

INFORME**GERMANY BEFORE THE NEXT REFORM OF (FISCAL) FEDERALISM:
LESS SOLIDARITY AND MORE COMPETITION?**por **Mario Kölling¹**; **Cesar Colino²****ABSTRACT**

At the end of the recent reform process of the German federalism, the Länder gained some of the political importance they had lost in former times but also lost one of the unique fiscal mechanisms which they had: the expenditures financed by new credits. However the reform of the Financial Equalization System has been postponed and has to be solved before the current system expires in 2020. In this context during the coming months, the debate over the Equalization System will become tenser in Germany. Nevertheless, in this article we will argue that the underlying problems of the financial relationships between the Federation and the Länder are even deeper and need a broader reform debate.

RESUMEN

Tras el reciente proceso de reforma del federalismo alemán, los Länder ganaron algo de la importancia política que habían perdido en el pasado, pero también perdieron a uno de los únicos instrumentos fiscales que tenían a su disposición: el endeudamiento. Sin embargo, la reforma del sistema de nivelación se ha aplazado y tiene que estar resuelta antes de que el sistema actual expire en 2020. En este contexto, durante los próximos meses, el debate sobre el sistema de financiación del federalismo alemán se hará más tenso en Alemania. No obstante, en este artículo argumentamos que los problemas subyacentes de las relaciones financieras entre la Federación y los Länder requieren un debate más amplio.

I. INTRODUCTION; THE RELEVANCE OF FISCAL FEDERALISM REFORMS

Debates around the raising, spending, and borrowing of money are highly complex and are hard to solve in all democratic states. Questions of the optimal design of the financial structure, as well as its impact on policy making and government accountability are also in the centre of political debates in Federations. Federal states have an additional complexity because there are at least two tiers of government, each with its own powers, responsibilities and perspectives. The dynamics between these tiers of government makes “fiscal federalism” one of the most studied aspects of federalism. (Anderson 2010) Global changes in institutional structures and social-economic conditions not only among countries but also within them, have determined the need for economic and political reforms during the past years, as well as the need for new debates on the division of fiscal and political responsibilities among governments. In addition, the Euro crisis of 2010/11 has shown the risks of extensive public borrowing.

The variety of types of fiscal arrangements and reform options is high within federal states. The German system is considered as “continental” or “integrative” system where

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the constituent units typically administer federal programs in areas of concurrent legislative responsibility. This means that the Länder have the obligation to carry out federal laws and constitutional provisions. Because of this, the distribution of revenues and expenditures are highly political issues.

The German fiscal federalism is characterized by a strong horizontal and vertical interdependence in intergovernmental finances, a low level of sub-national tax autonomy and the constitutional guarantee of “equality of living conditions” throughout the country. A clearer delimitation of powers and a reduction of joint decision making were the leitmotifs of the two reforms carried out in the past decade. At the end of the reform process the Länder gained some of the political importance they had lost in former times but also lost one of the unique fiscal mechanisms which they had: the expenditures financed by new credits. However some main questions, eg. the Financial Equalization System, have been postponed but have to be solved before the current system expires in 2020. In this context during the coming months, the debate over the Equalization System will become tenser. Nevertheless the underlying problems of the financial relationships between the Federation and the Länder are even deeper and need a broader reform debate.

II. MAIN TRADITIONAL PROBLEMS AND CONSEQUENCES OF THE SYSTEM

With regard to the structural and institutional problems of German federalism, we could highlight in the following paragraphs the following challenges and their consequences:

- deficiencies of transparency and accountability
- low competition among Länder
- economic heterogeneous performance of Länder
- demographic change and migration
- complex Financial Equalization System
- low tax autonomy but autonomy for borrowing for the Länder
- increasing debt of the public sector
- the European integration process

The German cooperative federalism has been frequently criticised because of its excessive bureaucracy, limited scope to design policies, the agreement on the lowest common denominator and deficiencies in transparency and control. In fact since the seventies the German system is characterised by a situation, labelled by Scharpf as joint decision trap, in which there is a tendency for government decisions to be taken at the lowest common denominator since the decision-makers have the ability to veto all proposals. (Scharpf 1985) In addition, this kind of joint decision making has made the political process less transparent. But also the strong horizontal and vertical interdependence of intergovernmental financial relations reduced the transparency of the decision making process. Because of lack of clarity on the political responsibilities, citizens increasingly do not understand which level is responsible for which revenue and expenditure. Nevertheless this fact didn't lead to a systematic problem since German federalism is valued more in relation to its output than its input. Survey evidence consistently shows that large majorities of the German public supports federalism as a political concept but prefers uniform federal regulation. (Bertelsmann, 2008) (Sturm 2011) In this sense the preference for decision making at the federal level and for common policy solutions as well as for uniform levels of taxation is high among all

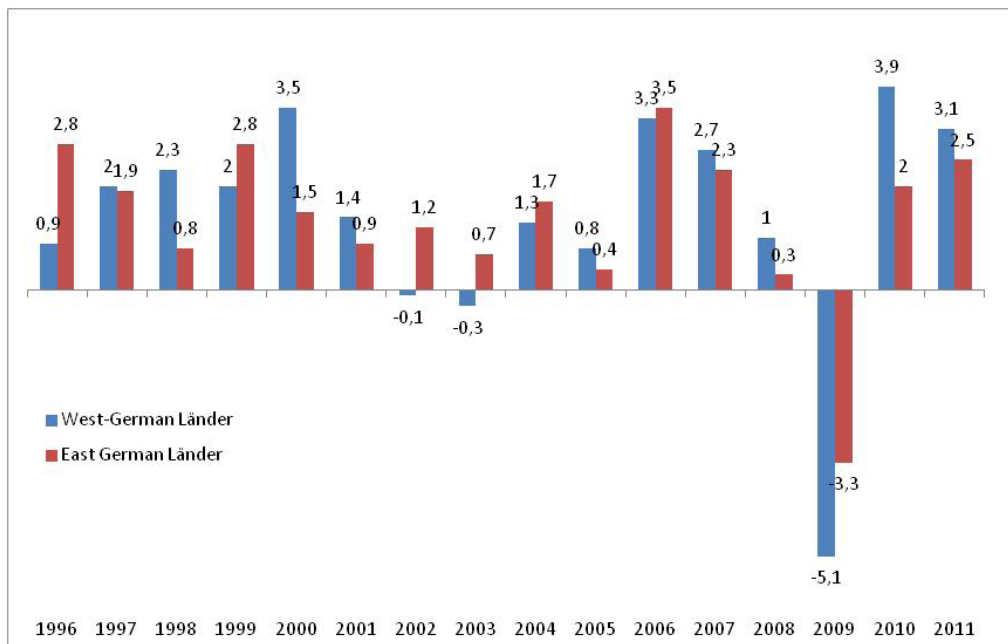
Länder. (Leuprecht 2012) The concept of “equality of living conditions”, according to which all sub-national jurisdictions have to exhibit identical or at least very similar policies in the most important policy areas, is enshrined in Article 72(2)³ of the German Basic Law. This political objective increases the tendency for national wide policy solutions.

At the same time Germans strongly reject inter-state competition and are almost unanimous in their support for the principle of solidarity, as well as favouring cooperation among Länder governments.

Although the Länder play a significant fiscal role in the legislative process, the interest in Länder politics is falling since the mid-90s. While in 1995, 39% of the German population was interested in Länder politics in 2009 only 31%. A majority of 58%, however, was only somewhat interested in Länder politics and 11 % not at all.⁴

A further structural problem which affects the current design of German Fiscal federalism is the heterogeneous economic performance of the Länder. Especially since German reunification the economic gap between the Länder has been increasing and the former fairly balanced West-German federal system has been replaced by a “new” German federal system which has to deal with previously unknown discrepancies among the Länder. Although some achievements could be made, the East-German economy reached only 70% to 75% of the West-German GDP. In this sense the most demanding challenge remains the economic and social integration of East-German Länder. Nevertheless also the West-German Länder do not present a homogeneous economic performance.

Graph I: GDP growth rates in West and East German Länder in %



Source: Bundesministerium für Wirtschaft und Technologie (2012)

3. “The Federation shall have the right to legislate on these matters if and to the extent that the establishment of equal living conditions throughout the federal territory or the maintenance of legal or economic unity renders federal regulation necessary in the national interest.”

4. Allensbacher Archiv, IfD-Umfragen 6019 and 1042/I.

Of course, because of the economic heterogeneity the financial needs and revenues are different. The poorer Länder have less revenue since they are primarily affected by structural changes and high unemployment but have to cover increasing costs of social spending.

Although the demographic change is an important issue in the whole EU, the consequences of this development are especially visible in Germany. Already at the beginning of 2010 more than 20.7% of the population was older than 65 years. According to Eurostat in 2030, the 8 regions with the highest median age of the total population in the EU 27 are the East-German Länder of Mecklenburg-Vorpommern, Brandenburg, Thüringen and Sachsen-Anhalt.⁵

In the following years this demographic trend will be increasingly noticeable in the public finances. The costs increase mostly in regions with less population, since public spending will remain the same or increase while the tax revenues will be reduced. In addition, the spending obligations of the sub-national level for ill-health, old age and unemployment people will also grow because of an increasing number of retiring Länder civil servants. According to initial studies this future spending obligation can already be translated in an implicit public debt of 230% GNP. (Moog, Müller, Raffelhüschen, 2010) The East-German Länder face in this demographic context challenges of unprecedented proportions while the effects of rapid population aging is accompanied by the migration of young, well educated professionals.

Within this social-economic and demographic context, the objective of “equality of living conditions” across the Länder seems to be increasingly difficult to reach, which will have consequences for the future design of the German fiscal system.

Until 2019, the Federal and Länder governments are interlinked in a complex Financial Equalization System. The system consists of three stages. In the first stage, the revenues from the shared taxes are distributed among the Länder⁶. The receipts from the income and corporation taxes are allocated according to where they were collected; 75% of the receipts from the VAT are allocated according to population shares. The remaining 25% are used to raise the revenues in fiscally weak Länder closer to the federal average. In the second stage, remaining differences in the fiscal capacity of Länder are further equalized through the horizontal equalization transfers from fiscally strong to fiscally weak Länder. As a result, the fiscal capacity of fiscally weak Länder grow to about 95% of the federal average. During the third stage of the transfer scheme, the federal government grants vertical transfers to the fiscally weak Länder. Any modification of this complex procedure, which reallocates 70% of total tax revenue, has to be decided by the Bundesrat. The Länder by their own can only make decisions on less than 8% of their tax revenue but decide autonomously on borrowing, which for a variety of reasons has developed very dynamically.

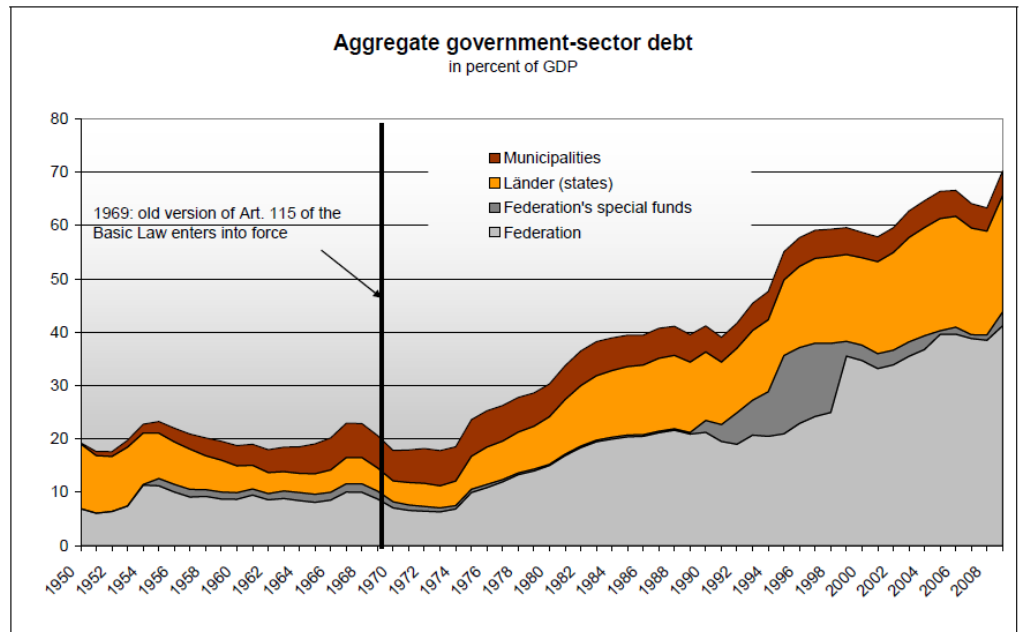
With regard to the increasing debt of the public sector, most scholars acknowledge that the rise of public debt at all levels of government in most OECD countries from 1970 onwards has been primarily due to political factors (Feld 2008). Recessions have been too short to explain the constant growth in public debt. Because of these increasing levels of debt, an ever increasing share of the public budgets has to be earmarked for

5. Eurostat, regional EUROPOP2008

6. Income tax, corporation tax and VAT are divided between the Federation and the Länder as a whole. The Federation receives 42.5 % of the income tax, 50 % of the corporation tax and around 53 % of VAT. The revenue accruing to the Länder is 42.5 % of the income tax, 50 % of the corporation tax and 2010 around 45 % of VAT. 15 % of the income tax and, in 2010, around 2 % of VAT go to the municipalities.

interest payments. This tendency reduced over time (not only in Germany) the ability of governments to implement policies together with constraining future generations. In 2007, the public debt was about 65% of GDP and thus 3.5 times as high as in 1970, when the ratio was 18.6% of GDP. This remarkable increase can not only be explained by the reunification of Germany. Already in 1989, the debt to GDP ratio was about 41.8% of GDP in West-Germany and hence more than double than in 1970.

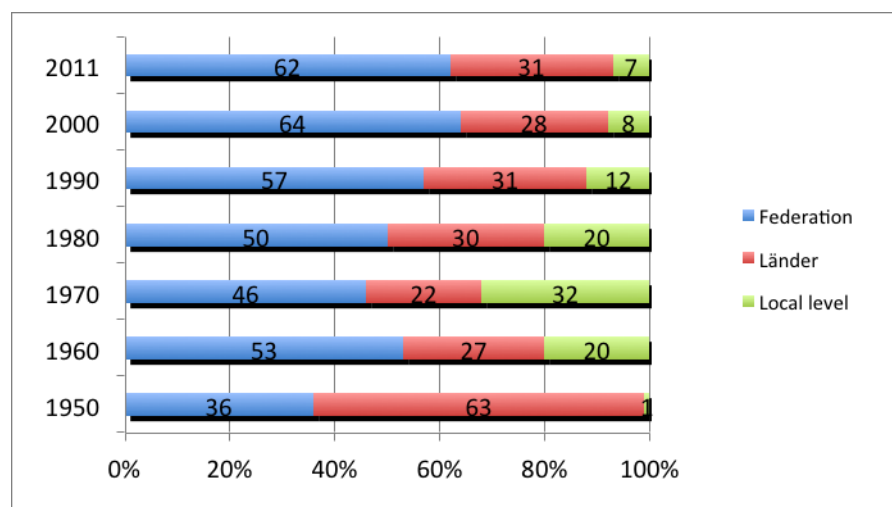
Graph II: Aggregate government-sector debt, in % of GDP



Source: Federal Ministry of Finance (2012)

While the federal share in public debt was 57% in 1990 and had increased to 62% in 2011, the Länder share remained constant at 31% from 1990 to 2011. At the end of 2011, the debt owed by the public budgets amounted to Euro 2,025.4 billion, which, according to the Federal Statistical Office, corresponded to a theoretical debt of 24,771 Euro per inhabitant.

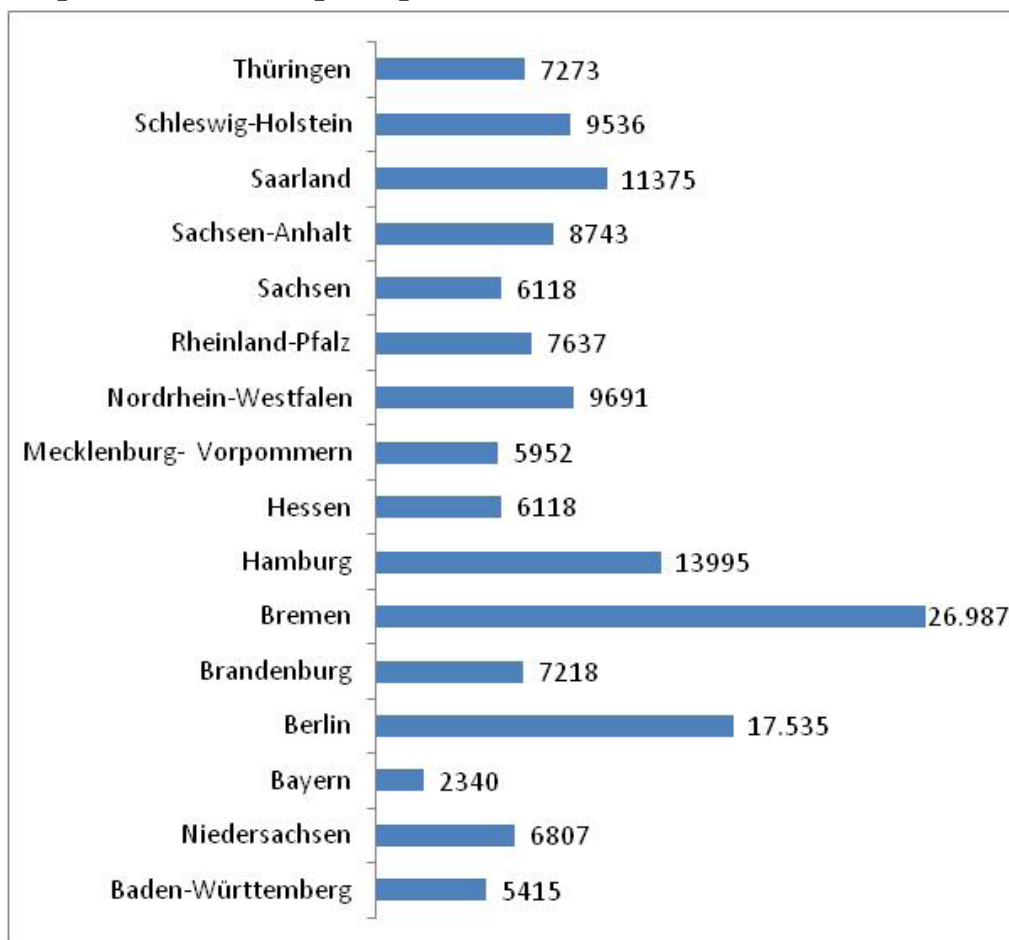
Graph III: Aggregate debt of German public administration in %



Source: own elaboration, data: Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung (2012)

Although the fiscal situation of most Länder has improved during the last few years due to favorable economic conditions, the situation within the Länder is very heterogeneous. Among them are financially strong West-German territorial states and financially weak East-German Länder. In the city-states the financing deficit is twice as high as in the territorial states. But some of the West territorial states (e.g. Rheinland-Pfalz, Schleswig-Holstein and Saarland) have also sizeable deficits. The East-German Länder have a far lower debt level because of their short history (they were established in 1990). In addition, they have received extra resources or direct federal redistribution so that the East-German Länder budgets were not much affected by the important spending programs for economic restructuring and infrastructure.

Graph IV: Public Debt per capita in the German Länder



Source: own elaboration, data: Statistisches Bundesamt (2011)

In the years 2007 and 2008 all Länder with the exception of Bremen and the Saarland were able to maintain their budgets balanced or could even reduce their debts. The years 2009 and 2010 changed the situation: the debts of the West-German Länder increased as a consequence of the bank crisis, especially since some of them had to rescue their Landesbanken⁷, while the East-German Länder were able to avoid such dramatic increases of their dept. (Renzsch 2012) According to recent data from the

7. Historically the Landesbanken have evolved as the corporate branches of the local savings banks and as instruments of industrial policy for the Lander. During the 2000s many Landesbanken extended their operations (too) far away from their traditional core activities and exposed themselves so much to the US sub-prime market and other fragile sectors that they tumbled in 2009.

Federal Statistical Office in 2011 seven Länder could reduce their debt. The largest decrease recorded the Land Sachsen where the debt was reduced by 10%; Mecklenburg-Vorpommern, Sachsen-Anhalt; Thüringen, Bayern and Hamburg have also reduced their debts.

As a member of the European economic and monetary union, Germany has to meet the requirements of the European Stability and Growth Pact, according to which EU Member States' budgets should be "close to balance or in surplus". Consistent implementation of these obligations at national level is a crucial condition and was therefore also the philosophy of the reform of the fiscal federalism 2009. In addition, the economic integration in the EU puts Länder in competition with other European regions on the internal market. In particular the wealthy Länder call for more competition at the European level and for better access to the European market, as well as for austerity of EU redistributive policies. The East-Länder have specific interests regarding the EU budget since they have been recipients from the EU regional policy and would like to continue receiving these funds.

II.2 Critical assessment of the structural and institutional problems of German fiscal federalism

Besides the positive effects for the beneficiary countries, the system is subject to continuous debates among the Länder and the Federal level. During the past years the group of net-contributors among the Länder have been decreased and the political conflict has grown. Political disputes arise regularly on the amount of the solidarity instrument, as well as about the objective of the Financial Equalization System and the effects of the transfers. The Financial Equalization ensures a convergence among the Länder at a high level, regardless of whether they invest successfully or unsuccessfully. In this sense the German fiscal equalization system creates primarily incentives for the beneficiary countries to shift their spending problems to the donor countries and the federal level, which contributes to increasing debt. (Feld 2010) Furthermore the system implies that every additional Euro collected by a (net contributor) Land leads to a reduction of receipts from transfers by an almost equal amount. At the same time the Land would have to incur the full costs of additional revenue collection. Thus, Länder lack incentives to generate additional revenue by fostering economic growth or policing tax fraud. Moreover since fiscally weak Länder have little incentive to change their fiscal behavior, dependence on transfer payments further diminish whatever incentives may exist. (Leubrecht 2012) The underlying reason for this situation is that Germany's fiscal constitution treats tax revenues as a common pool. (Feld 2010, Kirchgässner 2011).

The costs of redistribution are becoming a source of frustration that is beginning to undermine the solidarity and co-operation that have characterized the German federal system. Especially the new Länder are facing a gradual decline in solidarity payments until they run out altogether by 2019.

Furthermore the lack of fiscal autonomy and tax competition eliminates important characteristics of federal states, namely the possibility to search for specific policy solutions according to the social-economic conditions of each Land, and to try different solution patterns. However within their low tax autonomy several Länder started to legislate on tax issues in addition to use the limited regional tax room they have and raised the real property transfer tax.

The separation between the sovereignty of the design and the revenues of taxes requires a high degree of cooperation in the German federal system. Barring a few exceptions the Länder only participate in tax legislation via the Bundesrat and thus only on the revenue

volume. The requirement for majorities in both houses lead to frequent deadlocks. After the first federalism reform, fewer laws need the approval of the upper house. Nevertheless tax legislation still requires the consent of the Bundesrat.

Since the equalization system has always been insufficient from the perspective of the beneficiaries, they were interested in transfers from the federal government. In this sense also the federal government took advantage of this opportunity and connected frequently further transfers with the support to its own projects. The rich countries tolerated this procedure, because the alternative would have been higher contributions to the fiscal equalization.

Elections at the regional level underline the structural problems of the German fiscal constitution. If a Land government wants to increase expenditures, it is, from its own perspective, more reasonable to finance it with public debt. Although the Land has to repay the debt and its interest in the future, the costs of borrowing are only partly covered by the current government since the opposition may win the next election with a certain probability. This argument could be an explanation for the relatively low levels of public debt in Bayern and Sachsen, where we can find stable governments.

III. RECENT ATTEMPTS AT FISCAL CONSOLIDATION: CONSTITUTIONAL AND LEGAL REFORMS

III.1 Reform of the equalization system and debt ceilings –Germany– the second Föderalismusreform 2009

A clearer delimitation of powers and a reduction of joint decision making (“disentanglement” - *Entflechtung* and “budget equivalence”- *Konnexität*), were the leitmotifs of the two reforms carried out in the past decade. In 2007 the Constitutional Court demanded that German policy makers should formulate effective borrowing restrictions.⁸ Accordingly, the debt problem was the core of the second reform of Germany’s federal system (Feld 2010). The new borrowing rule, the debt brake, will fully come into effect in 2016 at the federal level and in 2020 at the Länder level (Art. 115 and Art. 109 GG). Since then, in principle, the budgets of the federation and the Länder should be balanced without debts. Exceptions for deficit spending are natural disasters, recession and emergency situations. (Kemmler 2009) In all cases governments have to provide a repayment scheme for the debts. Normal cyclical downturns will not constitute grounds justifying application of the exception. Article 115 of the Basic Law gives the Federation narrowly confined scope for structural borrowing of 0.35% of GDP. To secure compliance with the executed budget a control account will be created. If a negative balance on the control account exceeds a threshold of 1.5% of GDP, the provisions of the Basic Law require this excess to be reduced in a manner appropriate to the cyclical situation. (Kölling 2012) Furthermore, the Bundestag will only approve exceptions for deficit spending by a majority of its members. Four Länder with specific budgetary problems: Saarland, Berlin, Sachsen-Anhalt and Schleswig-Holstein, are already receiving 800 Million Euros annually from the other Länder and the federal government which should enable them to balance their budgets by 2020. This aid is monitored annually by the Stability Council. The Council can sanction any of these Länder if they do not use their resources according to the budgetary rules. Sanctions include the repayment of money received. Some Länder are already delivering fiscal consolidation. For

example, Sachsen-Anhalt's medium-term financial plan for 2011-2015 includes cost-cutting measures aimed at reducing new debt. While Sachsen-Anhalt aims to reduce its debt and other states plan for a net funding requirement of zero; others, including Nordrhein-Westfalen, will increase their debt.

III.2 Critical assessment of recent reforms and attempts at fiscal consolidation

The long transition periods have been frequently criticized, since they postpone the fulfillment of the new budgetary rules to the next generation of politicians, at the same time the end of transition periods will be linked to the debate on the reform of the Financial Equalization System. The Länder have only a theoretical obligation to reduce the deficit and may even increase their debt until 2020. The debt break makes only reference to the Federation and the Länder, so the Länder could reduce their fiscal transfers to local authorities or ask for compensation for assuming responsibilities, while the local authorities in turn would have to increase their debts.

Furthermore the Stability Council which consists of the Federal Finance Minister, the Länder Finance Ministers and the Federal Economics Minister assembles the same group of politicians, which it has to control. It could be argued that such a Council should have democratic legitimacy but expertise and independence should also be respected. Moreover, the Stability Council may criticise the Länder or even the federal government when they produce budget deficits, but it has less power of enforcement than the European Stability and Growth Act. The Council can ask for reports and multi-year budget plans as well as decide whether a Land is breaking the rules, but in the end the Council can only ask the Land to do better in the future. In other words it can raise its voice, but nothing spectacular happens if no-one listens. (Sturm 2011).

The zero-deficit rule also reduces considerably the room-for-manoeuvre of the Länder on the expenditure side. In order to maintain current levels of expenditures, especially the East Länder will have to increase their revenues by almost one-third (while at the same time confronting a shrinking population and tax base). But also Bremen, Saarland, Schleswig-Holstein or Berlin will lose any political room for action.

With regard to the term “cyclical debt”, despite the attempt to define the characteristics of a cyclical development that deviates from the “normal” economic situation, the concept is still very open to interpretations. (Korioth 2009) Furthermore although the existence of exceptional situations must be declared by the Bundestag, the requisite of qualified majority is not a big barrier. It would have been more effective if the Bundesrat would also approve the existence of these situations.

In addition, the effectiveness of debt breaks is often questioned by the empirical evidence. There seems to be no water-tight system to prevent increasing debts. Smart fiscal experts usually find ways to undermine existing rules or to place the debt outside the budget.

However, according to Enderlein and von Müller, by implementing “structural deficits” as reference points, the debt break introduces a cyclical component into future fiscal policies. (Enderlein; von Müller 2012) Since the Länder so far haven't applied pro-cyclical fiscal policies, the debt break implies a decisive moment of change with regard to the latter.

The additional payments and the different transition periods for the Länder and the Federation seemed to be the result of a political package deal and not an negotiation outcome which will contribute to increase the transparency of the decision making

process in German fiscal federalism. While the first reform of German federalism has been dominated by lawyers and the second has been discussed among economics, neither have been carried out with involvement of the civil society. And finally, although the publications of the Stability Council are aimed to increase the public awareness of the indeptness of public institutions, the diversity of models for the calculation of the structural debt will increase the opacity and limit the possibility to compare the results of policy making among the Länder.

III.3 Some recent problems and difficulties aggravated by the crisis

Even though Germany was not directly affected by the real estate crisis the reduction of the exports provided an important decline of the GDP. In order to compensate this negative impact of the crisis the federal government initiated a stimulus program of 50 billion Euros for the German economy. The government also contributed with substantial financial resources to the European crisis mechanisms. And, as already mentioned, several Länder had to rescue their Landesbanken. As a result the public debt increased dramatically since 2009 at all levels which has reduced the room for policy making, as well as increased the conflicts between the Länder and the federal level on financial resources. The crisis also further underlined the role of the federal government because the Länder depend even more on transfers from the federal level.

Not only the national crisis mechanisms affect the German financial constitution, but also the European Fiscal Pact limits the policy making of the federal government. From 2014, the German structural deficit should be 0.5% of GDP. The Fiscal Pact also foresees the reduction of the total debt through an annual reduction of 5% of the debt above the 60% of GDP debt level. The total debt of Germany was 81.2% of GDP in 2011. The Federation must therefore make an additional effort to reduce spending in order to present a balanced budget even before the debt break comes into force. The Länder agreed only to the ratification of the Fiscal Pact once the federal government had given them guarantees, which includes that the federal government would assume all penalties, which could be applied to Germany for not fulfilling the Fiscal Pact. In addition until 2019 the Pact will not limit the Länder more than the debt break.⁹

Besides the European or national restrictions, consolidating public budgets has become an issue of the political discourse and a concern among citizens. In this context the Constitutional Court of North Rhine-Westphalia declared for the first time in the history of the Federal Republic the budget of North Rhine-Westphalia unconstitutional¹⁰.

- The crisis and the differential bond yields in the Länder

While the main focus of the Länder has been traditionally on direct bank loans, since 2006 capital market financing has gained considerable significance for them (e.g. the capital market debt of Nordrhein-Westfalen has become higher than that of Portugal). The Länder benefit from the good ratings of the federal government and are able to refinance themselves on relatively preferable conditions. The federal and Länder governments re-insure their debts mutually, which complements the fiscal linkages already established in the German fiscal constitution but deactivates the control task of financial markets. Moreover the solidarity principle (Bundestreue) anchored in the German constitution reinforces the mutual support in the event that both levels of government face severe financial pressures. In 1986 and 1992 the German Constitutional

9. Bund bereit zur Einführung von Deutschland-Bonds, FAZ, 24.06.2012

10. VerfGH 20/10, www.vgh.nrw.de/presse/2011/p110315.htm.

Court indeed decided that federal transfers can be used to bail out fiscally troubled Länder (Rodden 2006). Because of this, the rating agencies considered the German Federal system solidary, where a Land experiencing budgetary problem can count on assistance from all other Länder. Yet, more recent rulings of the Constitutional Court rejected federal aid to Länder under financial distress. In addition, as the sovereign debt crisis extended, the Länder experienced significant changes in their fiscal circumstances and their borrowing costs increased. But also the differences of borrowing costs between the Länder increased slightly and, according to first projections, on a long perspective these differences will further increase. (Hong, Nadler, von Müller 2012) According to the rating agency Fitch, especially the different degrees of readiness for the debt break in 2020 will be more reflected in the variation of these costs between the Länder. In addition the future equalization system will have an impact on the future borrowing costs. In order to protect economically weaker Länder against high interest rates in the future, the federal government and Länder agreed to issue joint bonds. Joint emissions or “Jumbo bonds” are issued by several Länder together for several years.

On July 24 2012 Moody changed from stable to negative the outlooks on the long-term ratings of six Länder¹¹ which came along with the same change as the outlook for the Federation, issued on the same day. According to the rating agency the decision has been taken, not because of the economic performance or debt rate of these Länder, but because of the strong financial linkage between the central government and Länder. Which confirms the high correlation between the credit standing of the Federation and the Länder (in good times but also in difficult situations).

IV. THE CURRENT DISCUSSION IN GERMANY

In general terms, from the perspective of the “rich” countries more financial and political autonomy would be desirable; from the perspective of the majority of the “poorer” countries, a strong federal role is required and no softening of the cooperation principle in the federalism.

- The debate on more fiscal autonomy for the Länder

One solution discussed regarding the above mentioned debate is the introduction of tax autonomy at the Länder level. There might be a chance for a reform when the current fiscal equalization has to be renewed in 2019. Firstly, tax autonomy works against indebtedness simply because whenever spending is difficult to cut, the Länder governments would not only need to refer to debt, but could also raise taxes. (Feld; Baskaran 2007) Secondly, tax autonomy would help against excessive spending and limit the externalization of public spending to other Länder or to the federal level. Thirdly, tax autonomy would lead to a clearer specification of competences and responsibilities between the Federation and the Länder on top of more transparency in fiscal policy decision making. In this sense: “[...] who enjoy the electoral pleasure of spending tax money must first experience the electoral pain of extracting it from the tax payer [...]” (Kincaid, Tarr 2005) And fourthly tax autonomy would lead to tax competition which would most probably be beneficial for Germany overall. (Feld 2010)

The crucial question for the period up to 2020 is probably not whether a fiscal autonomy of Länder is created, but rather under which conditions this happens. In other words,

the question is under what circumstances would tax autonomy for the financially weak Länder be acceptable.

- The debate on the Finanzausgleich

As already mentioned the current financial equalization will continue until the end of 2019, and until then the financial relation between the Federation and the Länder have to be regulated. According to the logic of subsidiary, help can only be offered when Länder are in need, if not of their own fault e.g to address structural changes or demographic tensions. By contrast, if the main goal is to create equal living conditions throughout Germany, independently from the performance of individual state governments, the aid should not be limited neither in time nor in the amount.

Besides the mechanisms to limit the debt burden, other possible causes of deficits and subsequent increases in debt should be discussed and considered in the new Finanzausgleich. Given the differing developments in the Länder over time, one must ask to what extent structural (e.g. demographic; population density), economical, fiscal policy and political factors have to be taken into account.

- Fusion of Länder

The Finance Minister of Berlin predicted in 2012 a reorganization of the German Länder if they do not succeed to comply with the requirements of the debt brake. A reorganization and fusion of the German Länder, by size, population and financial strength, would be one of the first conditions for a fair competition between them. A competition among Länder with very different economic and financial power as well as without transitional arrangements would increase the differences among them. Nevertheless the Germans do not support a reorganization of the German federal system. When asked whether the number of Länder should be reduced only 37 % say yes, 55 % rejected the proposal.

CONCLUSIONS

The process of modernising the German federal system has not come to an end, in fact the prime ministers of Bavaria and Baden-Württemberg have already proposed a third Federal Reform Commission.

Without any doubt the public debt has to be brought down permanently. This will reduce the relative burden of interest payments on public budgets. However several difficult questions, e.g. a reform of the intergovernmental fiscal relations and the revenue system for the Länder, are still on the agenda. Nevertheless the next reform steps should not only include the division of fiscal responsibilities among governments, but must also address problems related to the heterogeneous economic performance and demographic trends which will affect the revenue capacity and expenditure of the Federal and Länder governments. This will also include a debate on the principle of equality of living conditions and the sustainability of the German cooperative federal model.

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