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

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

The “grand coalition” currently ruling Germany has
just passed a first federalism reform. Its implementa-
tion will lead to changes in a number of articles of the
German Constitution (the “Grundgesetz”). This contri-
bution describes the most important changes and of-
fers first evaluations of their likely effects. It concludes
that the changes are only a first step in the right direc-
tion, but a number of important steps have yet to follow.

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\(^{1}\) F. W. Scharpf: The Joint-Decision Trap: Lessons from German
Federalism and European Integration, in: Public Administration,
Vol. 66, 1988, pp. 239 f.

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

Fiscal Federalism

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

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

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

Federalism German Style: the Cooperative Version of Federalism

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

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