CONSENSUS DEMOCRACY AND INTERJURISDICTIONAL FISCAL SOLIDARITY IN GERMANY

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Abstract

The paper discusses recent developments of German fiscal federalism—especially the *Länderfinanzausgleich*, i.e. Germany's unique system of horizontal equalization. A ruling by the Constitutional Court has cracked the *status quo*, and the parties involved (federation and states) have begun a process of bargaining on a new equalization system. This process is assessed against the background of recent historic developments in particular with regard to interjurisdictional solidarity in Germany, which has come under scrutiny after ten years of significant financial transfers to the formerly communist states in the East. The paper argues that there is a conflict between solidarity and subsidiarity in today's Germany, whereby the former has won over the latter. Subsidiarity must now be emphasized more strongly than before. Taking Germany's federal structure as given, contractual forms of governance are shown to be a possible solution for some of the problems that are so far treated within horizontal equalization.

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I. INTRODUCTION

Ten years after Germany's reunification, which started the integrating of a formerly communist economy in the East into the Western Social Market System (*Soziale Marktwirtschaft*), the nation finds itself compelled to choose between even greater interregional solidarity and subsidiarity, or greater financial autonomy of the states.

While the economy in the East still has higher unemployment, is less productive, and picks up the revival of the European economy only slowly, it is time to assess the outcome of past transformation policies. One topic has come under special scrutiny in this respect: the growing feeling that the 1.4 trillion Deutsche Mark of net transfer to the East since 1990[1] did not have the expected positive effect on the economy but might rather be a part of the problem. Some analysts already fear that the East might turn into another *Mezzogiorno*, i.e. a region incapable of sustaining itself despite of yearlong transfers of resources.[2]

Germany's complicated system of fiscal equalization has become one of the main fields of discussion. In particular economists, but also scholars from other fields, feel that interjurisdictional solidarity might have gone too far. They argue that a more devolved system and greater accountability of regional governments might be called for in the spirit of subsidiarity.[3]

We shall proceed as follows: For readers unfamiliar with recent German history and the special "brand" of federalism we first present a brief overview. Then the current system of fiscal equalization is portrayed. We shall then dwell on a recent ruling by the Constitutional Court on the system of horizontal equalization, the *Finanzausgleich* that established clear guidelines on how to reform the system. This is followed by observations on the federal government's reaction to this ruling. Finally, we shall argue the case for more devolution in Germany on a theoretical level, but refrain from formulating just another specific reform proposal.

II. BRIEF OVERVIEW

The present state of German federalism can only be understood against its historical background. During most of the 19th century, Germany consisted of a patchwork of mini-states subject to hegemonial interests of both German-speaking superpowers (i.e. Prussia and Austria) and centrally

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[1] Compare iwd, Aufbau Ost: Ein Konzept auf dem Prüfstand, in: Informationsdienst des Instituts der deutschen Wirtschaft (2000), Vol. 26, No. 39, pp. 4-5.

[2] The Mezzogiorno is Italy's extreme south – a region that receives transfers since WW II, but still lags far behind the economic performance of the industrialized North.

[3] For instance, Wissenschaftlicher Beirat beim Bundesministerium der Finanzen (1992), Gutachten zum Länderfinanzausgleich der Bundesrepublik Deutschland Schriftenreihe des Bundesministeriums der Finanzen, Issue 47; or Föttinger, Wolfgang und Spahn, Paul Bernd (1994), "German unification and its consequences for intergovernmental financial relations", in: Current Politics and Economics of Europe , Vol. 4, Nr. 1, 37-49; and more recently Scherf, Wolfgang (2000), Der Länderfinanzausgleich in Deutschland. Ungelöste Probleme und Ansatzpunkte einer Reform. Gutachten erstattet dem Land Hessen.

controlled European nation states (i.e. France, Russia, and the United Kingdom). The German ambition at that time was the creation of a strong nation state to match competing European interests both politically and economically. When the German Reich was finally established in 1871, the Prussian hegemon controlled about two thirds of economic resources in Germany, truly a highly asymmetric construct which would render the federation vulnerable to centripetal tendencies and abuse of power.

Although formally a federation, with representatives of the constituent German states cooperating in a similar way as today's Council of the EU, the system had all characteristics of a monarchy with the Emperor and his nominated cabinet exerting the sovereign power of the Reich. True, there was an elected parliament, which became a source of continuing conflict, especially after the opposition to the ruling parties had won a significant majority, but it remained virtually powerless and without significant political influence.

After World War I, the Weimar constitution aspired to establish the accountability of government to an elected parliament, but failed to render the latter politically viable. A highly fragmented party system—representing a rickety society at a time of major social and political upheavals—and the national parliament fell prey to the Nazis, which ended the short-lived democracy between the two wars. Hitler's ascending to command had proceeded via Berlin and through Prussian institutions, the other states of the federation being impotent or unwilling to counterbalance his usurping of power. This is why the Allies would abolish the state of Prussia immediately after the War thus eliminating one important asymmetry and source of political instability.

Consequently the Allies divided Germany into occupation zones that did not necessarily respect historical boundaries. These zones were basically independent from one another as each military governor was responsible to his government only. This caused a number of problems, as solutions for the whole country were possible only if the "Big Four" would reach a compromise.[4] One point to which the Allies had all agreed was the creation of *Länder* or states, and the legalization of political parties. Elections were held in the newly created states in 1946 and state constitutions were passed in the following months. When the fifth conference of the Allied Foreign Ministers ended abruptly in December of 1947, the relations between the Soviets and the other three Allies were cooling down dramatically. This development changed the politics of the Western Allies, above all the Americans, who by then felt that West Germany was needed as a barrier against Soviet influence.[5]

The West German states were directed by the Western Allies to constitute a federal entity. They also made it clear that the new German federation would not reach full sovereignty, but remain under control in certain policy areas.[6] The Western Allies had clear perceptions of the constitu-

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[4] Generally, and from today's point of view, the Soviets and the French were less willing to reach such compromises, which led to the creation of the Angloamerican "Bizone" in January of 1947.

[5] Plans for Germany after the war included de-industrialization and transformation into an agrarian based economy – the famous Morgenthau Plan. The Americans had been in favor of a more moderate and development orientated treatment of Germany for quite some time then, e.g. the speech Foreign Secretary J.F. Byrnes held in Stuttgart on September 6th of 1946.

[6] Wolfgang Benz (1994), Die Gründung der Bundesrepublik. Von der Bizone zum souveränen Staat., S. 153 ff. The Allies also wanted the Germans to elect a national assembly to design the constitution. This was refused by the Ger-

tion the Germans were expected to draft, which caused a number of conflict while the parliamentary council (*Parlamentarische Rat*) was debating the new constitution which the Germans termed "Grundgesetz" (GG) to highlight its transitory and provisional character—in the hope of unification of all Allied Zones into one Germany.

Certain distinctive features of the modern German state can only be explained in the context of the deliberations during the immediate post-war period and the development of German democracy thereafter:

A. Federalism

The Allies had called for a federal form of government, but soon it became apparent that the perception of federalism by American consultants was quite different from the German concept of *Föderalismus*.[7] The American position survived in Article 30 of the GG, which reads:

"*Except as otherwise provided or permitted by this Constitution, the exercise of governmental powers and the discharge of governmental functions is incumbent on the States*."

This general rule is repeated in Article 70 I GG:

"*The States have the right to legislate insofar as this Constitution does not confer legislative power onto the Federation*".

But there is a qualification to this general rule in paragraph two of the same Article, which has proven to be decisive during the past fifty years:

"*The division of competencies between the Federation and the States is determined by the provisions of this Constitution concerning exclusive and concurrent legislative powers*."

The exclusive legislative powers, which are listed in Article 73 GG, include defense, currency as well as weights and measures etc. all of which would be managed by the federal entity in agreement with most scholars of federalism.[8] The concurrent legislative powers have proven to be extremely complex as Article 72 GG states that

"*… in the field of concurrent legislative power, the States have power to legislate as long as and to the extent that the Federation does not exercise its right to legislate by statute.*"

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mans who insisted on a body in which the states were represented. The Germans were trying hard not to give the Soviets reasons to push for a terminal division of Germany. The statute of occupation officially ended as part of the 2 + 4 agreements in 1990, which also ended the division of Germany.

[7] For Americans, the term "federalism" is used to describe the necessity of a central government for a union of states; Europeans (and especially Germans) tend to emphasize the relationship between layers of government and the relationship among the states. In particular the German variant of "cooperative federalism" describes the fact that authority and financing is shared by the federal government and the states in many policy areas.

[8] *F.A. von Hayek* held a different position concerning monetary policy for example – as he would have taken monetary authority away from national institutions altogether. This was finally achieved in the process of European integration and the creation of an independent European Central Bank in 1999.

In itself this constitutional provision would not be a problem, but when the constitution was drafted in 1949 the country was still devastated from the war and regional asymmetries in the supply of goods, infrastructure endowment, and local needs (e.g., the necessity to house refugees) were common. Therefore the usage of concurrent legislation was connected to cases in which (Article 72 II GG)

"*… the establishment of equal living conditions in the federal territory or the preservation of legal and economic unity necessitates, in the interest of the state at large, a federal regulation*."

Article 74 GG explicitly lists 26 policy fields in which concurrent legislation might apply. This high potential for federal legislation has strengthened the position of the federal government although the provision of Article 72 GG was originally designed to protect the sovereignty of the states. The federation has made extensive use of concurrent legislation since "balanced regional development" and "uniformity of living conditions throughout the nation" have always been (and still are) attractive features for policy making and institution building in Germany. Also solidarity between the federation and its member states, and among the member states themselves, is an important principles in almost all realms of policy.

In addition to the exclusive and concurrent legislation, Article 75 GG enables the federal government to enact framework legislation for the legislation of the States as far as Article 74a GG does not aver otherwise. In general the federal government made extensive use of its rights in the past—despite the general rule in favor of the states. Law making has become a federal affair in Germany whereas the administration of laws and their enforcement are almost entirely organized by the states. In view of this sharing of responsibilities, the division of expenditure between the states and the federal government is not straightforward. Instead there is almost always some form of joint financing among tiers of government.

A specific instrument of joint responsibility and cofinancing was written into the constitution in 1966: Joint Tasks (Article 91a GG), which are somewhat similar to matching grants in the United States.[9]

Under a joint tasks program, decisions on public investment projects are taken conjointly among states and the federal government within a coordinative body. Regional priorities are established through interjurisdictional negotiations and in accordance with the "uniformity of living conditions". In order to foster consensus and to express national priorities, the federal government carries a 50 per cent share or more of any state's project costs under the program.[10]

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[9] Joint Tasks explicitly allow for cofinancing in the following areas: Extension and construction of institutions of higher education, including university clinics; improvement of regional economic structures; improvement of the agrarian structure and of coast preservation.

[10] All in all the draft version of the Federal budget for 2000 lists 40 billion DM of cofinancing between the federation and states. This represents roughly 8 per cent of the federal budget. (see Dokumentation zu den Bund-Länder-Finanzbeziehungen auf der Grundlage der geltenden Finanzverfassungsordnung http://www.bundesfinanzministerium.de/fach/abteilungen/foefinpo/BLF2000.pdf).

Although political scientists heavily criticize joint tasks in Germany on the grounds that they blur accountability within a democratic system,[11] they can also be seen to represent a sound institutional approach to dealing with interjurisdictional spillovers and externalities in a framework of interjurisdictional contracting according to a contractual view of federalism. We shall elaborate on this a bit more in the concluding chapter.

In order to preserve the sovereignty of states, there is an institutional safeguard within the process of central legislation: all important laws affecting state interests need the approval of the *Bundesrat*, the Upper House (State House or Senate), where all states are represented. However, unlike the senators in the United States Congress, members of the *Bundesrat* are not elected, but appointed by state governments and recalled by them. The states' votes in the Upper House depend on the number of their inhabitants and can only cast "en bloc".[12] As state governments are composed of the same political parties as the Lower House, or *Bundestag*, the Federal Government may have to deal with a second chamber whose majority is either in favor of its policies or not. Since elections are spread over the years, the majority in the Upper House might change more than once in the four-year term of a federal government.[13] If the two chambers of parliament cannot agree on a certain matter, both sides have to negotiate. This negotiation process is institutionalized in a joint Intermediation Committee, or *Vermittlungsausschuss*.[14] This institution points to another important feature of policy making in Germany: compromise and consensus.

B. Consensus Democracy

It is typical for the German democracy that important decisions are based on broad majorities involving virtually all relevant groups of the society in the decision-making process. The experience of the Weimar Republic and the results of political fragmentation are still present and act as a corrective. German elections for the Lower House are based on a combination of direct voting

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[11] In Germany, cofinancing has been criticized extensively by scholars of fiscal federalism. At a theoretical level, matching grants could eventually be criticized on the basis of the so-called "flypaper effect" (see Fosset, James (1990), On confusing caution and greed: A Political Explanation of the Flypaper Effect, in: Urban Affairs Quarterly, Vol. 26 (1) pp. 95-117 and Oates, Wallace E (1999), An Essay on Fiscal Federalism, in: Journal of Economic Literature, Vol. 37, pp. 1129-1130).

[12] Each State has at least three votes; States with more than two million inhabitants have four, States with more than six million inhabitants five, and States with more than seven million inhabitants six votes.

[13] In fact voters tend to contemplate the federal government's policy even in local and state elections. E.g. the Schröder government (Social Democratic Party) lost its control of the Senate in 1999 after having won the general elections in 1998, as the opposition was able to recapture votes. This was largely due to the new government's troubling performance during the first months of its administration.

[14] Art. 53a I GG: *Two thirds of the members of the Joint Committee are deputies of the House of Representatives and one third are members of the State House. The House of Representatives delegates its deputies in proportion to the relative strength of its parliamentary groups; deputies may not be members of the Government. Each State is represented by a State House member of its choice; these members are not bound by instructions. The establishment of the Joint Committee and its procedures are regulated by rules of procedure to be adopted by the House of Representatives and requiring the consent of the State House.*

for about 50 per cent of the seats, and of indirect voting for the other half.[15] It is therefore hard for any one party to achieve a workable majority of its own. Instead coalition governments either led by the CDU (conservatives) or the SPD (social democrats) were in charge of the federal government for over 40 years now. So even before the government would eventually compromise with the Upper House, it has to compromise within the coalition government.

A number of studies[16] purport that democracies that are ruled by coalition governments tend to higher fiscal deficits and higher spending—a fact partly explained by logrolling within government. This tendency increases with the number of parties involved in a certain government. As more interests have to be taken into account, policy making becomes more complicated and costly.[17] One can expect this tendency to be very strong in Germany. Not only are political parties involved in such compromises, but also interest groups and NGOs, e.g. trade unions, employers' representative bodies, churches, etc. Therefore compromise does not only play a major role in German politics, but in almost all aspects of society. This is also true for public institutions with a semi-autonomous status.[18] There is a general resolve to keep respective "stakeholders" involved in guiding these institutions– which is part of a "democratization" process that started in the sixties and remains an important policy objective.[19]

C. Political Reality

This overview may help to understand some key elements of Germany's political reality and traditions: the desire to regroup the nation in line with language and cultural heritage[20]; the readiness to share the fruits of national economic development and growth on an even footing (interpersonal, sectoral, and regional solidarity); the acceptance of uniform standards throughout the nation including a homogeneity of policies at lower tiers of government. In an ultimate sense, the philosophy of the German brand of federalism is highly symmetrical as to potential outcomes. At present, it is however implying vast asymmetries in the functioning of institutions and the workings of political and bureaucratic procedures.

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[15] This rule is qualified by the fact that a party has to gain either 5 per cent of the vote or 3 direct seats to be represented in the Lower House.

[16] E.g. Poterba, James M. (1994), State Responses to Fiscal Crises: The Effect of Budgetary Institutions and Politics, in: Journal of Political Economy, Vol. 102, pp. 709-821; or Alesina, Alberto et al. (1993), Electoral Business Cycles in Industrial Democracies, in: European Journal of Political Economy, Vol. 9, pp. 1-23.

[17] Italy and Belgium are good examples for the underlying problem. While Italy is ruled by multiparty coalition governments, Belgium's problems are caused by tensions between linguistic groups.

[18] Examples include universities, public broadcasting corporations, and the social security system. In all these institutions interest groups have decisive influence on decision making.

[19] One of the most prominent example for this idea is the "*Betriebsverfassungsgesetz*" (Law on worker's coparticipation). In larger firms, employees have the right to elect representatives who may even sit on the supervisory board of the company that employs them.

[20] Legally, a German citizen is not defined by language, however. The criterion is still "blood relationship", which was written into the law in 1912 when Germany was still a monarchy.

In order to achieve the uniformity of living conditions and homogeneity of policies, for instance, there must be uniform—typically centralized[21]—guiding principles for the whole nation. This by itself brings in a new type of asymmetry at the vertical level. While other federations such as the United States or Canada accept concurring sovereignties at various levels, with full taxing and expenditure powers for each tier—albeit limited by constitutional provisions in order to reduce potential conflicts—, the German model of federalism can be characterized as asymmetrical power sharing. In this paradigm, the federation sets out a general framework for policy making for all states (and eventually municipalities), while the latter implement and administer such policies within these general setting. In particular, the tax law is identical, even for state and municipal taxes[22], and the states are denied any form of own taxation. Tax revenue is typically shared and apportioned among layers of government according to the constitution (income taxes) or law (VAT), and disbursed horizontally among regional entities according to formulae with strong equalization components.

The almost complete lack of policy discretion at lower tiers of government, and the "emptiness of the agenda" of state parliaments combined with the inability of states to use own tax instruments is exacerbated by a host of intergovernmental transfers that are all destined to foster national homogeneity and uniformity of living conditions. The equalization law, which we will discuss in the next part of the paper, is insofar not an aim in itself, but equalization is a necessary and sufficient condition for the German brand of federalism, as it exists today.

III. GERMAN FISCAL FEDERALISM—THE EQUALIZATION LAW

As numerous scholars (and one of the authors of this paper) have argued before, the German system of intergovernmental fiscal relations (i.e. the equalization law) is overcomplicated, and it sets adverse incentives for the parties involved (Federal and State governments) which is a direct consequence of a third point of critique—the amount of redistribution involved, i.e. the money transferred horizontally between states. A recent ruling by the *Bundesverfassungsgericht*, Germany's Constitutional Court, acting on challenges by the States of Bavaria, Baden-Wurttemberg and Hesse, the so-called "paying states", has brought this question back onto the agenda of policy.

A. The Rules of the *Finanzausgleich* since 1996

The equalization law was last reformed in 1992. Then the parties involved agreed on a new system that would incorporate the Eastern states from 1996 on.[23] Under the new rules, vertical

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[21] Centralizing such principles is the rule, but uniform principles can also be established through horizontal coordination among states. This is effected in conferences of state ministries and conforming treaties among governments. One prominent example is the cooperation in education and culture through the *Kultusministerkonferenz.* This body has come under heavy criticism recently as it was accused of working too slowly. Indeed consensus requirements imply that the slowest state will determine the timetable.

[22] Municipalities are, however, accorded some discretion to set tax rates within predetermined ranges.

[23] The current law on equalization is part of a consolidation package passed in consensus by CDU, FDP and SPD in 1992 to cope with the burden of reunification (Gesetz über ein Föderales Konsolidierungsprogramm).

equalization among the Federation and the States is based on Article 106 III-IX GG. It presumes that it is possible to define "necessary expenditures" at both levels—state and central governments—which are derived from a medium-term financial planning exercise, and to achieve a "fair compensation" (*billiger Ausgleich*) between both levels of government (Article 106 III). According to the objectives of the constitution, there is no "vertical fiscal imbalance" in Germany as exists in other federations with exclusive tax assignments (such as Australia or Brazil). This may be considered an advantage although the political and technical implementation of this constitutional rule is fraught with problems.

The constitution assigns half of the revenue from income taxes to both the federation and the states—with municipalities participating in the share of personal income taxes. This rule is technically simple as the shares are fixed and the horizontal apportionment of the revenue strictly follows the residence principle.[24] However the vertical splitting of the proceeds from VAT is governed by a federal law requiring the consent of the *Bundesrat* (compare p. 7). VAT sharing assumes the decisive role in securing "fairness" among the federation and its constituent states, and is therefore highly politicized. At present, the federal share of VAT is 50.5 percent with the states cashing-in the remaining 49.5 percent of a base adjusted for specific needs of the federation and municipalities.[25]

Horizontal Solidarity

At a first level, three quarters of VAT are apportioned to the states according to population. Another quarter is reserved for those states that are considered "financially weak". They receive supplementary transfers from VAT in order to bring their fiscal potential up to at least 92 percent of the average of total state taxes[26] per capita. The implicit redistribution effects of VAT sharing are often underestimated. When considering only the new states of the East (without Berlin), their tax potential was only 43.8 percent of the national average per capita before VAT distribution, but reaches a level of 84.6 percent of the national average after VAT revenues had been included.[27] It implies that these Eastern states acquire roughly twice as much VAT revenues per capita than their Western counterparts.

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[24] The horizontal distribution of income taxes is not without problems however. The regional distribution of the corporation tax requires a formula apportionment of income for firms with multiple regional activities (*Zerlegungsgesetz*), and the assignment of personal income taxes according to residence favors residential areas over production sites, which could be critical for municipalities and city states.

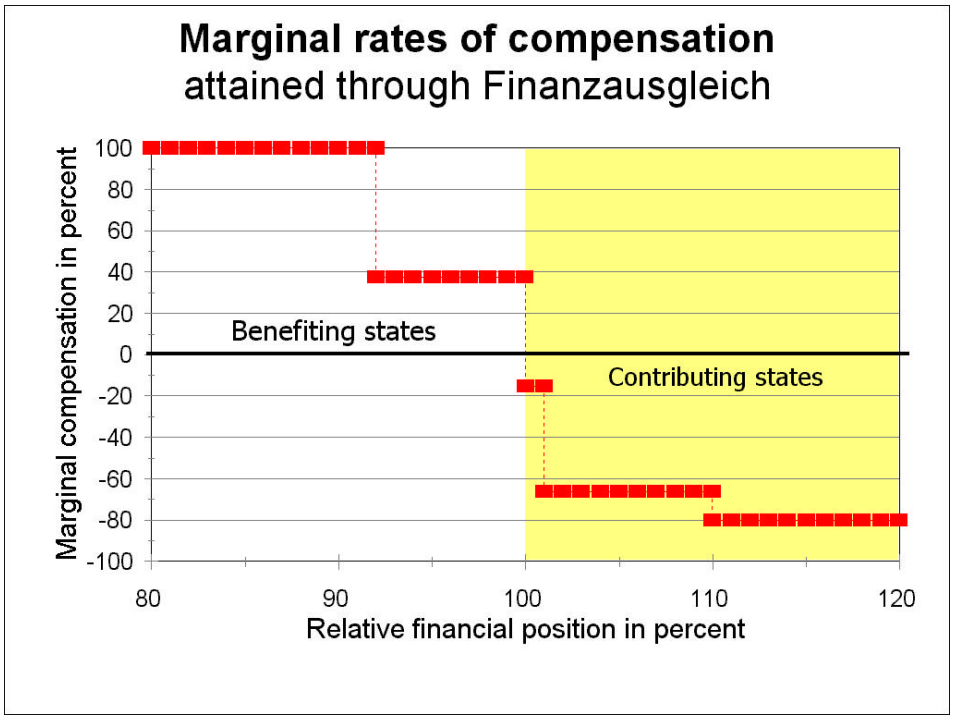
[25] At present (2000), the federation is entitled to an initial deduction of 5.63 per cent of VAT in compensation for supplementary contributions to the national pension system. The municipalities are participating in the sharing of VAT since 1998 (Article 106 sec. 5a GG). Their entitlement is 2.2 per cent prior to the sharing of VAT among the federation and the states.

[26] State taxes are defined in paragraph 7 (1) *Finanzausgleichsgesetz*.

[27] State taxes as in footnote 26—benchmark for compensation through supplementary VAT transfers—do not comprise VAT itself. This is why the share including VAT will remain below the yardstick of 92 percent mentioned before.

At a second level, there is the *Finanzausgleich* scheme, a redistribution of resources among the states. Such a scheme is logical for a situation where there are no vertical fiscal imbalances. However in the absence of such vertical imbalance, regional equalization must be arranged horizontally among the participating states. Germany is unique in having created such a system, which is, of course, based on a federal law reigning the mechanics of the scheme with uniform rules.

Figure 1: The Equalization Schedule



The definition of differentials in tax capacities requires a benchmark. It is found in a standardized "equalization yardstick" (*Ausgleichsmesszahl*) for state fiscal potentials, which is roughly the average tax revenue per capita multiplied by the population for each state. The procedure is, however, more complex. In particular it comprises an asymmetric bias in favor of city-states whose populations are weighted by a factor of 1.35 (compared to one for the other states). In addition to this, some—but not all—of the northern states are allowed to reduce their calculated tax potential as they are providing services to the nation through their harbors.[28] This yardstick is compared with the effective financial situation of each state, and the gap is subsequently equal-

[28] The equalization yardstick also accounts for tax revenues of the state's municipalities (at 50 percent). For local taxes, of which municipalities can vary the tax rate, an average national tax rate is used to standardize revenue. An unsystematic element of the scheme is the compensation for some "special burdens" according to paragraph 7 (3) FAG, which is taken care of by lump-sum corrections, e.g. the provision for harbors mentioned above. The weighing procedure for the population is ruled in paragraph 9 (2) FAG for the states, and in paragraph 9 (3) for local governments. The latter uses a progressive scheme in line with the population of the jurisdiction. The differential weights for city states and larger municipalities can be interpreted as accounting for some "agglomeration costs" of larger jurisdictions.

ized according to a formula. States below the average (*ausgleichsberechtigte Länder*) receive a compensation that is to be financed, in progressive steps, by the states above the average (*ausgleichspflichtige Länder*). The sum of payments received always equals the sum of disbursements; the scheme is thus a complete clearing mechanism. The progressive "tariff" of the redistribution scheme reflecting the degree of interregional solidarity among states is depicted in figure 1 below.

As table 1 illustrates, the equalizing effects of the *Finanzausgleich* are considerable. The program guarantees that the fiscal ability of all states attains at least 95 per cent of the average tax capacity. The marginal burden on the contributing states reaches 80 per cent, and it may even exceed the 100-per-cent mark under certain conditions.[29]

Vertical Solidarity

At a third level, there is a final corrective of the distribution of public resources in the form of asymmetrical vertical grants by the federal government: so-called supplementary federal grants (*Bundesergänzungszuweisungen*). Such transfers according to article 107 II GG have been widely used after unification while they were almost insignificant before. They also were decisive in establishing consensus among the various jurisdictions with the aim of compensating the formerly socialist Eastern states. Unlike for horizontal equalization, states that receive such grants are not considered "financially weak", but "weak in the provision of services" which is the general term used in the law for "entitled to federal support". In particular, factual "gap-filling grants" (*Fehlbetragsergänzungszuweisungen*) have been introduced that guarantee at least 99.5 percent of the average fiscal ability for all states. Moreover, nine states out of sixteen receive federal grants to relieve the costs of "political management" (*politische Führung*), and the new Eastern states as well as some Western peers receive federal grants in compensation of "special burdens".

The volume of the highly controversial „gap-filling grants" of the federal government was 5.8 bill. DM in 1998; the special grants for the new *Länder* were 14.0 bill. DM. They supplement state resources by 7.1 per cent on average.

The high volume of these federal grants has become subject to criticism not only by economists, who tend to stress the inefficiencies of "softening" budget constraints, but also by politicians and lawyers—and specifically the Constitutional Court—, who stress the excessive redistribution effects of this type of grants. The constitution had reserved such forms of asymmetrical federal intervention for exceptional circumstances only (such as unification, for instance); there was certainly no intention to use them as regular instruments for "filling gaps" in the budgets of a majority of states.

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[29] This is the case if the sum of payments needed for the deficient states exceeds the sum of payments for the contributing states as calculated according to the formula. In this case, the discrepancy is distributed evenly onto contributing states.

Table 1: The Impact of the Equalization on States' Relative Tax Capacity and on Their Marginal Burden of Own Revenue

State	Rank	Relative tax capacity per capita in percent			Rank	Marginal burden
	Before FA	*Before FA*	*After FA*	*After Grants*	*After Grants*	*in per cent*
Hesse	1	117.6	104.4	104.4	9	*79.8*
Baden-Wurttemberg	2	111.3	103.5	103.5	10	*68.2*
Hamburg	3	109.8	103.5	103.5	11	*97.8*
Bavaria	4	108.5	103.0	103.0	12	*62.1*
North Rhine-Westphalia	5	106.3	102.3	102.3	15	*58.4*
Schleswig-Holstein	6	100.3	100.3	103.0	13	*50.9*
Lower-Saxony	7	93.8	96.1	100.7	16	*85.1*
Rhineland-Palatine	8	93.4	95.9	102.7	14	*89.3*
Saarland	9	90.1	95.0	138.5	2	*98.7*
Brandenburg	10	85.6	95.0	118.9	7	*97.0*
Saxony	11	84.7	95.0	118.4	6	*94.6*
Saxony-Anhalt	12	84.6	95.0	120.0	4	*96.8*
Thuringia	13	84.1	95.0	120.0	5	*97.1*
Mecklenburg-West Pommerania	14	83.7	95.0	120.7	3	*97.9*
Bremen	15	71.8	95.8	151.8	1	*98.9*
Berlin	16	70.1	95.0	114.2	8	*94.5*
National Average		100.0	100.0	107.1		

The importance by volume of each of the three steps of horizontal equalization is shown in table 2 for the year 1998.

Table 2: Volume of redistributed resources

Volume of redistributed resources (1998 in bill. DM)		
VAT (only supplementary payments)	*Finanzausgleich*	Federal grants
17.6	13.5	25,7

B. The Court's Ruling

As mentioned already, a recent ruling of the Constitutional Court on the *Finanzausgleich* punctured the German equalization law.[30] It is obvious that a court, whose role is to control the validity of norms, cannot transgress the framework set by the constitution or ask for its outright revision in the spirit of competitive federalism. The arguments of the Court will always be constrained by the constitutional status quo. However, its verdict has given some support to an in-depth revision of the general philosophy of the *Grundgesetz*, and it has spurred farther-reaching discussions of intergovernmental fiscal relations in Germany. In this context the following points of the Court's findings may be noteworthy:

The arguments underline "the preservation of the historic individuality"[31] of the states and "a degree of competition among the individual states as secured by the federal principle" (sec. 213) as well as the "innovation-fostering function of political competition among the states, and vis-à-vis the federation" (sec. 214). This takes up elements of a more fundamental criticism by competitive federalism theorists.

The verdict requests the legislator not only to revise the existing law on equalization, but insist on a "law on general standards" (*Maßstäbegesetz*) which is to specify the constitutional principles as to their content that would reign the equalization process (sec. 277). This law would attain almost constitutional rank, and is supposed to be drafted in the spirit of Rawls' "veil of ignorance" (sec. 282)—albeit intricate to realize in practice.

In this vein of thought, the Court has even expressed its unwillingness to tolerate legislation, which, in practice, conveys equalization to the sole responsibility of the *Bundesrat* (sec. 284). A

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[30] BverfG, 2 BvF 2/98 of November 11, 1999, sec. 1 – 347; http://www.bverfg.de/.

[31] This and the following citations of the Court are own translations.

simple parliamentary majority would not justify equalization at the expense of a minority of states—even though their governments may have actively and positively been involved. It conveys a responsible, balancing, and neutrally appraising role to the federal government, a duty confined by elementary, general, and overarching legal principles.[32]

On a more technical level the Court called for the abolition of certain guarantee clauses and ordered lawmakers to use a broad definition of "financial ability" when assessing states' and municipalities' resources, i.e. their tax income.[33]

It should be mentioned that the verdict only accelerates a process of discussion that would have been started anyway as certain rules of the 1992 compromise between the federation and the states will run out by 2004.

C. The Finance Ministry's Position

In reaction to the Court's ruling, the finance ministry issued an "*Eckpunkte-Papier*"[34] in September of 2000, which is roughly the equivalent of a Green Paper. It clarifies the federal government's position in the upcoming negotiations with the states. As had to be expected the government is not promoting a grand reform of Germany's fiscal system, but proposes minor revisions of the law that will bring the current system in line with the Court's demands while keeping it generally intact. Accordingly the government calls for a consensus solution (sic!) in the spirit of cooperative federalism.

Vertical Distribution of VAT

The federal government proposes to base the distribution of VAT on the budget and financial planning exercise, in which the states are involved on a regular basis. This is to discharge a request that the volume of spending be based on medium-term financial planning (see above). It is the finance ministry's view that the "law on general standards" requested by the Court is not needed, because the techniques used to establish medium-term financial planning would include standardized measures for determining "necessary expenditure" and "current income" already.

The shares of VAT distributed between the states and the federation would generate similar coverage ratios between "current income" and "necessary expenditure" at each level. This procedure would ensure fair compensation in the splitting of VAT proceeds. The ministry also suggests that

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[32] This is in sharp contrast to the *de facto* behavior of the federal government which used pork-barreling to buy votes in the *Bundesrat* in favor of a proposed tax reform recently. The concessions even included the guarantee of specific benefits to city states that had been censured by the Constitutional Court.

[33] Compare BverfG sec. 318-327. Whether certain resources have to be taken into account or not is one of the most fought over issues in the history of the equalization law. States have every incentive to "hide" income which in turn reduces their "fiscal ability" and enhances the transfers they receive.

[34] The "*Eckpunkte-Papier*" was available to the authors only as draft paper of the ministry. All citations and translations are made from this draft.

a more automatic rebalancing mechanism than the hitherto used (see Art. 106 IV GG above) might be considered.

Horizontal Distribution of VAT

The ministry is convinced that the distribution of VAT among the states should still be based on the number of inhabitants. States whose financial endowment is below average should receive supplementary shares of the states' share in VAT. However negative incentives of the distribution mechanism should be reduced.

Horizontal Equalization

The government considers a correction of the primary distribution of tax income necessary as long as it is inadequate from the viewpoint of solidarity. The differences in the financial ability of states would be equalized neither in a manner that will weaken the paying states, nor even-out state finances completely. The rules governing the calculation of the amounts to be transferred among states need to be designed in a transparent way. As the present guarantee clauses are not without contradictions, they would be abolished.[35]

The Court ruled that financial capacity was to be understood in a comprehensive sense; therefore concession levies[36] must be taken into account for equalization as well as all incomes generated by municipalities.[37] As to the weighing of inhabitants, it is the governments' position that it is essential to take the particularities of city-states into account—but that it could be based on more reliable and objective criteria.

Federal Grants

The Court's ruling particularly censured federal grants.[38] It clearly states that federal grants are to be considered extraordinary and transitory measures to mitigate the financial stress of particular states. They must not affect the horizontal equalization or the vertical splitting of VAT on a permanent basis. The federal government will therefore have to reduce the number of its grants as well as their magnitude.

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[35] In the current system there are up to five different guarantee clauses which are designed to keep the sequence of the states' financial position intact after equalization. The consistency problem results from the fact that the criteria used are different from the ones used for equalization itself (e.g. the tax income of municipalities is treated differently).

[36] Concession levies are collected by German municipalities as a compensation for granting infrastructure companies (e.g. telecommunications or electricity firms) rights of way.

[37] As one will not find a passage in the ministry's paper that addresses municipalities directly what is presented above is the newspaper's and our interpretation on a rather general sentence on income relevant for states' financial ability. The ministry did in fact support this interpretation when asked about it on the telephone.

[38] BVerfG sec. 296-300

In the future, grants for special burdens would be the exception from the rule and their duration is limited. As a first consequence the Ministry has announced that grants for the relief of additional costs of political management[39] will no longer be conceded. States who are in a situation of budgetary distress will still receive grants in the future, but only for a limited amount of time and on a regressive scale. States that are to receive such grants will have to present binding plans for financial reorganization. The federal government and the states will share the burden of such grants in relation to their spending.[40]

D. Evaluation of the Ministry's Position

As was pointed out above a 'grand reform' of the Germany's equalization system is highly unlikely as the matter is politically intricate and pressures to reach a consensus are ever present. However it must be stressed that the Ministry's proposal falls short of the Court's requirements although it might be constitutionally sound.

Vertical Aspects of VAT Sharing

The demand to design the vertical sharing of joint taxes on the basis of positive statistical criteria for "necessary expenditure" and "current income" of each layer of government is virtually impossible to comply with. The vertical splitting of competencies is always a political decision. Peffekoven has expressed skepticism on the prospects of a quasi-automatic adjustment of vertical VAT sharing.[41] This skepticism is based on the experience of an expert commission that was set up to in the beginning of the eighties in order to define "necessary expenditure" and "current income", and other loosely defined concepts of Germany's fiscal constitution. At that time the experts could not reach agreement in all aspects of the discussion.[42] However there was agreement that the constitution should not penalize public entities that are successful in consolidating their budget, which is what happens in the current system because consolidation improves the relationship between own revenue and expenditures, resulting in a loss of resources.[43]

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[39] The costs of political management are now thought to be roughly fixed, i.e. they increase on a per capita basis as the jurisdiction becomes smaller.

[40] It is an important (and unfortunate) feature of German cooperative federalism that the Constitutional Court, in an earlier decision, has interpreted solidarity between jurisdictions to comprehend the need to bail-out state budgets in distress. This constitutes an incentive to accumulate debt without considering consequential payments – as this debt is practically guaranteed–which is straightforward and its resulting behavior can already be anticipated in the accumulation of debt by the eastern states. (see Spahn, Paul Bernd (2000), Zur Kontroverse um den Finanzausgleich in Deutschland, pp. 14-15).

[41] Peffekoven, Rolf (1999), Das Urteil des Bundesverfassungsgerichts zum Länderfinanzausgleich, in: Wirtschaftsdienst 1999, Issue XII, p. 710.

[42] Sachverständigenkommission zur Vorklärung finanzwissenschaftlicher Fragen für künftige Neufestlegungen der Umsatzsteueranteile, Maßstäbe und Verfahren zur Neuverteilung der Umsatzsteuer nach Art. 106 III und IV Satz 1 GG, in: Schriftenreihe des BMF, Heft 30, Bonn 1981, S. 22 ff.

[43] See Peffekoven (op.cit.), p. 711.

Moreover, the ministry ventures that a specific "law on general standards" as requested by the Court is not necessary. This view is based on Art. 106 GG where medium-term financial planning is referred to as a guiding rule for VAT sharing between the federation and the states. Basically, the position boils down to: what is good for the constitution must also be good for the Constitutional Court.

This position of the federal government is highly dubious because the quantitative framework of medium-term financial planning is rather "shaky" and mainly destined to express political priorities.[44] Moreover, the *Finanzplanungsrat* (financial planning council)—the institution responsible for medium-term planning—is likely to shift the emphasis of its work onto monitoring the Maastricht criteria for budget performance in the future. Its projections must therefore strike a balance between policy ambitions and actual performance in line with the budget criteria if Germany is to maintain its AAA rating in the bond markets.[45] If this is going to happen, the outlay figures produced by the Financial Planning Council in line with the Maastricht criteria are unlikely to represent "necessary expenditure" in an economic sense.

Horizontal Equalization

Article. 107 II, first sentence, GG obliges the legislature to equalize differences in financial capacity (*Finanzkraft*) suitably. The latter refers to actual financial resources, not to a relationship between revenue and specific expenditure needs [46] The Court has reemphasized the number of inhabitants to form an "abstract needs criterion" (equal per capita financial resource) as a yardstick for horizontal equalization. And it criticizes the "weighing" of population figures (*Veredelung*) as a means to express specific burdens (for instance of the city states). Indeed, the economic profession is split over the question on whether the costs of providing local public goods do in fact rise with population density.[47] Already in 1992, the Court has asked for more accurate data and a scientifically founded backing of the weighing procedure for inhabitants, but so far neither the federal government nor the states have seen any necessity to act. The Court also questions the wisdom of "specific burdens" that have crept into the equalization system such as for harbors.

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[44] For instance, during the last two decades the fiscal deficit was typically reduced to almost zero for the fifth year of the planning period. However, the planned reduction of the federal deficit was never achieved. The figures were simply arithmetically adjusted year by year. (See *Bundesfinanzbericht* or the reports of the *Sachverständigenrat zu Begutachtung der gesamtwirtschaftlichen Lage.*

[45] Under the Maastricht treaty no member state of the European Monetary Union is supposed to run a nation-wide public deficit higher than 60 per cent of GDP, and a consolidated public sector budget deficit exceeding 3 per cent of GDP in any given year.

[46] See BVerfGE 72, 330 ?.

[47] There are not only "agglomeration costs" of densely populated states; there may also be cost disadvantages of smaller communities and thinner-populated states. See for instance Carl, Dieter (1994), Bund-Länder-Finanzausgleich im Verfassungsstaat, S. 87

The federal government seems to be decided to retain the weights in favor of city-states. More importantly, it has practically promised a continuation of the scheme in an effort to win Bremen's support for a tax reform package.[48]

As to horizontal equalization among states the government seems to be willing to abolish specific "needs related" elements such as the provision for harbors. It has long been questioned for instance whether Hamburg's harbor constitutes a fiscal "burden" or whether the state might actually be worse off without it. Agglomeration effects are difficult to analyze—but generally one would suspect Hamburg to benefit from its historic position as a logistic hub of the nation.

Moreover, the federal government seems to accept the Court's request to conceive financial ability of states in a comprehensive sense, i.e. including all financial resources of municipalities. This will reduce the current system's complications noticeably as changes in the assessment bases—as were common—will no longer exist. However the reaction of the paying states remains to be seen, as they would probably lose resources. This is due to the fact that municipalities in paying states have a greater financial ability, on average, than municipalities in states receiving transfers.[49]

Federal Grants

As to federal grants, an overall reduction is indeed necessary because an instrument originally designed for cases of emergency has in fact degenerated into a source of general revenue for some states. As these grants constitute a heavy burden on the federation's budget, the federal government is most likely to follow the Court's order in this case. In our opinion the proposed reform should indeed focus on the supplementary grants for special burdens. They should only be granted for a certain (preferably short) periods of time, and they should be phased out beforehand. Otherwise it is to be expected that the recipient states will get used to the additional resources and have every incentive to prolong the measure.[50]

In a first step, the grants for specific burdens of political management would be abolished. We support this for two reasons:

From a systematic point of view, the weighing by the number of inhabitants (used to compensate for higher costs of population density) and grants for specific costs of political management (used to support small-scale jurisdictions) are hard to defend if used concurrently within the same equalization framework. This would only make sense if the costs of providing local public good were V-shaped, which is unlikely to be the case. On the contrary: one might argue the provision

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[48] Compare BverfG. (1999) sec. 319-321

[49] Whether this innovation will lead to losses heavily depends on the general design of the future transfer schedule.

[50] The Eastern states' behavior of the past 24 months clearly reveals the underlying incentive. Time and again the East German prime ministers have argued—regardless of partisanship—that the level of transfers needed in the future should not fall below present levels.

of local public goods to have constant returns to scale after reaching a certain number of inhabitants, as congestion phenomena are counteracting possible economies of scale.

More importantly: the states have the right to reorganize themselves.[51] If states are not willing to reduce the costs of financing political management by merging into larger jurisdictions, their citizens/voters should be ready to pay for it. The costs of preferring small political unities and hence higher management costs should be borne by those who opt for it, not by the federal government and the nation as a whole.

IV. The Future of Germany's Fiscal Federalism

As outlined above we shall not present another equalization model, but try to make a general case for more competitive forms of federalism in Germany while maintaining interjurisdictional solidarity. In our opinion it is absolutely necessary to make room for more decentralized solutions at all levels of government—economic and political developments after reunification providing evidence in favor of this presumption.[52] We will focus on two newer strands of theory—contract federalism and laboratory federalism—each of which will be discussed with a view on the German situation. In this context we shall also discuss the possibility of an increase in the quality of service delivery within a model of contract federalism.

A. Spillovers, Fiscal Equivalence, and Contract Federalism

There are numerous spillover problems within the German Federal structure. While the relevance—in some cases even the existence—of these spillovers is debated, the phenomenon clearly points to a more general problem: the size of jurisdictions and the structure of the German federation. Certain states are extremely small compared to the others; there are major differences in the number of inhabitants and tax potentials. Nine out of sixteen states are currently receiving supplementary grants for compensating costs endured in political management, i.e. they are considered incapable of financing governance, or their own statehood.[53] Using Breton's or Olson's

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[51] This observation is less theoretical than one might think: In 1995 there was a serious political attempt to merge Brandenburg and Berlin. While it was possible to come to a political solution that was drafted into a treaty between both states and took both political as well as bureaucratical hurdles a majority of Brandenburg citizens was not in favor of the measure.

[52] For example the West German model of labor relations, whose core is the "freedom of coalition", was transferred to the East immediately after reunification. This meant that wages and general working conditions were suddenly agreed upon through collective bargaining. Furthermore, labor unions were successful in negotiating fast increases of East German wages with the objective of attaining the Western wage level as soon as possible. The process of determining wages was generally independent from the development of labor productivity (value added per capita), let alone of the situation of single enterprises. In effect this policy is probably the main reason why the unemployment is still much higher in the East than in the West. Under these auspices, many enterprises left the employer's association and went back to decentralized bargaining, a survival tactic that, even though economically necessary, is considered illegal by some.

[53] One should not overlook that a state does not only consist of government. In addition to its executive, it has legislative and judicative branches with corresponding bureaucracies to render them effective. In the case of some Ger-

phraseology respectively, there are indications that Germany does not posses an economically optimal constitution or that fiscal equivalence is not reached within all German jurisdictions.[54] However one must accept that the actual setup of states is a direct consequence of historic developments, i.e. it is path-dependent. I must therefore be considered an exogenous variable of Germany's fiscal federal relations even though economists might be able to identify superior structures.[55] If one accepts the political reality, there is need for techniques to help jurisdictions in coping with regional spillovers (or non-equivalences) that affect the horizontal and vertical relationships among jurisdictions. In addition to existing externalities, states and municipalities are facing a continuum of new problems that might call for collective action. Three possibilities have to be considered according to Olson.[56] Of these possibilities, the case where collective goods/bads or their utilities/disutilities reach beyond a jurisdiction's border poses severe problems.[57]

Breton has argued that a higher level of government is needed to bring about a Pareto-efficient allocation of resources in such instances. He mentioned the possibility of treaties, organizations and committees, but considered them only imperfect substitutes for interventions by higher levels of government. This is in contrast to Buchanan who explicitly assumes that individuals facing certain externalities or having similar preferences for certain collective goods will form clubs. Benefit taxation can then be used to finance the provision of collective good to the members of a club. Buchanan apparently emphasizes Coasian bargaining[58], while Breton does not. Even though, one must ignore for the moment that Breton considered agreements between jurisdic-

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man states one must add the public broadcasting systems, state central banks (subdivisions of the Deutsche Bundesbank), school systems etc., that were established almost regardless of efficiency considerations.

[54] Compare Breton, Albert (1965), A Theory of Government Grants, in: Canadian Journal of Economics and Political Science, Vol. 31, pp. 175-187; and Olson, Mancur (1969), The Principle of "Fiscal Equivalence": The Division of Responsibilities among different Levels of Government, in: American Economic Review Proceedings, Vol. 49, pp. 479-487

[55] Compare Oates (1999), pp. 1130-1131 on similar thoughts concerning the US. states. One might be skeptical about such computing as the result it produces will probably lose its validity quite fast in a changing environment, i.e. the rise and decline of certain sectors alters the buoyancy of regional tax bases.

[56] The collective benefits might either reach beyond the boundaries of a providing jurisdiction, it might be of the same size, or it might be smaller.

[57] As an example of relevance for Germany, consider infrastructure projects like major airports. As the discussion on a new airport Berlin/Brandenburg or the discussion about an expansion of the Rhine-Main airport in Frankfurt demonstrate, the scope of a regional project often goes far beyond the borders of a single state.

[58] More recent thinking on the Coase theorem and its information requirements has shown that it will deviate from the Pareto-Optimum if not all participants are fully informed *ex ante*. This is likely to be the case when states bargain with each other. However one may still be skeptical whether a higher jurisdiction is better suited to overcome this information asymmetry.

tions, while Buchanan was originally concerned with agreements between individuals that form jurisdictions to supply particular public goods.[59]

Nonetheless, negotiations and contractual agreements between states resulting from such bargaining should be used to internalize spillovers that are now compensated by grants. This is especially true for city-states that constitute agglomeration centers within their respective regions. At present, their fiscal burden is carried by *all* other states. Compared to bilateral or multilateral negotiations, this may lead to an oversupply of local public goods by the city, because the individuals whose preferences determine demand do not bear all resulting costs. This problem would not exist in bilateral or multilateral negotiations involving only those states which benefit directly from the provision of public services: If an agglomeration center plans a new infrastructure project, for instance, it must decide on its scale and scope.[60] It will use cost-benefit analysis to decide whether the project should be undertaken. Generally there are two possible outcomes:[61]

- The center or the center's voter/citizens are willing to undertake the project alone—i.e. the combined utility of the center is larger than the projects costs.
- The center is not willing to undertake the project alone—i.e. the costs of the project are higher than the combined willingness to pay.

In the first case it its rational to complete the project even though the surrounding state may free ride on its benefits. This the classic Olson case where one "individual" has preferences that are strong enough to produce a public good on its own.[62] Still the center might try to bargain with the periphery but chances of success are slim as long as preference-revealing mechanisms cannot be used.[63]

The second case is the more interesting one as the center could negotiate with surrounding jurisdiction, which, again, may have two rational outcomes:

- The combined willingness to pay for the project is smaller than its costs and therefore the project is not executed.
- The center and its neighbors agree to realize the project conjointly because a distribution of costs is found leaving all participants better off than without the project. A club of two

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[59] Nevertheless there is a certain realism to the idea of one club per public good as Olson (1969) reports 1.400 governments in the New York metropolitan area alone – counting school, sewerage, pollution control districts, and the like, as governments.

[60] Even now—without bargaining—it is hard to imagine Hamburg, for example, to built a new museum or theatre without considering how many potential users of such an enterprise might be living outside Hamburg's geographical region.

[61] Compare Homburg (1994), Anreizwirkungen des deutschen Finanzausgleich, in: Finanzarchiv N.F. 51, pp. 319-321 for a similar argument.

[62] Compare Olson, Mancur (1968), The Logic of Collective Action: Public Goods and the Theory of Groups

[63] If preference-revealing mechanisms, such as Groves-Clarke's, could be used this would produce another problem: resulting user charges are most likely to be insufficient.

or more states is formed in line with Buchanan's original concept, which results in a Pareto-improvement.

The example could easily be transferred to a situation in which there are two or more smaller states all of which have preferences for statehood and are facing a situation of scarce resources, e.g. because special grants for costs endured in political management have indeed been abolished. These states will have every incentive to bargain on a number of issues and institutions that they might be able to use and finance in concert.[64,65]

These are strong reasons in favor of abolishing the supplementary grants for costs endured in political management and the weighing by inhabitants respectively. Stronger budgetary pressures would then encourage less expensive and problem-oriented solutions.[66] It should be clear that this point depends on the question how the future transfer schedule for horizontal equalization will be conceived. If states cannot retain at least as much of their bargaining rents as they would save by trying to socialize their problems, bargaining will either break down, or not start off at all.

We call such bargaining processes instigated within a deficient federal structure and their institutional forms of interjurisdictional cooperation and coordination "contract federalism". While the basic constitution remains untouched, new institutions are set up and function of the basis of single-purpose contracts among states, eventually only for a limited period. The political reality in Germany renders contract federalism, i.e. bargaining among states (or municipalities) and formal interjurisdictional so attractive in a second-best world.[67]

Frey goes even further by envisioning so-called functional, overlapping, competing jurisdictions (FOCJ) that do not only have the power to tax, but are run and ruled by their constituents. As in the Tiebout model, individuals constrain government behavior through their option to leave and to join jurisdictions at their discretion, whereby any individual can be a member of several jurisdictions and face several governments at the same time.[68] While it is improbable that FOCJ could function in the real world for several reasons (e.g. the high cost of voting required, time and resources spent by individuals in deciding which FOCJs to join, control cost etc.), the concept is

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[64] There are already some examples of German states making use of joint institutions, e.g. Baden-Wurttemberg and Rhineland-Palatine merged their public broadcasting systems, which is a considerable success insofar as the two separate systems (running against states' borders) had existed since the Allies had created them in the late forties. Equally, regional central banks were not automatically tolerated for the new Eastern states, which was an incentive to create supraregional institutions.

[65] There are notable examples for contacts among states on a number of issues, although only at an informational base. For instance, Bremen and Lower-Saxony have set up a body that coordinates regional planning in the Northwest of Lower Saxony. However, incentives to reach bilateral solutions are inexistent as it is always possible for Bremen or any other city/small states to socialize the costs and let all fellow states carry their share of the burden.

[66] There is one qualification to this conclusion: the Constitutional Court's judgment on the handling of budgetary distress of certain states that allows them to socialize their debts too.

[67] The usage of "second best" in this context may be questionable theoretically, but highlights the fact that contract federalism is a superior solution under given political and institutional constraints.

[68] Compare Frey, Bruno S. (1997), Ein neuer Föderalismus für Europa: Die Idee der FOCJ. As an example for FOCJ, Frey refers to Swiss municipalities that are generally ruled by their citizens in direct democracy.

useful in guiding proposals to tackle the problem of interjurisdictional spillovers.

B. Service Delivery

Even though this paper is concerned with a first generation type of policy reform we do believe that contractual forms of federalism can significantly improve the quality of service delivery in the public sector—a second generation type of reform.[69] There is one simple reason for that: contractual forms of governance affect the relationship between the parties involved, i.e. they create supplier-user relationships. Financial flows corresponding to service delivery would correspond more or less to *quid pro quo* transactions, and any partner dissatisfied with the quality of the service could exit as under market conditions. Of course citizens can be considered "customers" of public services even under present conditions, but so far this relationship was problematical in two instances:

- Generally consumers' potential to organize themselves is weak, *and*
- consumers now typically face monopolies for providing public services, i.e. there is no choice or exit option.

While contract federalism does not necessarily alter the relationship between a public administration and the citizen/consumer, the perception is different from the viewpoint of states or municipalities. If one assumes that bargaining would indeed take place and that certain jurisdictions might specialize in the production of specific public goods, the "producer" possesses a "make-or-buy" option.[70] If it decides to buy the public good, i.e. to contract goes to another jurisdiction or a private business, the quantity of goods and the level of quality expected within the agreements' lifetime are at stake inevitably. It is important to recognize that while, at a first glance, contractual governance replaces one multilevel principal-agent relationship (voter-politician-public service) with another (voter-politician-service provider), this will effectively terminate supply-side monopolies.[71]

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[69] Second generation reforms like improvements in the provision of services in the public sector are receiving more attention lately as it becomes clear that policy reforms alone will not generate desirable and durable effects. Compare Tanzi, Vito (2000), The Role of the State and the Quality of the Public Sector, IMF Working Paper 00/36, pp. 22-23.

[70] Two additional points might be in order here: Jurisdictions with traditionally large public sectors might specialize in providing services to others with the aim of using their capital and labor more efficiently. Jurisdictions facing a "make-or-buy" option are basically redefining the borders of their "firm". Here, as in many other cases, theory that was originally designed for a private business environment, e.g. Coase and Williamson on transaction costs, contracts and principal-agent relationships may yield powerful insights for the public sector.

[71] Of course the supply-side-monopoly would eventually be replaced by a bilateral monopoly, which has its own drawbacks. However it would still represent an improvement of the situation compared to present arrangements.

Public choice is enriched by options and choice and one can be optimistic about its economic virtues—even though it may be restricted to politicians because consumer-led FOCJs do not appear to be a realistic option:[72]

- Politicians who face such choices are likely to use contracting because it could improve the quality of service delivery or reduce its costs.[73] This would be popular with consumers/voters, an politicians who ignore these options are vulnerable to critique by party peers and consumers alike.
- Theory predicts that consumer welfare will rise as more options become available.

The representation of interest groups criticized above might actually be an advantage of the German system in this context. While the Labor government in Britain, for instance, attempts to involve consumers in the regulatory process, such involvement is a matter of tradition in Germany. This constitutes a fertile ground on which to build new institutions that would support politicians in making "make-or-buy" decisions. This would compensate, at least in part, the loss of political influence, e.g. of state parliaments, that would result from state governments bargaining with other jurisdictions.

C. Laboratory Federalism [74]

Proponents of laboratory federalism have argued that—with imperfect information—learning by doing and testing different options may enhance the quality of policy. Such experimentation is perhaps a particularly attractive feature of a federal system.

The argument relates basically to von Hayek's critique of centralized economies. He argues that the ability to process information of a central planning commission is weak compared to the market system's facility to process that same information. Thus the ability of a nation to process information may increase as more than one level of government (or different governments on the same horizontal level) can test different options.[75]

The concept of laboratory federalism forms an antithesis to the German perception of solidarity and uniformity of public services. Germany's present fiscal constitution rather includes incentives that encourage states to go for the wrong solution: Innovation is almost pointless where the financial outcome from such innovations has to be shared with fellow states—instantly and al-

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[72] It should be noted in passing that new technologies such as the internet enhance the possibilities of participatory governance such as participatory budgeting (a model initiated by the city of Porto Alegre in Brazil) or e-government which allows quality controls through consumer feedbacks.

[73] Again Wicksellian tax prices could render consumers accountable for the consequences of the politician's actions more directly.

[74] Compare Oates (1999) pp. 1131-34 for a survey on the literature concerned with laboratory federalism.

[75] Historians have argued, for instance, that the European economies and nations of the Renaissance period constituted nothing else but laboratories, and that competition among those states spurred innovations and propelled them into leading positions in the world. See North, Douglass C. (1981), Structure and Change in Economic History, chapter 11.

most completely. A degree of solidarity that brings *all* states to 99.5 per cent of their average financial endowment per capita is simply excessive in economic terms.

An excessive degree of solidarity has even greater adverse effects if it is put in a dynamic and longer-term setting. In a globalizing world—where nations have to compete among each other—there are high risks for a country whose rate of innovation in the public sector is consistently lower than abroad. It could cause companies to exit, or to raise their voice—both activities that are costly for the companies themselves as well as for the country and its economy more generally.

V. CONCLUSIONS

Germany has a highly developed model of cooperative federalism, which requires consensus within government, among public institutions, and among different layers of government. Cooperation is typically institutionalized, and there are exemplary conflict-resolving bodies and procedures. Joint tasks represent just one example of responsibility sharing and joint financing in order to tackle the problem of interjurisdictional spillovers. The *Bundesrat* is another example for cooperation and coordination among layers of government.

A second feature of German federalism is its high degree of uniformity in public service delivery. This is mainly achieved through revenue sharing and interjurisdictional solidarity, with significant resource flows among governments and a high degree of interregional equalization. While such transfers have created a regionally balanced public infrastructure and evened out income differentials among states, they tend to obliterate the incentive of regional governments to develop their own resources—and hence the accountability to their citizens. Nonetheless, the German states have some, albeit limited, discretion on the expenditure side of their budgets, which they are indeed exploiting to differentiate their policy profiles.

At present, the German model of federalism is under revision in response to a ruling of the Constitutional Court on the system of horizontal equalization, the *Finanzausgleich*. Moreover, there is increasing competition within the public sector and among public institutions as well as among countries in a globalizing world. This has remarkably improved the quality of service delivery through corporatization, privatization, and the greater use of “make-or-buy” options. Negotiated solutions within existing cooperative arrangements and institutions tend to account for possible regional spillovers and constitute an appropriate response to coping with market inefficiencies. This has contributed to both interregional solidarity and efficiency.

Generally speaking, the German model of cooperative federalism has indeed functioned remarkably well in the past: the quality of public service delivery is high, and governments are responding to regionally differentiated voter preferences while maintaining a certain “uniformity of living conditions” throughout the nation. What is at stake now is to open up such institutionalized forms of interjurisdictional cooperation, which are now formal and subject to legal procedures, and thereby limited (for instance for the joint tasks). Conventional budget procedures have to be opened up by focusing democratic control on budget outcomes, rather than rigid allocations of funds and budgetary processes, and to be replaced by more open contractual forms of interjuris-

dictional cooperation. This would certainly improve the quality of public services and could lead to a greater variety of such services if laboratory conditions are created at a larger scale.[76] Open forms of contractual intergovernmental relations would also be reflected in interregional resource flows as counterparts to the costing of providing public services through greater interjurisdictional cooperation.

Interjurisdictional solidarity is firmly established and will prevail in Germany. And horizontal and asymmetrical forms of equalization will continue to be used to achieve it. However the Constitutional Court has expressed the need to limit the degree of interstate financial redistribution.[77] This has to be welcomed from an economic point of view. What is critical, though, is the fact that the Court defines state financial resources comprehensively, which would not allow regional governments to protect some own revenue against interregional redistribution. This contradicts the economist's quest for more accountability. The Court also interprets interjurisdictional solidarity to comprise virtual bailouts of governments in financial distress. Again this verdict runs counter the economist's aim of promoting more efficiency through the equivalence of the costs of service delivery and the willingness of citizens to pay. Even the usage of user charges (over taxes) does not constitute a way out of the dilemma if the Court continues to interpret fiscal revenue comprehensively.

It is hoped that the benefits of interjurisdictional contractual arrangements and the need to redesign intergovernmental resource flows are recognized by German politicians, and that the pending revision of the fiscal constitution will render the system of equalization more efficient. In particular negative financial incentives could be eliminated by allowing the states to generate some own revenue (such as user charges, but also state taxes or, preferably, surcharges on national taxes) that are at the discretion and responsibility of regional authorities. Moreover, such extra revenue must be protected against interregional redistribution in order to preserve incentives. This must not necessarily jeopardize solidarity among governments.

The irony of the German system could be that its basic philosophies and actual fiscal arrangements could be interpreted to foster such developments, as cooperative federalism is in fact the nucleus and archetype of more open forms of contractual federalism. However the need for consensus and a partisan-driven misinterpretation of regional solidarity may ultimately prevent this modernization of German federalism to come to pass.

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[76] Laboratory federalism now begins to bear fruits chiefly at the municipal level in Germany.

[77] The Court seems to accept a level of equalization up to 95 per cent of the national average.

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