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Germany after Unification**

by

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On the Politicization of Intergovernmental Fiscal Relations in Germany after Unification

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Abstract:

A recent decision of the German Constitutional Court requires political decision makers to revise the system of intergovernmental transfers in order to limit free bargaining among state and federal government officials. The present paper provides empirical support for the thesis that political discretion has become increasingly important in the transfer negotiations after Unification. We attempt to show why political influences gained weight relative to economic considerations in the determination of net gains. This politicization of the fiscal transfer system appears to be a consequence of the inability of policy makers to agree on a fundamental reform in the early 1990's.

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1 Introduction

In November 1999, the German Constitutional Court pronounced an intensely debated decision on the current system of intergovernmental transfers ('Länderfinanzausgleich', LFA). To limit free bargaining among state and federal government officials in the negotiations for fiscal transfers, the Court bound political decision makers to follow a two-step procedure to a reform of the LFA (Bundesverfassungsgericht 2000). Firstly, the Court demands legislators to frame a set of universal standards for the vertical and horizontal distribution of tax revenues ('Maßstäbengesetz'). Secondly, the rules to be laid down in the 'Maßstäbengesetz' should serve as a guideline for a more specific statute, the 'Finanzausgleichsgesetz' (FAG). According to the Court's decision the FAG is required to contain more precise and technical regulations which allow to calculate the flow of financial resources between the states ('Länder') and the federal level ('Bund'). The current rules of the LFA were declared to be partly unconstitutional and will be nullified if both chambers of the German federal legislative do not agree on new regulations until 2002. Consequently, the Court's decision sets political decision makers under heavy pressure for urgent renegotiations about a fundamental reform of the LFA.

A substantial critique of German Federalism as expressed by political scientists is a mutual dependency of federal and state governments concerning a vast number of decisions that is often said to cause political stalemate, see Scharpf (1985), and Benz, Scharpf, and Zintl (1992). Economic scholars are mostly troubled with the inefficiency of the current fiscal transfer system, attributable to a far-reaching equalization of the state's financial positions. See Homburg (1994), and Huber and Lichtblau (2000) for an overview. A shorter list of contributors discuss the political rationale behind extensive interstate redistribution of fiscal revenues in Germany (Homburg, 1997, Lenk and Schneider, 1999, Blankart, 2000, Pitlik, and Schmid 2000, Pitlik, Schmid, and Strotmann, forthcoming). These papers suggest that especially political forces are at the heart of an explanation of the expansion and the direction of redistribution in the German intergovernmental transfer system.

This paper illustrates why even in the very extraordinary situation of German Unification in 1990 the political decision makers at the state and the federal level were unable to reach an agreement about an elementary reform of the LFA. Moreover, we aim to show that after Unification political discretion has become increasingly

important in the LFA. This is the more surprising if one recognizes that East Germany's economic legacy might have called for a substantial reform of the LFA rules in order to manage the transition process. Section 2 gives a brief overview about the economic and political developments influencing the decision on a (non-)revision of the LFA. Section 3 contains an empirical test of our main hypotheses. Finally, in section 4 we discuss implications for a likely translation of the German Constitutional Court's requirements into distinct political action.

2 The road towards a further politicization of the LFA

2.1 Pre-Unification Germany's fiscal constitution

Since the founding of the Federal Republic of Germany in 1949 the fiscal constitution experienced a remarkable process of centralization (Döring, 1999, Blankart, 2000). With respect to the expenditures side the most important functions became assigned to the federal level. This is mirrored by a more and more integrated system of revenue sharing, with almost all authority concerning tax legislation lying on the federal level. The proceeds of these joint taxes accrue to all tiers of government according to ex ante negotiated shares. The regional distribution of resources, the LFA, is composed of three stages. Since 1970 Article 107/1 Basic Law stipulates that 75 per cent of the VAT proceeds are distributed among the Länder on a per capita basis. The remaining 25 per cent serve for an improvement of the fiscal position of financially weaker states (stage 1). The second stage of the LFA sets up a scheme of equalization transfers flowing from wealthier to weaker states to correct for remaining fiscal imbalances. On a third stage, established already in 1969, the federal government donates specific vertical grants ('Bundesergänzungszuweisungen', BEZ), intended to provide a supplementary coverage of certain states' fiscal needs. Since then, in particular the financial volume of these BEZ has grown enormously¹. As a result, each state is lifted up to at least 99.5 per cent of average per capita revenues.

Roughly speaking, the pre-1990 LFA contained elements of equalization rules primarily based on the states' economic strength as well as on an unspecified formula, leaving a considerable political discretion in determining the amount of fiscal transfers.

1 A Constitutional Court's decision (Bundesverfassungsgericht, 1986) set the basis for further 'special needs-grants'

See Pitlik and Schmid (2000) for details. In a recent empirical paper, Pitlik, Schmid, and Strotmann (forthcoming) have shown that there was sufficient scope for a political manipulation of redistributive flows on all three stages of the LFA. A net distributive advantage of the smaller states prior to German Unification can in part be explained by their extraordinary bargaining strength in the upper house of the federal legislature. For the time period 1979-90 they also found bargaining powers of less populated states to be much more important on the third stage of the LFA than on the two previous stages.

2.2 *The conflict over a reform of Germany's Fiscal Constitution after Unification*

2.2.1 *The economic and political context*

The breakdown of the communist regime in East Germany in late 1989 led to a dramatic change of Germany's economic and political environment. As of July 1990 a monetary union between the two Germanys was set in place. Unification occurred in the fall of 1990. The economic consequences of nearly 50 years of central planning in East Germany (including the years of the Nazi regime) were disastrous. In 1989, per capita GDP was roughly about 2.5 times higher in the Western states than in the communist East. Similar to other transition countries, the low competitiveness of East Germany's industry and the transformation of the entire economic system worsened the situation during the subsequent years. A serious adjustment crisis of the new Länder widened the economic gap to the West (Sinn and Sinn, 1993).

With respect to the interstate transfer system, from 1991-94 resources flew from the West to the East largely in an ad hoc manner. The Contract of Unification in 1990 did not establish a permanent regulation of the intergovernmental fiscal relations in Germany. Both the Bund and the 10 old Länder contributed to a special fund ('Fond Deutsche Einheit'), set up as an interim solution to cover the pressing financial needs of the new states, including the city state of Berlin. The primary source of additional proceeds, however, was not a higher tax burden, but a significant increase of deficits in the federal budget as well as several off-budget agencies. During this time, the fiscal equalization system among the Western states remained nearly unchanged, and a temporary transfer scheme among the new Länder had been institutionalized.

2.2.2 *The failure of a reform of the fiscal constitution*

About one year after Unification the two federal legislative bodies decided to form a Constitutional Commission to work out proposals for a constitutional reform, requiring a 2/3-majority in both houses of the federal legislature. With regard to a revision of the fiscal constitution all options were left open, at least in principle². Thus, there was an opportunity to reverse the creeping centralization of tax and expenditure competencies and the tendency to over-equalize the states' fiscal positions.

The return to a more decentralized system was clearly not in the interest of the Commission, though. All 64 Commission members were not external constitutional experts but consisted of a parity of representatives of the upper house ('Bundesrat') and the lower house ('Bundestag'). The Commission's line-up therefore nicely reflected the interests of legislators at the federal level and at the state level³.

A majority of the upper house, i.e. the state's governments representatives in the Commission, were not attracted by a fiscal devolution for various reasons. Firstly, the decentralization of taxes and expenditures would have enhanced competitive pressure among the states. As pointed out by Brennan and Buchanan (1980) subcentral entities in a federation prefer to escape fiscal competition by a centralization of responsibilities. Germany is exceptionally instructive for this collusion hypothesis, see Blankart (2000) and Pitlik and Schmid (2000). Prior to Unification numerous governmental functions and tax responsibilities became centralized, but in turn the Länder gained political rights to co-decide on federal matters in the upper house⁴. Thus, the state governments are provided with veto positions for a substantial part of legislation at the federal level⁵, and with respect to a constitutional reform they were supposedly unwilling to give up co-decision rights.

Secondly, the new Länder in 1992/93 did not materialize a substantial economic recovery. During the first years of transition the lack of competitiveness of the Eastern states became more and more visible. The breakdown of the industrial sector led to a further erosion of the East German Länder's tax capacities and the restructuring of the

2 For a more detailed portrait of the Constitutional Commission's work, see Häberle (1992) and Benz (1993).

3 While the Bundestag's members are popularly elected, the members of Germany's upper house are nominated directly by their respective state governments.

4 Currently, about 60 per cent of the federal laws require the approval of the Bundesrat.

public infrastructure still remained in its infancy. For these reasons, especially the delegates of the new Länder had no incentive to support a less centralized system. Certainly, this may have provided an incentive for financially strong Western states – namely Baden-Württemberg, Bavaria, Hamburg, and Hessen – to demand a decentralization of fiscal liabilities, as these richer states could expect to be net winners of an enhanced interstate competition. However, there was evidently no chance to arrive at a 2/3-majority in both legislative chambers required for a constitutional revision, because the wealthier states only represented a minority in the upper house⁶.

The representatives of the Bundestag in the Commission also had no incentive to support a major reform of the fiscal constitution because they had to fear a loss of competencies. Promoting international integration of the new Germany was clearly a price the federal government had to pay in order to receive international permission for the project of Unification. Accordingly, lower house agents were unwilling to give up further fiscal liabilities in favor of the Länder. To sum up, it should not come as a surprise that the Commission in May 1993 did not agree on a reform and decided to delegate the topic of a revision of the fiscal transfer system to the state ministers of finance (Benz 1993, p. 887).

2.2.3 *The 'Federal Consolidation Program'*

Shifting the responsibilities for a revision of intergovernmental fiscal relations to the ministers of finance and their bureaucracies led to a narrowing of the reform focus. Apparently, the key interest of a fiscal bureaucracy is the state of fiscal affairs in their respective jurisdictions. In view of the customary tendency of the administration to preserve the status quo, the state ministries of finance could be expected to continue the 'tradition' of the established rules of the LFA.

The main conflict line concerning the vertical relation between the federal and the Länder administrations was the distribution of VAT shares. In this respect, the entirety of the states formed a strong coalition against the Bund. The federal ministry of finance had to concede immediately to a higher VAT share of the Länder amounting to

5 The veto player-framework is discussed in Tsebelis (1995).

6 Furthermore, insisting on a fundamental reform by the richer states governments may have been akin to committing political suicide as in the early years there was still a strong but, admittedly, quietly declining West-East solidarity.

about DM 16 Billions. This was approximately the sum, the old Länder expected to lose by an incorporation of the new states on the first stage of the LFA (Lenk, 1999, p. 170). As a consequence, the largest part of the financial burden of the incorporation of the new Länder into the LFA had been shifted to the Bund (Peffekoven, 1994, p. 306). Yet, the federal government regained its fiscal position to a certain extent by introducing a 'solidarity surcharge' on the income tax, which receipts solely accrued to the Bund (Blankart, 1996).

With respect to the horizontal dimension, the ministers of finance had to cope with a serious heterogeneity of interests in forming a majority of state votes in the upper house. In principle, the ministers of finance had to choose between

- (1) establishing a completely new set of rules for fiscal transfers (*'full reform'*), or
- (2) a prolongation of the old rules, i.e., applying the previous fiscal transfer system to the new states without any modification (*'no reform'*), or
- (3) a slight revision of the pre-Unification LFA system, strengthening various elements of political discretion (*'muddling through'*).

A full reform was obviously a very risky task for *all* participants. From a theoretical perspective numerous alternative transfer schemes exist that lead to an improvement of the financial positions of a specific group of states, which jointly shape a majority in the upper house⁷. As in each simple majority decision game concerning redistributive issues, serious cycling problems are prevalent here (McKelvey, 1976). Establishing a completely revised set of rules was therefore akin to 'opening up a box of worms', possibly generating totally unpredictable results. There was clearly the political risk of reaching no accord on a new institutional arrangement since one could always form different majorities of states blocking any reform proposal.

The 'no reform' option was completely unfeasible. Without a modification of the LFA rules in effect for the 'old' Federal Republic, an integration of East German states would have turned the former net winner states of the fiscal redistribution game into net

7 Lenk and Schneider (1999), for example, develop a modified LFA system, intended to weaken the perverse incentive effects of the LFA. In sharp contrast to many other proposals, mostly ignoring the political feasibility of a change, the argument Lenk and Schneider (1999) work out in favor of their proposal is that it alters financial flows in a direction which is supposed to achieve a majority of the involved states because it improves their financial capacities.

losers. Furthermore, the initial net payer states in the West had to expect a further significant decline in their fiscal positions. As depicted in table 1, in 1990 GDP per capita of the 10 (old) Länder were positioned in a range from 0.82 (Lower Saxony) to 1.61 (Hamburg) of Germany's weighted average per capita GDP. In 1995, the poorest state (Thüringen) had a per capita GDP of only 0.56 of the national average, whereas Hamburg's per capita GDP increased to about 1.83 of Germany's average. Unification improved the *relative* income positions of *all* Western Länder. No majority of Western state finance ministers would have agreed to an equalization formula based primarily on economic conditions; they could easily foresee that this would have led to a permanent subsidization of the Eastern Länder. Framing a revised system designed primarily to overcome economic backwardness was therefore clearly at odds with the interests of the Western Länder and the Berlin government.⁸ As proposals for a modified LFA had to be ratified by both federal legislative bodies keeping the status quo rules was therefore also impossible.

– table 1 about here –

The least conflicting way to manage the problem of integrating the new Länder without harming a majority of the old states was to rely more heavily on bargaining procedures, protecting the basic elements of the established system. In this respect, a fraction of Western states that could expect to be net winners in the future bargaining game due to their extraordinary bargaining powers, together with the 5 new states plus Berlin jointly held a majority of 40 votes in the Bundesrat. Hence, this group of states constituted a 'natural' coalition supportive of an enlargement of discretionary elements in the system of interstate fiscal relations.

As a result, the three-stage nature of the LFA remained virtually unchanged by the so called 'Federal Consolidation Program'. The integration of the East German states into the LFA on from 1995 was accompanied by the introduction of two new categories of supplementary grants. Firstly, additional general purpose grants flow to the new Länder to foster economic recovery. Secondly, a new kind of supplementary grants were introduced, benefiting a faction of the old states to compensate them for fiscal

⁸ See also Homburg (1997, p. 66f.) for a related argument.

losses they experience from an integration of the new Länder. Thus, the 'Federal Consolidation Program' not only brought about an increase in the total sum of vertical and horizontal equalization payments but also a proliferation of various discretionary elements in the determination of transfers. The higher complexity of the rules in effect on from 1995 led Esser (1994) to claim that "intransparency is the guiding principle" of the post-Unification LFA. See also Lenk and Schneider (1999, p. 418). As ambiguity of rules and political discretion increase, the scope for politically motivated interstate redistribution seems to be greater since 1995, which leads us to the following two suggestions:

Hypothesis 1: The relative importance of bargaining powers as compared to economic backwardness in explaining the net redistributive advantage of a state has grown as compared to the situation prior to 1990.

Hypothesis 2: Pitlik, Schmid, and Strotmann (forthcoming) have shown that the three stages of the LFA are not equally sensitive to a rent seeking behavior of the states. If Unification made the system more open to bargaining, this should be observed in an increasing importance of political factors especially at the stage of a determination of federal supplementary grants.

3 Empirical investigation

3.1 The model

Our theoretical investigations led to the conclusion that the relative importance of bargaining powers as compared to economic backwardness in explaining the net redistributive advantage of a state has grown as compared to the situation prior to 1990. To evaluate the impact of economic and political variables on the determination of fiscal transfers and to be able to compare results before and after unification we chose to estimate models of the following basic type (see also Pitlik, Schmid, and Strotmann, forthcoming):

$$\text{RELATIVE NET GAIN}_i = \beta_1 + \beta_2 \cdot \text{ECON}_i + \beta_3 \cdot \text{POLIT}_i + e_i$$

Pitlik, Schmid, and Strotmann (forthcoming) referred to absolute net gain defined as net per capita redistributive advantage of state i in the fiscal transfer system as compared to other states as dependent variable. For the sake of comparison we choose here to define the dependent variables in a *relative* way as a state's net gain in relation to the average net gain. We both analyze the German LFA in its entirety and on its separate stages in different time periods pre-Unification and post-Unification.

The annual net gain on the first stage is calculated on the ground of the final distribution of VAT revenues. It is defined as a state's VAT surplus compared to the state receiving a minimum VAT per capita. The annual net redistributive gains on the second stage and on the third stage are defined in the same manner. The total net gain is simply the sum of the three separate stages.

The economic variable (ECON) considered here is a state's GDP per capita as compared to the national average. We assume that this provides a useful proxy for the fiscal capacity and the fiscal need of a subcentral unit. Of course, one might have also employed the formal calculation of fiscal capacities and fiscal needs instead. The calculations of these variables are, however, a result of political bargaining and are thus 'politically distorted' themselves, see Pitlik and Schmid (2000).

The POLIT variables are employed to measure the bargaining powers of a state. From a public choice perspective the central hypothesis, as put forward by Grossman (1994, p. 298), is that, all else equal, "... grants go to those states with political agents with the most – and most valuable – political capital to sell." Seen from this viewpoint, a state's net gain in the interstate redistribution game is partly determined by its ability to supply political support in exchange for special privileges. Nevertheless, there are a number of different ways to explain the bargaining strength of the states, see Pitlik, Schmid, and Strotmann (forthcoming).

It can be argued, firstly, that state governments with a closer political affinity to the federal government are supposed to expect higher transfers (Grossman, 1994). Yet, this 'partisan argument' is not that clear-cut. Crain, Leavens, and Tollison (1990) claim with respect to pork barrel politics in the U.S. that favors which go to states governed by a similar party as the federal government has undesirable consequences if the respective incumbent is defeated in a future election. Usually, grant programs persist over a number of years. A program that confers benefits to a party companion of a

certain state in one year might then benefit the previous opposition party after an electoral defeat. The same holds in the reverse direction. For example, in Germany only two of the incumbent conservative-liberal Länder governments (Bavaria and Saxony) were almost sure to be re-elected in 1994/95. The conservative-liberal government at the federal level therefore might have been unwilling to provide too much transfers to other states governed by a conservative-liberal coalition.

Moreover, the federal government coalition may be confronted with a majority of state governments composed of opposition parties in the upper house. Depending on the majority in both legislative chambers, the incumbent federal government may then be forced to purchase political support of states governed by parties belonging to the opposition in the lower house. Thus, at least in this situation of divided government, it is doubtful to expect significantly higher bargaining powers according to party affinity. In view of the fact that the political effects may be different in situations of divided and non-divided government, the respective time period is divided into three different sub-periods. In the fall of 1982, the federal government in Germany changed from socialdemocratic-liberal to conservative-liberal. As therefore in 1983 all incumbent state governments also changed their political affinity, the period before German unification is divided in two sub-periods from 1979-82 and 1983-90. In the first period, Germany's federal legislative had been divided, in the second period it had been unified. From 1995 to 1998, the federal government had been confronted again by a majority of opposition parties in the Bundesrat. To capture possible 'partisan effects' on the political determination of net gains, we employ a dummy variable ABC^9 with value "1" if state and federal government are of a similar party composition, otherwise it is assigned a "0".

An alternative way to measure state bargaining powers is to rely on their relative voting strength in the upper house. As noted above, the federal government's policy implementation often depends on a majority in the upper house (Bundesrat). Homburg (1997) proposes the idea that due to institutional features some Länder in the upper

9 German political scientists often use the terms "A-Länder, B-Länder, and C-Länder" with respect to the political affinity of state and federal governments. A-Länder, like Bavaria and Saxony in 1994, are governed by coalitions which are solely composed of parties that are also members of the federal government. In B-Länder the opposite is the case. C-Länder governments are composed of both incumbent and opposition parties at the federal level. See, e.g., König and Bräuninger (1997).

house are in a privileged bargaining position. The number of each states' seats in the upper house depends on its population size. However, there is no perfect proportional relation between the number of upper house seats and population size, leading to an over-representation of the smaller states. Denote the shadow price of a states' vote in the Bundesrat as its population size (in millions of inhabitants) divided by the number of seats held by each state. Then the shadow price shows how many inhabitants of a state are represented by a single vote¹⁰. In table 1 it can be seen that in 1995 a single vote of the city state of Bremen, for example, represents a population of about 226,000. On the contrary, one upper house seat of North Rhine Westphalia in 1995 represents 2,970,000 inhabitants¹¹. The most attractive coalition partners are therefore Länder with a low shadow price since for any given amount of per capita transfers these states supply more votes. In a political bargaining game there is a strategic incentive to purchase 'cheaper' states' votes. Hence, we expect a negative coefficient with respect to its shadow price.

One might also argue that the new Länder have a higher bargaining power due to their special political situation. Obviously, the federal government depends crucially on the political support of the new states, as the voters in the East are still not habitually or ideologically oriented toward a particular party. Thus, the fluctuation of voters between the major parties may have a considerable influence on electoral decisions. However, including a dummy for the new Länder (inclusive of Berlin) in an empirical testing raises a serious problem of multicollinearity. Therefore, with respect to the new Länder, it is almost impossible to distinguish between these political and economic effects¹².

3.2 *Regression results*

3.2.1 *The impact of economic and political factors on relative gains in the LFA*

To allow for an empirical test of the relevance of political affinity we chose to estimate regressions with a pooled data set. Because pooled observations are not independent,

10 Note that a state's votes in the upper house cannot be split.

11 A high correlation between a state's shadow price of votes and its number of inhabitants might lead to the conclusion that a state's bargaining power does not depend on the shadow price, but on a state's size. However, as there are no convincing economical rationales for privileging smaller states the shadow price hypothesis might give a plausible politico-economic explanation for a higher net gain of smaller states. For details see Pitlik, Schmid, and Strotmann (forthcoming).

12 We tested for these effects, but as expected we found the multicollinearity problem to be too strong to include a dummy for the new Länder.

standard errors were corrected for clustering and estimated heteroscedasticity-consistent using White's (1980) method.

Considering the German LFA in total at first, the findings of a previous study by Pitlik, Schmid, and Strotmann (forthcoming) for 1979-90 are confirmed. In every period before and after German Unification a state's relative net gain depends negatively on its economic strength. The considerable impact of a state's bargaining power as measured by its shadow price is also confirmed as the coefficients are statistically significant negative both from 1979-82 and from 1983-90. After Unification both the impact of relative economic power and of political bargaining strength on relative redistributive net gains can still be approved.

– table 2 about here –

However, the results for the dummy variable measuring the impact of political affinity are ambiguous. While in 1979-82 and 1995-98 we found no significant difference in net gains between A-Länder and B-Länder, from 1983 to 1990 political affinity appeared to hamper a state's relative net gain. States which were governed in opposition to the federal government received notable higher transfer payments. Since 1983-90 had been a period of unified government the relative privileging of states governed by parties in opposition to the federal government is somewhat surprising.

Turning to the individual stages of the LFA, the GDP per capita and the shadow price variable show the expected signs at every stage before and after Unification and significance is almost always confirmed. It can be seen that the negative impact of the ABC-dummy stated for the LFA in its entirety for the 1983-90 period depended on a remarkable privileging of opposition governed states on the third stage of the LFA. On the first and the second stage its impact was highly insignificant.

3.2.2 Investigation of the hypothesis of increasing politicization

Two aspects of our preceding estimations might already indicate that the importance of political factors in the redistributive process of the German LFA has even grown after the inclusion of the new Länder. Firstly, while before 1990 a convincing significance of the shadow price variable was only given on the second and the third stage, but missing

in the VAT distribution, it proved to be significant at a 5%-level of significance on all stages after 1995. Secondly, economic strength loses any significance in explaining the relative net gain from federal supplementary grants after Unification.

For a further investigation of the hypothesis of a growing politicization after Unification we modified our regression framework by pooling the data for all periods and interacting a dummy variable which is "1" for the period after German unification with the shadow price variable. If the relevance of political manipulation has increased since 1995 a negative sign of the interaction term with the shadow price must be expected. Table 3 presents the results of White heteroscedasticity consistent OLS-regressions for the LFA in total and on its separate stages.

– table 3 about here –

The GDP per capita and the shadow price variable again show highly significant negative coefficients on all three stages and in the LFA in its entirety. Accepting the shadow price variable as a suitable measure of political manipulation, the negative coefficients of the interaction term in every model – being significant in total LFA and on the third stage – can be interpreted as an empirical underpinning of the growing importance of political manipulation of the German LFA after Unification. As due to German Unification economic inequalities between the states have increased one might have expected that the impact of the economic strength-variable on the redistributive net gain should have grown. However, this cannot be confirmed by the data when introducing an interaction term of the unification dummy with the GDP per capita instead (see also table 3). As a regression with both interaction terms suffers from multicollinearity results are not reported here.

Though never statistically significant, the regression coefficient of the ABC-variable is negative without exception. If anything, this might be a very weak indication for a privileging of states governed by politically different rather than similar state governments by the governing federal coalition. A partisan hypothesis is not supported by our data.

4 *Final remarks and outlook*

The theoretical discussion above as well as our empirical investigation has shown that state bargaining powers are a major force in explaining the direction of redistribution in the German system of intergovernmental transfers. These political forces appear to be a key obstacle for a revision of the LFA. Although Unification significantly changed the economic and political context of the LFA, political agents at the state and federal level were nevertheless unable to agree on a fundamental revision of the fiscal constitution. The requirement of a supra-majority in order to change the Basic Law proved to be too high a hurdle for an elementary reform.

Shifting the reform topic from the constitutional level to the level of a 'simple statute' did not improve matters, though. While the formal prerequisite for a change had been reduced, the diversity of state interests in combination with mutual veto powers generated a political deadlock which could only be escaped by a further intensification of discretionary elements under almost unchanged LFA rules. This politicization of the fiscal transfer system after Unification appears to be a compelling consequence of the inability of federal and state policy makers to agree on a fundamental reform. Seen from this view, it is hardly surprising that the Bavarian and Baden-Württemberg governments appealed to the Court in 1998, as these wealthier Western states are usually in a bad bargaining position with respect to transfer negotiations. And it is even less surprising that the plaintiffs especially complained about the effects of the third stage of the LFA (Arndt, 1998).

These considerations do not leave too much optimism on the prospects of a future reform. The principal aim of the Court's recent decision is to channel the future bargaining process of political decision makers at both the federal and the state level involved in the negotiations for intergovernmental transfers. For this purpose the Court referred to a well known figure from Constitutional Economics, i.e. a separation of the choice between rules from a choice within rules (Buchanan, 1987). However, similar to the situation shortly after Unification, and in sharp contrast to this idea, the legislators addressed by the Court to set up new regulations do not act behind a veil of uncertainty. But even if this were the case, one might doubt the ability of policy makers to agree on a mutual beneficial reform. As a state senator of finances puts the political problem:

'How can we agree on new fiscal transfer rules if we do not know its distinct financial consequences?' (Handelsblatt, 2000).

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Table 1: Number of seats in the upper house and shadow prices of the German Länder (1990 and 1995)

State	1990			1995		
	Per capita GDP relative to national average	Number of seats in the Bundesrat	Shadow price (Homburg)	Per capita GDP relative to national average	Number of seats in the Bundesrat	Shadow price (Homburg)
Baden-Württemberg	1.07	5	1.92	1.12	6	1.71
Bavaria	1.02	5	2.24	1.13	6	1.99
Berlin	-	-	-	1.02	4	0.87
Brandenburg	-	-	-	0.63	4	0.64
Bremen	1.22	3	0.22	1.33	3	0.23
Hamburg	1.61	3	0.54	1.83	3	0.57
Hessen	1.13	4	1.42	1.30	4*	1.50*
Lower Saxony	0.82	5	1.46	0.91	6	1.29
Mecklenburg-Vorpom.	-	-	-	0.59	3	0.61
North Rhine Westphalia	0.93	5	3.42	1.00	6	2.97
Rhineland-Palatinate	0.86	4	0.93	0.89	4	0.99
Saarland	0.85	3	0.35	0.94	3	0.36
Saxony	-	-	-	0.59	4	1.15
Saxony Anhalt	-	-	-	0.57	4	0.69
Schleswig-Holstein	0.84	4	0.65	0.92	4	0.68
Thüringen	-	-	-	0.56	4	0.63

* In 1996, Hessen's number of seats in the Bundesrat increased to 5. Its shadow price correspondingly fell to 1.2.

Table 2: Impact of economic and political factors on relative gains in LFA

	Before unification		After unification
	1979-1982	1983-1990	1995-1998
Observations	40	80	64
<i>LFA in total</i>			
Relative GDP p.c.	-2.636 (0.007)***	-3.242 (0.000)***	-1.848 (0.014)**
Shadow price	-0.521 (0.012)**	-0.856 (0.002)***	-1.273 (0.018)**
ABC-Dummy	0.483 (0.391)	-0.994 (0.032)**	0.069 (0.876)
Constant	4.489 (0.000)***	6.537 (0.000)***	4.902 (0.000)***
R-squared	0.655	0.636	0.573
<i>First stage: VAT distribution</i>			
Relative GDP p.c.	-5.907 (0.202)	-4.803 (0.043)**	-5.464 (0.004)***
Shadow price	-1.738 (0.239)	-0.789 (0.152)	-1.101 (0.018)**
ABC-Dummy	-0.282 (0.846)	-0.753 (0.230)	0.549 (0.412)
Constant	10.606 (0.155)	7.813 (0.035)**	8.149 (0.000)***
R-squared	0.276	0.404	0.636
<i>Second stage: Horizontal equalization scheme</i>			
Relative GDP p.c.	-2.481 (0.009)***	-2.361 (0.008)***	-0.864 (0.058)*
Shadow price	-0.458 (0.023)**	-0.710 (0.014)**	-0.637 (0.017)**
ABC-Dummy	0.667 (0.260)	-0.915 (0.096)*	-0.102 (0.695)
Constant	4.125 (0.001)***	5.316 (0.001)***	2.937 (0.000)***
R-squared	0.583	0.487	0.343
<i>Third stage: Supplementary federal grants (BEZ)</i>			
Relative GDP p.c.	-3.219 (0.092)*	-6.997 (0.000)***	-1.003 (0.640)
Shadow price	-0.799 (0.031)**	-2.027 (0.000)***	-2.411 (0.053)*
ABC-Dummy	-1.047 (0.294)	-1.679 (0.022)**	0.010 (0.990)
Constant	6.310 (0.004)***	13.063 (0.000)***	5.884 (0.000)***
R-squared	0.775	0.620	0.396

Note: ***, **, * denote statistical significance at 1%, 5%, and 10% -confidence level, P-values in parentheses standard errors corrected for clustering with heteroscedasticity-consistent estimation

Table 3: Politicization of the German LFA after Unification

	LFA in total	First stage	Second stage	Third stage	LFA in total	First stage	Second stage	Third stage
Relative GDP p.c.	-2.155 (0.001)***	-5.076 (0.003)***	-1.182 (0.050)*	-3.293 (0.003)***	-2.120 (0.001)***	-4.900 (0.003)***	-1.127 (0.078)*	-3.222 (0.004)***
Shadow price	-0.764 (0.011)**	-0.986 (0.039)**	-0.514 (0.038)**	-1.538 (0.001)***	-0.800 (0.009)***	-1.054 (0.041)**	-0.545 (0.033)**	-1.621 (0.001)***
Shadow price * unification dummy	-0.215 (0.046)**	-0.323 (0.321)	-0.165 (0.126)	-0.510 (0.053)*				
Relative GDP p.c.* unification dummy					-0.040 (0.787)	-0.652 (0.387)	-0.170 (0.428)	-0.043 (0.936)
ABC-dummy	-0.342 (0.122)	-0.411 (0.240)	-0.260 (0.169)	-0.680 (0.233)	-0.299 (0.121)	-0.525 (0.240)	-0.269 (0.169)	-0.563 (0.194)
Constant	4.870 (0.000)***	8.323 (0.001)***	3.353 (0.000)***	7.770 (0.000)***	4.797 (0.000)***	8.371 (0.001)***	3.334 (0.000)***	7.581 (0.000)***
Observations	184	184	184	184	184	184	184	184
R-squared	0.542	0.391	0.352	0.439	0.530	0.399	0.348	0.423

Note: ***, **, * denote statistical significance at 1%, 5%, and 10% -confidence level, P-values in parentheses standard errors corrected for clustering with heteroscedasticity-consistent estimation

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