclusive competence are enumerated in art. 73 GG. Although these two articles seem to assign a strong role to the states, their importance has continually diminished since the Constitution was passed. Art. 72 proved to be the main instrument for the factual centralisation of ever more competence onto the federal level. This article establishes the

[2] For further details, cf. C. M. Tiebout: A Pure Theory of Local Expenditures, in: The Journal of Political Economy, Vol. 64, 1956, pp. 416 f.; W. E. Oates: Fiscal Federalism, New York 1972; A. Breton, A. Scott: The Economic Constitution of Federal States, Toronto 1978; R. P. Inman, D. L. Rubinfeld: Rethinking Federalism, in: Journal of Economic Perspectives, Vol. 11, 1997, pp. 43 f.; W. E. Oates: An Essay on Fiscal Federalism, in: Journal of Economic Literature, Vol. 37, 1999, pp. 1120 f.

[3] Cf. M. Olson: The Principle of Fiscal Equivalence: The Division of Responsibilities among Different Levels of Government, in: American Economic Review, Vol. 5, 1969, pp. 479 f.

[4] Cf. R. Coase: The Problem of Social Cost, in: Journal of Law and Economics, Vol. 3, 1960, pp. 1 f.

[5] In translating terms of the German Constitution into English, the authors have largely followed the translation proposed by A. Tschentscher: The Basic Law (Grundgesetz); The Constitution of the Federal Republic of Germany, Würzburg 2002, Jurisprudentia Verlag.

Table 1
Types of Legislation in Germany

Type:	Exclusive Legislative Power of the States (Art. 70)	Exclusive Legislative Power of the Federation (Art. 71)	Concurrent Legislation (Art. 72)	Framework Legislation (Art. 75)
Conditions for Application:	*General Principle*	List enumerated in Art. 73	"Federation has legislation if and insofar as the establishment of equal living conditions … or the preservation of legal and economic unity necessitates …"; List enumerated in Art. 74	
(Examples for) Areas of Application	-	Foreign affairs, defence; Citizenship; Freedom of movement, passport matters, immigration, emigration; Currency, money, weights, measures; Unity of customs and trading area; Air transport; Traffic of railroads; Postal affairs; …	Civil law, criminal law and execution of sentences, judicial organisation; Registration of births, deaths, marriages; Association and assembly; Residence, settlement of aliens; Weapons, explosives Public welfare; Economic matters, Nuclear energy for peaceful purposes; Labour law; Educational and training grants; Expropriation …..	(1) Legal status of persons in public service; (2) Principles governing higher education; (3) Legal status of the press; (4) Hunting, nature conservation, landscape management; (5) Land distribution; regional planning, management of water resources; (6) Registration of residence/ domicile and identity cards (7) Protection of transfer of items of German culture to foreign countries.

"concurrent legislation" that allocates competence to the states *as long as* the federal level remains inactive. It has, however, the right to become active if its activity is needed in order to establish "equal living conditions", or preserve "legal and economic unity" (the "enabling clause"). Another kind of legislation, also based on the requirements just named, is called "framework legislation". Here, the federal level defines the common frame within which the states can pass their own legislation (art. 75 GG).

The key to understanding the federal system in Germany and, hence, also its shortcomings, is the manner in which functional competences are divided between the various government levels. In the German version of federalism, legislative competence is overwhelmingly allocated to the federal level, whereas the states are responsible for the execution of legislation, i.e. carry the administrative burden. This is why the system is also called "executive" or "administrative federalism".[6] In order to be passed, however, many laws need the consent of the chamber representing the states (the "*Bundesrat*").[7] Yet, this applies neither to the federal budget nor to the power to pass tax laws. According to the Constitution, states do not have at their disposition the competence to levy substantial taxes. Their competences are confined to the levying of rather marginal local consumption and expense taxes (like the beverage tax, the dog tax, the hunting tax, the entertainment tax; see art. 105 sec. 2a GG). Although factually the power to tax is overwhelmingly allocated to the federal level, all three levels of the federal structure have a right to their own sources of income in order to ensure a certain financial autonomy. In Germany, a distinction is made between a "separation system" (*Trennsystem*) and a "connex system" (*Verbundsystem*). The proceeds of taxes that belong to the former are allocated to one single level of the federal system, whereas various levels share in the proceeds of the latter (these are also called joint taxes). Materially, the connex system is more important than the separation system as some 70 per cent of the entire tax receipts of the state belong to this category.

A number of characteristics are not in line with the principles of fiscal federalism outlined above.[8]

- Drawing on the instrument of concurrent legislation, the federal level has centralised an ever larger number of tasks. The two reasons that the federal

[6] The term "cooperative federalism" used above refers to the necessity of the federal and the state level cooperating when passing new legislation, which is the case in some 60% of all new laws. The term "executive federalism" used here refers to the role of the states in the implementation of existing legislation. Here, the states function as executors of federal legislation.

[7] More precisely, the *Bundesrat* represents the *executives* of the states.

[8] For an overview, cf. T. Döring: Reform Needs in German Fiscal Federalism, in: H. Zimmermann (ed.): Pressing Problems in Fields of Economic Policy in Japan and Germany, Marburg 2001, pp. 169 f.

Table 2
The Execution of Federal Legislation in Germany

Type:	States execute federal statutes as matters of their own concern (Art. 83)	State Execution With Federal Supervision (Art. 84)	State Execution as Federal Agency (Art. 85)	Direct Federal Administration (Art. 86)
	Basic Principle	States provide for establishment of requisite authorities and the regulation of administrative procedures. The Federal government may issue general administrative rules (but the *Bundesrat* needs to consent).	Establishment of requisite authorities remains concern of the states unless otherwise provided. The Federal government may issue general administrative rules (but the *Bundesrat* needs to consent). States are subject to instructions of federal authorities.	
		Federal supervision covers lawfulness of execution.	Federal supervision covers both lawfulness and appropriateness of execution	
Examples		Social and Youth welfare; Protection of the Environment; Urban Redevelopment; Building Laws;	Federal Highways; Federal Motorways; Air traffic administration.	Foreign Service; Federal finance administration; Administration of Federal Waterways; Federal Border Guard; Central offices for police information; Armed Forces; Aviation; Railroads

level can offer as a justification for centralisation (namely equal living conditions and legal and economic unity) have been misused as a tool to justify just about anything. The current form of centralisation of public tasks ensures a rather high degree of homogeneity in the supply of public services across the country. This could be regarded as positive from the viewpoint of equalisation. However, from the perspective of allocation objectives, this amounts to an offence against the subsidiarity principle.

- A large number of tasks are either carried out jointly or financed jointly; as competence has become diffuse, it has become ever more difficult to make specific actors responsible for certain outcomes. Vice versa, this means that it is also difficult to make actors accountable for non-action. The high need for consensus related to the joint fulfilment of public functions often leads to inefficient political bargaining outcomes or to mutual policy deadlock, which is thus in a way also an inefficient outcome of political bargaining. This amounts to the non-observance of the principle of institutional congruence.

- Autonomy presupposes that each level has a number of exclusive competences. Currently, some 2/3 of all laws passed at the federal level need to be consented to by the states, which means that they can create gridlock. Many revenues of the states and the communes are decided upon at the federal level; the lower levels are thus heteronomous. It has been estimated that some 15% of the states' expenditures and only some 2% of their revenues can be described as autonomous.[9] This amounts, hence, to a contempt of the principle of autonomy.

- State and local authorities enjoy only a low degree of tax autonomy. More than three-quarters of the total German tax revenue is accounted for by joint taxes (income tax, corporate tax, value added tax and local business tax).

- Relatedly, expenditure decisions by the state and local authorities are frequently prescribed by federal laws and hence externally determined.[10] One much-debated example of this practice is that the federal level decides on the content of the Federal Welfare Act, but it is the state governments and above all the local authorities which have to bear the resulting costs. This contradicts the principle of fiscal equivalence.

These are only a few examples in which the principles of fiscal federalism have been disregarded. We now turn to present the most important aspects of what is called federalism reform in Germany.

The Reform Measures – an Overview

The reform measures aim at reducing the joint decision problems which can be achieved by attributing

[9] Cf. C. B. Blankart: Öffentliche Finanzen in der Demokratie, 6th edition, Munich 2006, p. 666 f.

[10] This applies to the disbursement of funds statutes in the German Constitution (art. 104a sec. 3), fiscal assistance by the federal level (art. 104a sec. 4), and above all to the general gearing of expenditure responsibility towards administrative competences and not towards legislative competences (art. 104 sec. 1).

Table 3
An Overview Over the Main Reform Measures

Areas	Planned Measures
Framework Legislation (Art. 75 GG)	Framework legislation will be abolished and the competences divided between the federal level and the states. With regard to environmental law and higher education (both admission and degrees), the states enjoy the newly created institution of explicitly deviating from federal law (Art. 72, sec. 3 new GG).
Concurrent Legislation (Art. 74 and 74a GG)	Part of concurrent legislation will be allocated exclusively to the federal level (law relating to weapons and explosives, law on nuclear energy) or the state level (e.g. law of association and assembly, on closing hours of shops). Part of concurrent legislation can be exercised by the federal level even without providing proof of its necessity (Art. 72 Abs. 2 GG).
Necessity of consent of *Bundesrat* with regard to legislation executed by states under federal supervision (Art. 84 sec. 1 GG)	Consent of the *Bundesrat* only necessary if federal laws have financial consequences for the states (exception: the federal level demands a uniform execution by the *Länder*).
Joint Tasks between the Federation and the States (Art. 91a und 91b GG)	Abolishment of two joint tasks, namely "extensions and construction of higher institutions, including university clinics" and "educational planning".
Financial Grants of the Federation to the States and the Communes (Art. 104a sec. 4 GG)	Conditions for financial grants spelled out in more detail (Art. 104b new GG).
Domestic Distribution of Payments resulting from non-compliance with supranational or international treaties (Art. 104a sec. 6 new GG)	New rule on the distribution of payments in case of financial sanctions pursuant to the non-compliance with international/supranational treaties (Art.109 sec. 5 new GG).

more exclusive competence to either the federal or the state level. In fact, both of these measures will be used: on the one hand, the ratio of federal laws to which the states have to consent is to change from about 2/3 to only 1/3. On the other, the areas in which the states can pass legislation on their own are also to increase. The mixed financing of policies via financial grants is also predicted to decrease as a consequence of the reforms. It is noteworthy that it takes a grand coalition to correct some of the consequences of the reform of federalism that were implemented in 1969 – a period in which the last grand coalition was active.[11]

From an economic point of view, most of the general ideas behind the reform seem laudable: increase the autonomy as well as the responsibility of both the federal and the state level and reduce the mixed decision-making that blurs responsibilities. This could result in a supply of public goods more in line with the preferences of the citizens. The degree of institutional competition might increase which could, in turn, induce a higher level of institutional innovation. Below, we shall have a closer look at some of the details of the reform.

[11] Initial evaluation of the reform measures has been performed by R. Peffekoven: Auch die bundesstaatlichen Finanzbeziehungen müssen reformiert werden, in: Wirtschaftsdienst, Vol. 86, 2006, pp. 215 f; U. Häde: Die Mutter aller Reformen? – Zum Entwurf des ersten Teils der Föderalismusreform, in: Wirtschaftsdienst, Vol. 86, 2006, pp. 220 f.; W. Renzsch: Bundesstaatsreform – endlich der erste Schritt!, in: Wirtschaftsdienst, Vol. 86, 2006, pp. 223 f.

Modification of Competences in Legislation

The current reform provides for

- the abolishment of framework legislation (art. 75);
- the reassignment of tasks organised as concurrent legislation (art. 74);
- the reduction of the areas to which the enabling clause can be applied (art. 72, sec. 2);
- the introduction of a right of the states to explicitly deviate from federal legislation (art. 72, sec.3 new).

Over the past few years, the Federal Constitutional Court had to decide a number of cases in which the states quarrelled with the federation over the extent of the competence that the framework legislation assigned to the federal level with regard to higher education, given that education has been one of the main competences of the states. The existence of framework legislation created, hence, uncertainties concerning the allocation of competences between the federal and the state level. Its abolishment is only logical – and should reduce uncertainty. Most of the competences enumerated in art. 75 were moved to art. 74, i.e. now belong to the area of concurrent legislation. Since the consent of the upper house will no longer be necessary with regard to many laws, this would have meant less influence of the states. The states were "compen-

sated" by the introduction of a right to explicitly deviate from federal legislation (art. 72, sec.3 new).

How do these abstract changes translate into concrete competences? The federal level will have exclusive competence concerning matters relating to the registration of residence and to identity cards and to the protection against the transfer of items of German culture to foreign countries (these two competences are moved from art. 75 to art. 73). Further, the law relating to weapons and explosives, benefits to war-disabled persons and to dependents of those killed in war as well as assistance to former prisoners of war, and the production and utilisation of nuclear energy will also become exclusive competences of the federal level (these competences used to be part of concurrent legislation and are, hence, moved from art. 74 to art. 73). Additionally, the competence of protection against international terrorism is newly created. In order to pass new laws in this area, the consent of the *Bundesrat* is needed, however (art. 73, sec. 2 new).

What are the areas, then, that will be the exclusive competence of the states? Among others, these will be the execution of prison sentences, the fees of notaries, the law of assembly, the law regulating senior-citizen homes and the like, parts of trade law (closing hours, restaurants and the like), and the law of land consolidation. Technically, these competences are explicitly exempted from concurrent legislation in art. 74, implying that they are the exclusive competence of the *Länder*.

There is a political consensus in favour of the reallocation of most of these tasks. This cannot be said regarding a number of tasks that are allocated to the states which are still quite controversial:[12] the remuneration and pensions of civil servants, (higher) education, and nature conservation. These tasks will be part of concurrent legislation. What is new, however, is the deviation clause (art. 72, sec. 3 new) that allows the *Länder* to deviate from federal legislation with regard to nature conservation and higher education.

[12] For a traditional economic division of public responsibilities into efficiency, distributional and stabilisation functions, cf. R. A. Musgrave: The Theory of Public Finance, New York 1959. To answer the question of more centralisation or decentralisation of the mentioned public functions, cf. for example W. E. Oates, R. M. Schwab: The Allocative and Distributive Implications of Local Fiscal Competition, in: D. A. Kenyon, J. Kincaid (ed.): Competition among States and Local Governments, Washington DC 1991, pp. 127 f.; J. M. Buchanan, C. J. Goetz: Efficiency Limits of Fiscal Mobility, in: Journal of Public Economics, Vol. 1, 1972, pp. 25 f.; D. E. Wildasin: Factor Mobility and Redistributive Policy, in: P. B. Sorensen (ed.): Public Finance in a Changing World, Basingstoke 1998, pp. 151 f.

Having the states decide how they want to remunerate their public servants can be interpreted as an increase in the autonomy of states. After all, costs for personnel are the single most important position in the budgets of the states and it seems only logical to increase their autonomy in this area. This solution could also be termed "institutional renovation": it re-establishes the competences the states held until 1971.

Preferences concerning higher education might deviate from state to state which would be an argument for provision at that level. Additionally, negative spillovers beyond the states seem unlikely. The argument that the public good education could be consumed by students from other states and that the congruence principle would, hence, be broken will be mitigated by the possibility of demanding tuition fees. Pundits of the new allocation of competences point to the danger of the "balkanisation" of degrees. This could, however, be prevented by the mutual recognition of degrees. In fact, the mutual recognition of university degrees is already secured via European legislation.

Finally, giving the *Länder* the option to pass legislation on nature conservation seems to be the most controversial point. Clearly, it seems, this is an area in which potential spillovers could be huge and some observers stress the danger of a "race to the bottom". Yet this fear seems largely unfounded: first, European legislation binds not only the federal level but the states as well. Secondly, the basics of environmental protection will be largely harmonised between states as "deviation-free cores" have been created, meaning that core areas of environmental protection will not be subject to the right of the *Länder* to deviate from federal legislation.

Reducing the Need for Bundesrat Consent

One of the most obvious manifestations of the joint-decision trap is that some 2/3 of all laws passed at the federal level need the consent of the *Bundesrat*. Politicians claim that after the implementation of the reforms, this should be down to about 1/3 of all laws. As explained above, federalism German style contains not only a cooperative component but also an executive component: legislation is often passed at the federal level, but it is then executed by the *Länder* since the federation does not have a vast bureaucracy at its disposal. This means that laws passed at the federal level can create costs at the state level and, following the principle of institutional congruence, asking for the consent of the *Länder* seems justifiable. The re-

form attempts to correct some problems of the current institutional set-up: passing laws at the federal level which create costs at the local level will be prohibited outright (art. 85, sec. 1 new). If states execute laws by order of the federation and these put monetary burdens on the states, the states will have to consent to such laws (art. 104a, sec. 4 new). Here, the consent of the *Länder* is newly introduced, not abolished. The hopes of the politicians who predict that the number of laws to which the *Bundesrat* will have to consent will dramatically decrease is evidently based on a change in art. 84 which deals with the execution of laws by the *Länder* as their own affair. Here, the *Bundesrat* will not have to consent to new legislation in the future.

In the past, the joint-decision trap has been particularly severe with regard to laws concerning the fiscal constitution, i.e. in particular laws having to do with tax revenues and their distribution. But changes with regard to income and corporate taxes will need to secure the consent of the *Bundesrat* even in the future. This also holds with regard to changes in the value added tax. It therefore seems doubtful whether the reform is indeed a way out of the joint-decision trap.

Reducing the Mixed Financing of Tasks

The German constitution envisages that a number of tasks are jointly financed by the federal and the state level ("joint tasks", art. 91a and b). From an economic point of view, these joint tasks are problematic because they lead to a blurring of responsibilities. It would, hence, only be consistent to abolish them entirely. The present reform does not go that far but does go in the right direction. The "extension and construction of institutions of higher education including university clinics" as well as educational planning will be abolished as joint tasks. As should have become apparent, the reform aims at making the states more fully responsible for education, including higher education. It is only logical to make them also responsible for the costs of constructing and extending universities. It is, however, hard to understand why the other joint tasks were not abolished simultaneously: the "improvement of regional economic structures" and the "improvement of the agrarian structure and of coast preservation" will remain joint tasks. Both are clearly, even by definition, regional tasks with specific regional preferences playing a potentially important role. This part of the reform hence stops half-way.

A second method for the mixed financing of tasks is by way of financial assistance from the federation to the states. Such assistance is possible for particularly important investments provided that they are necessary to avert a disturbance of the overall economic equilibrium, to equalise differences of economic capacities within the federation, or to promote economic growth. These conditions will remain unchanged (they will, however, be moved from art. 104a, sec. 4 to art. 104b new). On top of these, three conditions that read as if they were taken out of an economics textbook will be added, namely that

- resources are granted for a limited period of time
- their adequate use has to be checked periodically
- the funds dedicated to these tasks decrease over time.

These additional conditions make eminent sense. It remains, however, to be seen how easy it is to circumvent them, e.g. by creating substantially identical assistance programmes under new names etc.

Extending Decentralised Tax Autonomy

A higher degree of autonomy for both the states and the communes with regard to fulfilling their tasks should logically be combined with a higher autonomy in terms of their revenues. The autonomy principle indicates that they should be able to decide not only what they want to do – and how exactly they want to do it – but also how to finance it. It has already been mentioned above that only 2% of all revenues of the *Länder* can be described as autonomous.[13] It would therefore be apt to increase their tax autonomy.

The reforms do allocate the competence to determine the rate of the tax on land acquisition to the states. This is, however, only a very small first step as the importance of this tax is rather limited: in 2005, the entire revenues from this tax amounted to €4.8 billion

[13] This seems to be a very low figure. Stegarescu has recently proposed a new indicator for measuring the degree of public sector decentralisation and has presented figures for 23 OECD countries. He finds that the common claim that federal countries are more decentralised than unitary ones is unfounded. One of his indicators measures the degree of tax revenue decentralisation. Unsurprisingly, Canada and Switzerland find themselves at the top of the list with more than 52%. The autonomous own tax revenue of sub-national governments in Germany is calculated to be 7.61%. This includes not only the states but also the communes however. This figure is stunning if compared to that for France, often assumed to be the archetype of a centralised system. There, it is calculated to be 19.53% (all values for 1998). Cf. D. Stegarescu: Public Sector Decentralization: Measurement Concepts and Recent International Trends, Discussion Paper 04-74, Zentrum für Europäische Wirtschaftsforschung, Mannheim 2004.

(in comparison, in 2005, the sum of revenues of the states was more than €235 billion and the proceeds of the tax on land acquisition thus constituted only some 2% of their entire proceeds).

Time and again, economists have emphasised the urgent need to reform Germany's fiscal constitution. Most politicians now claim that the current reform is only part one of a more extensive reform, and part two would then deal with the fiscal constitution. It remains to be seen whether the grand coalition will produce sufficient momentum to bring about this second part of the reform.

Creating Rules for a National Stability Pact

Germany's fiscal problems have been widely reported. It has not complied with the deficit criterion of the European Stability and Growth Pact for the last four years. If it does not comply with the maximum deficit of 3% of its GDP next year, sanctions of up to €10 billion would loom large. There needs to be a rule indicating who would have to pay that bill.

Under the current constitutional rules, the states would participate in the sanction according to their share in the overall deficit. This implies that only those states would be sanctioned that contribute to the deficit. After the implementation of the reform, this will change: now, the federal level will pay 65% of the sanctions, the states the remaining 35%. Out of these 35%, 65% (i.e. 22.75% of the entire sanction) will have to be borne by those states which caused the deficit. That means, in turn, that the remaining 35% of the entire 35% (i.e. 12.25% of the entire sanction) will have to be borne by the states in their entirety. These 12.25% thus constitute a certain "solidarity principle" between the states.

The evaluation of this reform is highly ambivalent: on the one hand, it is to be welcomed that precise rules have been introduced. On the other, it is unclear why states that choose a sound fiscal policy should participate in paying the fines for those which choose unsound policies. True, there is an incentive for constraint, yet states with unsound policies can still create considerable spillovers. More generally, the rule now implemented presupposes that a number of more general issues have been settled which have, at least until now, not been settled at all. These issues are

- how to allocate the permissible deficit between the federation and the states
- how to calculate the permissible deficit amongst the states based on a number of economic indicators
- how to domestically sanction those states that do not comply with the domestic allocation rules.

Conclusion and Outlook

In Germany, there is a broad consensus that a reform of federalism is a precondition for solving, or at least reducing, some of Germany's most pressing problems such as the high unemployment rate, the low growth rate, the high deficit and the reform of the welfare state. The current reform is one step in the right direction, but some more steps need to follow suit. From an economic point of view, the most important reform would modify the institutions of the fiscal constitution. More specifically, the fiscal autonomy of both the states and the local authorities needs to be strengthened.

How likely is this reform? The reason for not including the fiscal constitution in the current reform was simply that consensus seemed impossible to reach. The majority of states are financially rather weak and any move towards a stricter separation system would mean new problems for them. Their incentives to be against any such reform are thus obvious. What is more, it is highly unlikely that some of the most important issues of the fiscal constitution will be part of a second reform (if it ever comes about): a coalition of East German and small West German states succeeded in securing that a number of issues would not be part of federalism reform.[14] Among these is the current fiscal equalisation scheme, which is to continue unchanged until 2019. As the degree of fiscal equalisation between the states is extremely high, it discourages the richer states from increasing their efficiency further (because most of the gains would be transferred to the poorer states) but it also discourages the poorer states from improving efficiency (as that would reduce the amount of transfers received). In sum, the current reform is a small step in the right direction, but it seems likely that it will also be the last one for years to come.

[14] Cf. F. W. Scharpf: No Exit from the Joint Decision Trap? Can German Federalism Reform Itself?, EUI Working Paper RSCAS No. 2005/24, European University Institute 2005.