



# German federalism at the crossroads

New weaknesses emerge in the success story of postwar German federalism.

BY RAINER-OLAF SCHULTZE

**The** highly successful West German federal system, which for 40 years brought economic and social prosperity to Germany's "second" democracy, has fallen into a state of crisis, mostly as a result of the momentous changes that occurred toward the end of the 1980s.

On the surface, German reunification looks complete – there are five new *Länder*, and West German institutions have been introduced in the East. However, reunification is still in progress on the cultural and economic levels, the consequences of which will continue to weigh on German politics for decades to come.

These strains have made structural reforms essential for the political system. However, Germany is poorly prepared for such changes and is wrestling with the necessary fundamental reforms. The reason for this difficulty is that the reform processes are slowed down by the past successes of Germany's federal model. The resistance to reform has clearly caused German policy-making to fall behind, although this cannot be blamed solely on federal institutions. It is also due to:

- an electorate very attached to the status quo;
- a government-focused political culture oriented toward consensus and output;
- political parties and politicians who shy away from innovation.

## Even in early days there were problems

From the very beginning, the German federal system suffered at least four structural problems:

1. **Contradictory pressures.** Highly centralized federal democracies like West Germany are operating on two contradictory political principles. Horizontally – across *Länder* and across the country – the parties and their members in the federal and *Land* governments follow the logic of competition and the marketplace. Vertically – from city to *Land* to the nation – they work by the politics of accommodation and consensus.
2. **Executive federalism**, growing out of interlocking government, lacks transparency and legitimacy and accentuates the loss of influence by the federal and *Land* parliaments.
3. **Too much veto power** by too many players. The result is long negotiations, a freeze on innovation, and policies that usually fail to rise above the lowest common denominator (see box "How the German federal system is structured").
4. **Gridlock** resulting from legislative authority at the federal level and the administrative authority residing with the

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Edmund Stoiber, Premier of Bavaria, whose CDU/CSU party could block reforms

*Länder* or local governments (see box "Postwar history and German federal principles"). West German federalism has proved to be a "joint-decision trap", in the words of Fritz W. Scharpf, that was virtually impossible to escape.

## New *Länder* bring new challenges

There are now 16 *Länder* of very different sizes and capacities. The number of players, possible vetoes and coalitions has grown, as have the asymmetries in the federation, fairly insignificant in the past. These asymmetries include:

- economic disparities between *Länder* in the east and in the west;
- cultural diversity; and
- differences in political and cultural attitudes increasing between the people in east and west, north and south in Germany. Political parties can no longer appeal to all regions, especially the two large catch all parties, the CDU/CSU and SPD.

The particular challenge of German reunification is the need for policy-makers to show solidarity with eastern Germany and redistribute wealth for decades to come while at the same time recognizing that the principle of equal living conditions cannot be maintained (see box "Postwar history and German federal principles").

The basic task of German federalism is no longer just to provide checks and balances and efficient government through functional differentiation but also to ensure diversity and competition, i.e., integration through autonomy and subsidiarity – tasks usually easier to achieve in "dual" systems of federalism than in systems of "intrastate" federalism.

## European integration

The process of European integration has meant a loss of sovereignty by national governments as various fields are

## Postwar history and German federal principles

- 1948 German Constitutional Convention (poster)

The highly integrated structure of German federalism, as designed after the Second World War in the *Grundgesetz* of 1948-49, was not only a reflection of German tradition. This structure also reflected the demands placed on policy-makers after the Nazi dictatorship and total defeat in the Second World War. The primary aim of the founding fathers was to prevent an abuse of power. In shaping German federalism, they aimed therefore at putting controls on powers and at a balance of power, but not especially at the vertical separation of power.

Second, the founding fathers aimed to achieve equal standards of living in the various *Länder*, and not to create especially diverse, independent *Länder*. "Equal living standards" developed into the most important principle in German federalism. This principle was a focus for policy-makers, constitutional lawyers, citizens and interests groups. This principle was only marginally watered down in the 1994 constitutional reform, with the result that the Basic Law now refers to "equivalent living standards."

Third, the founding fathers aimed to help the governments of the *Länder* influence federal policy-making, rather than to make the *Länder* more independent or encourage competition among them. With the establishment of the Bundesrat, they created a "Republic of *Länder* princes" or *Republik der Landesfürsten*. (see box "How the German federal system is structured") While these princes are interested in the politics of their own *Land*, their primary aim always was to ensure the equality of living standards throughout the entire republic.

### Why did this system emerge?

The capacities demonstrated by West Germany's federal system in the past depended on certain preconditions, without which policymakers would hardly have achieved the efficiency and success that they did. These pre-conditions included:

- **a single culture** - a society that was relatively homogeneous on the social and cultural levels after the rebuilding of West Germany;
- **few economic disparities** - only small economic disparities and asymmetries, especially as the national government was still able to take effective action to steer the economy and social policy. These conditions prevailed in the so-called "30 glorious years" of the welfare state, until the 1970s.
- **a common political landscape** - a party system that was highly integrated both horizontally and vertically so that the competitive, coalition and opposition constellations were broadly similar on the federal and the *Länder* level and political personnel were regularly exchanged vertically within parties. To give just two examples: Four of the seven federal chancellors (Kiesinger, Brandt, Kohl, Schröder) and six of the men who were candidates for chancellor (Strauß, Rau, Vogel, Scharping, Lafontaine, Stoiber) served as the premier of a *Land* either before they ran for chancellor or simultaneously. In addition, the elections to the *Land* parliaments served as a test for federal policies. Their results also affected the composition of the *Bundesrat* and the majorities in it.

Political parties on the federal and *Land* levels usually thought in terms of influencing and accommodating rather than confronting. With few exceptions, this led to moderate, middle-of-the-road policies in the past. The approach also corresponded to the relationship between politics and society typical of what has been called "the capitalism of the Rhein".



brought within the EU system and various jurisdictions and tasks are transferred to Brussels and EU institutions (Commission, Council of Ministers, Parliament, Court of Justice). Secondly, it has meant more "inter-governmentalism" by the national governments. Both processes reduce the competencies of national and sub-national parliaments and their ability to make decisions, while increasing the amount of "inter-connectedness" by adding many more players and another layer to the multi-level system of governance.

Fostering open markets has been the major focus of the EU's integration efforts on the economic level. Supported by the decisions of the European Court of Justice, the EU has concentrated almost exclusively on the liberalization of markets. The creation of the internal market, the economic union and the currency union are typical examples. This forces the member states to engage in "competitive deregulation" and the privatization of tasks formerly accomplished by government.

At the same time very few market-correcting policies have been transferred so far to the EU level. This is especially true of redistributive policies and therefore also of transfer payments in the area of social policy, which remain a jurisdiction of the member states.

One theory has it that in federal welfare states the constituent provinces and districts should concentrate primarily on infrastructure and economic development, for reasons of site competition, while the national government should concern itself with macroeconomic policy, especially tax policy and social policy (see box "Who gets what from German taxes").

### The political reality in Germany is quite different.

Both the federal government, ever since the foundation of the Federal Republic, and the European Commission of the EU are permanently involved in the industrial, infrastructure and site policies pursued by the *Länder*. Conversely, the governments of the *Länder*, through the *Bundesrat*, have substantial influence over virtually all macroeconomic decisions of the federal government, especially in the area of social policy. What results is a mishmash of jurisdictions and responsibilities that is not very appropriate from either the standpoint of innovation and efficiency or of democracy and legitimacy.

## How the German federal system is structured

German federalism is a highly integrated and centralized system of government. It is the model of intrastate federalism and is best captured by a term coined by Fritz W. Scharpf: *Politikverflechtung* or interlocking government based on joint decision-making.

*Politikverflechtung* refers to a political system in which all major political decisions are made jointly by the federal and *Länder* levels of government on the basis of solutions negotiated among the participants. It means that most governmental activities have to be implemented jointly by the federal and *Länder* governments: horizontally through inter-*Länder* cooperation and vertically through federal-*Länder* cooperation and multi-level governance. This process involves levels of government from EU institutions down to the municipalities. Institutionally, interlocking government is caused by the following:

- **constitutional clauses** that give precedence to federal over state law; clauses that enable the federal government to act and intervene if the *Länder* have not yet legislated in a particular field of shared responsibilities, or if the national interest or the interests of third-party members of the federation are affected by the legislation of a *Land*, or in order to protect the legal and economic union of the federation.
- **functionally differentiated distribution of responsibilities** where legislation is predominantly a federal responsibility (except for the areas of culture, education and the judicial system, which are under the jurisdiction of the *Länder*) while the *Länder* and municipalities carry out most administrative tasks
- ***Länder* participation in federal legislation** via the *Bundesrat*. *Länder* representation in the second chamber is based on the so-called *Bundesrat* principle – it is neither equal nor consistent with the representation-by-population rule; representation is asymmetrical and weighted. Members are not elected, but are delegates of the *Länder* governments. They have to vote as a block and according to the decisions taken by the cabinets of their respective *Länder*.

The *Bundesrat* has a hand in all federal legislation. There are two kinds of bills: those for which the second chamber has a suspensive veto only (*Einspruchsgesetze* in German), and those for which it has an absolute veto (*Zustimmungsgesetze* in German). In case of opposing majorities in the two chambers, the pending legislation is referred to the mediation committee with 16 members each from the *Bundestag* and the *Bundesrat*. The latter group of “absolute veto laws” includes not only more than 60 percent of all federal laws but also all major legislation - economic and social policy, as well as tax laws and acts concerning fiscal federalism.

### Blocked reforms

Under current conditions, German federalism is increasingly developing into the main obstacle to necessary social changes.

The political impasse is primarily a consequence of the opposing political imperatives of party competition on the one hand, and the politics of accommodation on the other. Depending on tactical political considerations, the *Bundesrat* serves either as a tool for blocking the federal government or as a forum for compromise. It is, however, mostly responsive to the intentions of the parties that form the opposition in federal politics. For example, after the mid-1990s, the reform plans of the federal government under Chancellor Helmut

Kohl were blocked by the Social Democratic majority in the *Bundesrat* under the leadership of Oskar Lafontaine, including the efforts that were already underway to reform the pension plan and tax system.

At the present time, the main opposition parties, the CDU/CSU, are using their majority in the second chamber in a similar way usually as a tool for blocking legislation or gaining concessions or amendments. It is still the same policies that need reforming. With Chancellor Gerhard Schröder’s reform package – dubbed “Agenda 2010” – attention is currently focused on tax reform, overhaul of the immigration law and labour market policies, and urgent reforms to the health care system and old age security. However, because of conflicting tactical calculations of political parties and the large number of players with veto powers, there is a form of gridlock. In this stalemate, no one on the German political stage has the power any longer to actually make decisions, but all have the power to prevent them from being made. In other words: “No one really wants what is done, and no one will accept responsibility for it” (Fritz W. Scharpf).

### Necessary reforms

The blockages in German federalism make substantial reform more urgent than ever. Everyone wants reform, from interest group representatives to academics and even the political players themselves. There is also considerable agreement about the goals of such a reform. What is needed is a new political architecture that provides more independence, subsidiarity and competition while taking European integration into account. The missing piece is a political architecture that provides a multi-level governance system that is as efficient as possible and, at the same time, highly responsive.

In particular, such a reform should aim for:

- separation and clear assignment of responsibilities;
- simple, transparent decision-making;
- more opportunity for citizens to participate and exercise some control through referenda and other forms of direct democracy;
- fair competition that not only tolerates social and cultural diversity but to some extent even encourages it, while at the same time having enough safeguards built in to prevent the *Länder* and regions from engaging in a race to the bottom.

Institutionalizing cooperative yet competitive federalism would be a major accomplishment. Today, even in federal systems based on independence and competition, federal government and provincial governments work together, although on the basis of loose linkages and voluntary cooperation.

### To escape the “interlocking government trap”

The road to such a systematic change is arduous. Before such changes are achieved, the following steps are necessary:

1. **Disentangle the legislative jurisdictions** and redistribute government tasks on the basis of functional criteria. The increasingly important shift from an industrial society to a knowledge-based and service-industry society requires concentrating these responsibilities in the *Länder*. At the end of a long process of decentralizing functions, the central government would retain, in addition to its traditional jurisdiction over foreign policy and security, authority over financial policy, social policy, large-scale infrastructure policy, and possibly research policy. In any

case, many of these functions will probably be transferred in the future to the European Union in Brussels.

2. **Reform fiscal federalism** to break up the shared tax system and grant the *Länder* additional tax jurisdictions and latitude to structure their own rates, while at the same time seeking to harmonize national taxes on the EU level.
3. **Change the competencies of the *Bundesrat*** by substantially reducing the amount of federal legislation subject to its approval. You can't have it both ways: helping to rule on the national level via the second chamber and engaging in competition among the *Länder* at the same time.
4. **Redraw the borders of the *Länder*** and reduce their number from 16 to about nine. They will then have the resources to act and carry out their responsibilities and to compete on the European level. In the long run, re-drawing *Länder* borders is essential if we are serious about the disentanglement and transfer of powers. It is relatively easy to draw up a blueprint like this, but implementing it is another story.

History shows that mega-constitutional politics only rarely succeed. This holds true as well for the reform of German federalism. There is a lot of path dependence in the way of such large institutional reform. In addition, the politicians and civil servants in the federal and *Land* governments would have to renounce much of the influence they now exercise over the other level of government. This does not seem very likely. An incremental approach to change seems more promising, beginning with a few reforms that could provide the political actors with the necessary practical experience.

### Indirect disentanglement

Germany's 1948 constitution, the *Grundgesetz*, is translated as the "Basic Law". In the debates over reform, there are serious discussions on amending the constitution, for instance, about

- abolishing the so-called "joint tasks" (Sec. 91a Basic Law),
- changing the framework legislation of the federal government (Sec. 75, Basic Law), and
- transferring jurisdictions in the area of concurrent legislation to the *Länder* (Sec. 74/74a Basic Law).

The transfer of jurisdictions could be done in two ways: directly through agreements on which tasks in particular should be transferred, and indirectly through a general clause giving the *Länder* the right under certain conditions to diverge from federal regulations by passing their own legislation. Both ways should be tried, although the indirect approach through opting out seems more promising.

### Fair competition

Opting out or having loose linkages creates room for competitive attempts to find alternate solutions. Loosening of the tax system is absolutely essential in reforming fiscal federalism. Every *Land* should have some leeway in the handling of its own exclusive taxes, even in setting discretionary income tax rates. In addition, as opposed to current practices, the horizontal equalization payments should provide some incentives to be thrifty and competitive. Differing tax rates are quite common in interstate federal systems, but are foreign to Germany's political culture, and it would be difficult to convince the population of their advantages.

## Who gets what from German taxes

The tax system and equalization payment system are especially telling examples of the intra-state, centralized nature of German federalism. In 2001, the revenues of all three levels of government reached 443.1 billion euros. All three levels of government have at least a few exclusive tax powers. Exclusive federal taxes include the gasoline tax, tobacco tax, and 5% excise tax on income tax for the rebuilding of East Germany. These taxes amount to approximately 18 per cent of all tax revenue. Exclusive *Länder* taxes are among others automobile and inheritance taxes. *Länder* and local government taxes amount to 7.5 per cent each of all tax revenue.

The vast majority - 70 per cent - of the revenues of all levels of government come from shared taxes, especially income tax and the Value Added Tax (VAT). Of all revenues, 51 per cent went into the coffers of the federal government, 35.6 per cent into the coffers of the *Länder*, and only 13.4 per cent into the coffers of local governments. All taxes and tax rates, even those levied exclusively by the *Länder*, are determined by federal legislation. So is the distribution of the shared taxes among the three levels of government. Federal and *Länder* tax rates are therefore identical in all parts of the country.

The distribution of income tax is enshrined in the constitution of 1949 or Basic Law, which gives the federal and *Länder* governments each 42.5 per cent, and local governments receive 15 per cent. The distribution of the VAT is set by simple federal legislation: currently the federal government takes 52 per cent and the *Länder* 45.9 per cent. There are two forms of equalization payments, which are also determined by federal legislation: vertical and horizontal transfers. The horizontal transfers, called *Länderfinanzausgleich* in German, were introduced in the 1950s. The wealthier *Länder* contribute to, and the poorer ones draw from an inter-*Länder* revenue pool, according to a formula that has to be agreed upon by the federal and *Länder* governments. The formula has been challenged in the Constitutional Court several times and amended accordingly, although without abandoning the general principle. Vertical (federal) transfers are a more recent (1969) addition to the equalization system. Various federal supplementary payments are made to *Länder* whose financial capacity is below average or which have special needs - such as the city-states and the five new states in the East. These payments are taken from the federal VAT share and close 90 percent of the gap between the respective state's fiscal position and the average. Together, both processes of equalization have achieved almost full harmonization on the revenue side. All *Länder* can expect to see their financial capacity brought up to at least 99.5 of the mean. Intergovernmental transfers represented 12.8 per cent of *Länder* revenue in 2001.

The incremental reforms outlined here would be only the initial steps toward extricating Germany from its interlocking government trap. Because of past experience, when reforms generally led to greater interlock and uniformity, there is every reason for scepticism about the chances that these reforms will be undertaken. In contrast to the past, though, there is greater pressure now than ever before on federal and *Land* politicians to take action. Now, there is a realistic chance that the reforms needed to disentangle German federalism will actually be undertaken. ⑥