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## **Institutional Arrangements for Coordination Among Governments in Germany**

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# **Institutional Arrangements for Coordination Among Governments in Germany**

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## 1. Introduction

The theory of fiscal federalism makes a strong case for decentralizing government functions in order to enhance the efficiency of allocating public goods where preferences differ among regions. Decentralized collective decision making fosters social and political cohesion at the level of the nation state by protecting minorities, by strengthening the accountability of politicians, and by mobilizing citizens through greater participation at the local level. Federalism respects different cultural and individual traditions among regions, and it emphasizes local diversity. Federalism thus reflects the regional dimension of democracy.

However, decentralized government raises severe coordination problems. Coordination of public agencies *within* government—among the Executive, the Legislative, the Judicature, and the Administration—is difficult enough, yet it is further complicated in a multi-layer government framework where different authorities interact—governments and parliaments that are more or less autonomous and accountable to their respective constituencies. This may call for specific institutional provisions and rules for policy coordination and for dealing with conflicts between the levels of government. The focus of this paper is on the mechanisms of coordination as established in the Federal Republic of Germany (FRG) with its specific tradition of “cooperative federalism”.

## 2. “Cooperative federalism” and the traditional view of federalism

“Cooperative federalism” is best understood by contrasting it to the traditional approach to federalism. The latter is influenced mainly by the Constitution of the United States that aims at defining complete public functions and allocating them exclusively to each layer of government vertically. Each level of government has—in principle—own expenditure responsibilities and own revenue sources, although these may in practice overlap and even become a matter of conflict. Intergovernmental transfers are mainly based on federal programs with not much regard to interregional solidarity or equity. In such a framework, there is little need for a cooperative machinery since all governments operate more or less

independently, and are even encouraged to compete among each other. Of course, governments would cooperate voluntarily on the basis of reciprocity and specific contracts, but this does not necessarily call for a permanent cooperative machinery in order to resolve potential conflicts that arise in a multi-tiers framework.

The Anglo-Saxon tradition is in sharp contrast to the German approach to federalism. Although the *Grundgesetz* (GG), the German Constitution, makes some attempt to divide government functions among the tiers vertically, its basic philosophy is different from that of the United States in the following aspects:

- At the central level, emphasis is laid on legislative functions, the allocation of financial resources, and the formulation of policy guidelines through federal legislation.
- Lower tiers, the States and local governments, are generally in charge of implementing and administering federal policies—in addition to their own exclusive competencies.

### **Box 1: Historical background of the federal arrangements in Germany**

During most the 19<sup>th</sup> century, Germany consisted of a patchwork of mini-States subject to hegemonial interests of German-speaking superpowers (Prussia and Austria) and other European nations (France, Russia, Great Britain). Unity was finally achieved in 1871 with the creation of the Reich. Sovereignty was enshrined in the Emperor, also king of Prussia. Prussia then controlled about two thirds of the territory and economic resources. The system was highly asymmetrical, and the primacy of the state of Prussia and a monarchic constitution favored centripetal tendencies.

The Reich was a federation of 22 monarchies and 3 Hanse cities, which formed the *Bundesrat*, the States' assembly. The responsibilities of the Reich were limited (defense, foreign affairs, communication, etc.), and it had virtually no administration of its own. Central legislation was by an elected parliament (*Reichstag*), while the implementation of policies relied essentially on state administrations.

The legacy of the Reich explains some key constitutional arrangements of today's FRG: the existence of City-States, the statute of an Upper House (*Bundesrat*) that (unlike the US Senate) consists of (non-elected) representatives of state governments, and the sharing of responsibilities among layers of government, whereby the Federation concentrates on legislation while the States focus on policy implementation and administration.

After World War I, the Weimar constitution had established the accountability of government to parliament, but failed to render the latter politically viable. Given a fragmented party system, the national parliament fell prey to the Nazis in 1933. Hitler's ascending to command had been facilitated by the leading role of Prussia and centralism. This is why the Allies would abolish Prussia immediately after the war. Germany (and its capital Berlin) were divided into occupation zones with the Russian zone (and sector of Berlin) pertaining to the communist world, while the Western zones would form the Federal Republic of Germany in 1949. The Russian zone would set up its own state, the German Democratic Republic, which was finally merged into the Federal Republic in 1990.

The experience of the Nazi period explains why regional balance, symmetry, and uniformity of living conditions throughout the nation became attractive features for policy making in West Germany. These principles were incorporated into the new Constitution, the *Grundgesetz* (GG). A prominent feature of the Constitution was a mandate to governments to bring about a "uniformity of living conditions". They even survived the quandary of unification. Political and economic integration—with the formerly socialist East representing roughly 20 percent of the population, but only less than 6 percent of total value added—still is the most important challenge for today's Germany.

### Box 2: Main elements of the German fiscal constitution

The almost complete lack of policy discretion of lower-level government, and the inability of States to use own tax instruments has promoted revenue sharing and intergovernmental transfers for fostering national homogeneity in Germany.

Taxes are basically uniform and their proceeds are often jointly appropriated among layers of government. This is true for about 75 percent of total revenue (including the main municipal tax, the *Gewerbesteuer*). Revenues from exclusive (but uniform) state taxes are only 4.4 percent of total tax. The sharing formulae are designed to balance fiscal resources between layers of government (vertical equalization), and to level out differences of regional tax potentials (horizontal equalization).

Vertical equalization among the Federation and the States is based on Article 106 (3) - (9) GG. The Constitution presumes that it is possible to define “necessary expenditures” at both levels and to achieve a “fair compensation” between them. Intentionally, there is no “vertical fiscal imbalance” in Germany as exists in other federations (such as Australia or Brazil).

As regards the assignment of income taxes, the Constitution is extremely rigid: half of the revenue falls to the Federation, the other half to the States (with some participation of municipalities). The horizontal allocation follows the residence principle (with formula apportionment for the corporate income tax). “Fair compensation” between layers of government is primarily achieved through the vertical splitting of the turnover tax (VAT). Its allocation is governed by a federal law requiring the consent of the *Bundesrat*.

Vertical equalization was last revised in 1992 when the Eastern States were included into intergovernmental fiscal arrangements (from 1996 onwards). As a consequence, the States’ shares of VAT have considerably increased reflecting the need to reach agreement of the Western States. At present the federal share of VAT is 50.5 percent.

The horizontal equalization mechanism consists of three stages:

*At a first level*, the horizontal allotment of VAT exhibits strong equalization effects. Three quarters of the States’ share are allocated by population. Another quarter is reserved for those States that considered to be “financially frail”. They receive supplementary transfers from VAT to bring their fiscal potentials per capita up to at least 92 percent of the national average.

*At a second level*, there is a specific horizontal equalization scheme (*Finanzausgleich*). Regional equalization is arranged among States in a “brotherly” fashion. The focus is on taxable capacity (as in Canada), with little or no concern for specific burdens. As the tax law is uniform there is no need to standardize taxable capacity among regions. Unlike in Canada, where the “poor” receive compensations while the “rich” do not participate in the equalization arrangements, the “rich” German States pay off the “poor” through financial transfers. The system acts as a clearing mechanism without interference of the Federal government.

*At a third level*, there are asymmetrical vertical grants: so-called supplementary federal grants. Such transfers have been widely used after unification while they were insignificant before. In particular, factual “gap-filling grants” have been introduced that guarantee at least 99.5 percent of the average fiscal capacity for all States. Moreover, nine States out of sixteen receive federal grants to relieve the costs of “political management”, and the new Eastern States (as well as some Western counterparts) receive federal grants in compensation of “special burdens”.

Thus, lower levels of governments typically execute policies on behalf of higher levels, where financing is sometimes tied to the mandated function—with corresponding grants or cost restitution. However, federal legislation may also require that some functions be financed by the lower tiers from own resources and without federal compensation (so-called “unfunded mandates”). A prominent example in Germany is subsidiary welfare, *Sozialhilfe*<sup>1</sup>.

The central administration is less developed in general, and the States bear the brunt of administrative responsibilities in Germany (including those for tax administration). This particular division of functions—central decision-making with decentralized execution—has been labeled the horizontal approach to federalism in contrast to the vertical model of the Anglo-Saxon world (Spahn 1978). These institutional differences are explained by history (for an abstract, see Box 1). However, some important government functions are also assigned in an exclusive fashion “vertically”—such as defense to the central government, or education to the States—as in other federations.

With regard to financial arrangements, the horizontal distribution of functions is matched by the prevalence of revenue sharing. All major taxes (personal income, corporate income, value-added taxes) accrue to federal and state governments jointly<sup>2</sup>. Legislation on taxes is uniform and centralized. Parliaments of regional jurisdictions have no power to legislate on national taxes, although some smaller taxes continue to be assigned to state or local governments. All taxes are assessed according to the same national tax code—in particular as regards the tax base.<sup>3</sup> Although tax administration is decentralized, its basic rules are standardized and more or less uniform throughout the nation.

Moreover, the German federal constituency exhibits a high degree of interjurisdictional solidarity and operates a sophisticated system of regional equalization among the States, and—for each State—among municipalities. This in itself reflects a coordinative machinery both vertically among the Federal government and the States, and the States among themselves under federal guidance (see Box 2). Although this equalization mechanism has come under severe pressure by a constitutional challenge in 1999, its basic principles are likely to endure (Spahn 2000 and Spahn/Franz 2000). The high degree of responsibility sharing and joint financing among different layers of government as well as between local jurisdictions is matched by a great number of formal arrangements for coordination and cooperation. Such arrangements work at the vertical level (between layers of government) as well as horizontally among governments of the same level.

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<sup>1</sup> Local governments are in charge of administering subsidiary welfare, based on a uniform federal law. They must also carry these subsidies in their own budgets. But the States typically compensate parts of these payments through the state grants system.

<sup>2</sup> Even municipalities form part of this joint appropriation of taxes. They receive a share of the personal income tax and of VAT, and they transfer a part of their own tax on businesses to higher levels of government.

<sup>3</sup> However, some discretion is accorded to local governments in the setting of tax rates.

## 3. Vertical coordination among tiers of government

### 3.1 Vertical coordination of the Federal Legislature

The Constitution of 1949 confers primary state powers to the States.<sup>4</sup> However, this tier of government has since experienced an erosion of its original competencies in favor of the Federal government. This results from concurrent legislation in a number of responsibility areas (according to Articles 72 and 74 GG), and from a provision by which “federal law overrides state law”. Even in areas of primary state responsibility, the States’ competencies have been reduced by increased sharing of responsibilities and joint decision making. Today, a large part of state and local responsibilities is derived from federal laws. It is therefore essential to understand the process of federal legislation and the way the States inject their voice into that process.

#### 3.1.1 *The role of the States’ House (Bundesrat)*

Virtually every law that affects the interests of the States has to pass the *Bundesrat*, the States’ legislative assembly or Upper House. This institution is—unlike the equivalent in other federations such as the United States, Canada or Australia—a true States’ House in the sense that its members are appointed by State governments<sup>5</sup> and recalled by them (Art. 51 (1) GG). They are strictly bound to the directions of their respective governments (Art. 51 (3) GG, the so-called “imperative mandate”). The votes they cast in the *Bundesrat* are by State and undivided,<sup>6</sup> and they are weighted by fixed integer numbers that roughly reflect the size of the State’s population—with a bias in favor of the less-populous States. The institution of the *Bundesrat* allows the 16 States to inject their voice jointly, and by majority voting, into federal legislation (and administration) in accordance with Article 50 GG.

In principle, the *Bundesrat* is involved in all federal legislation, yet the intensity varies in accordance with the type of law. A distinction is made between “objectionable laws” (*Einspruchsgesetze*) and “consensual laws” (*Zustimmungsgesetze*). In the former case, the *Bundesrat* has the right to object to a federal law according to Article 77 (3) GG, i.e. after having passed through a mediation process (see below), but the Federal parliament (*Bundestag*) can overrule this appeal by an absolute majority vote of its members.<sup>7</sup> In the second case, however, the consent of the *Bundesrat* is mandatory, i.e. it possesses veto power.

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<sup>4</sup> Article 30 of the Constitution provides that the exercise of governmental powers and the discharge of public functions (legislation, executive and administration of justice) shall be incumbent on the States in so far as the Constitution does not otherwise prescribe or permit. However, the Constitution contains a number of provisions that favor centralization. The catalogues of federal competencies found in Articles 73, 74, 74 a, 75 and 105 GG are extensive. As a general rule, however, the Constitution lays emphasis on legislative functions at the central level, but also on the formulation of policy guidelines and on the allocation of financial resources through the Federation.

<sup>5</sup> The members of the *Bundesrat* are not elected, neither in general elections by the citizens of their respective States nor by members of state parliaments.

<sup>6</sup> Where state governments are supported by a coalition of parties, this requires consensus forming at the state level before casting a vote in the *Bundesrat*. It entails delicate political bargaining especially where a party may be in power in a State, but in opposition at the federal level. If no political agreement can be reached within a state coalition government, the representative of the State in the *Bundesrat* may abstain, but a State can never cast two (or more) opposing votes.

<sup>7</sup> This provision is more restrictive than in normal legislation where the absolute majority of the members in attendance is sufficient.

In this case, as prescribed by the Constitution, the law must interfere with the States' interests in a particular way—for instance by affecting their budgets, their organizational structure, or administrative processes. Since most of the federal laws will have to be implemented by the States as “matters of their own concern” (*eigene Angelegenheiten*), the consent of the *Bundesrat* is essential in all these instances.<sup>8</sup>

The proportion of “consensual laws” is slightly above 50 percent. They typically impinge on fundamental relationships between the Federation and the States, on the marking out of the federal administration and its interference with state administrations, on the execution of the federal judiciary by state courts, and the like. Since state governments act within the framework of federal legislation on a variety of policy issues, the consent of the *Bundesrat* is required for a great number of federal initiatives. Virtually every law affecting the interests of the States has to pass the *Bundesrat* (Articles 50ff GG). In particular:

- Amendments of the Basic Law require a two-thirds majority in both the *Bundestag* (Federal parliament) and the *Bundesrat* (Art. 79 (2) GG).
- Legislation affecting matters of state finance or state sovereignty in administrative matters requires an absolute majority of the *Bundesrat*'s votes (for instance, Articles 105 (3), 107, 108, 109 GG).
- In so far as the consent of the *Bundesrat* is not required for a bill to become law, it may nevertheless object to a bill adopted by the *Bundestag* according to Art. 77 GG. But the appeal of the *Bundesrat* can be overridden by the *Bundestag*.
- In addition, the *Bundesrat* is given the right to take initiatives in areas of federal legislation.

Particularly in the field of taxation and related fields, the influence of the States is far-reaching. The consent of the *Bundesrat* is required notably with regard to

- all laws affecting the proceeds of taxes accruing entirely or in part to the States;
- federal laws on fiscal equalization, and
- federal laws regulating the administration of taxes by fiscal authorities of the States (Articles 105 (3), 106 (4), 107 (2) and 108 (3) GG).

However, *Bundesrat* decisions are usually much less spectacular than decisions of the Federal parliament. This is for a variety of reasons, mainly because of the strong responsibility-sharing element in the Constitution, in combination with a sophisticated communications network.

All federal bills are first sent to the *Bundesrat* for an opinion, and modifications of the original drafts are usually made to account for objections by the States. When the last version of a draft law is sent to the *Bundestag* for final approval, the implicit consent of the *Bundesrat* can be expected in most instances. This results from the intense consultation process and the interchange of views among bureaucrats at federal and the state levels. It is therefore known well in advance whether a measure proposed by the Federal government or the *Bundestag* will encounter opposition at the state level.

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<sup>8</sup> In certain instances, the decision whether a piece of legislation is only “objectionable” or requires the consent of the *Bundesrat* has been controversial. In these cases, the *Bundesrat* would eventually seek a ruling of the Constitutional Court in that matter. Every federal law requiring the consent of the *Bundesrat* would be declared void.



The *Bundesrat* (and also the *Bundestag*) rely heavily on the expertise of a highly qualified state bureaucracy, which inserts its opinion into the legislative process through committees. State bureaucrats are in fact often more experienced than their colleagues at the federal level since they are in charge of administering many of the policies set up by federal legislation (Spahn (1978), pp. 9 and 10).

The status of the *Bundesrat* in federal legislation has given the German States jointly a strong position, which counterbalances the loss of individual state sovereignty in specific areas.

### 3.1.2 Resolving conflicts within the Federal Legislature

The normal procedure of establishing consensus between the two chambers of parliaments involved in federal legislation is, again, institutionalized in a formal bureaucratic and political mediation process.

Federal legislation typically starts with an initiative of the Federal government, leading to a draft law fleshed out by its bureaucracy. In a first instance, it will have to pass the Cabinet, which requires an inter-ministerial consultation and coordination process, but it is then immediately transferred to the States' House before even reaching the Federal parliament. This is to ascertain support of the States or, eventually, to identify possible conflicts early. Potential sources of disagreement are discussed between bureaucrats at both levels, and often resolved at a technical level. This is true in particular for administrative procedures where state bureaucrats typically possess greater experience. Remaining conflicts are tackled either by adjusting the legislation between the two chambers of parliament, or through formal mediation. This process of institutional mediation is effected through a Standing Inter-parliamentary Mediation Committee (*Vermittlungsausschuss*).

This Mediation Committee is composed of members of the *Bundestag* and the *Bundesrat*. The chairperson of the Committee alternates between the two bodies on a quarterly pace. Each Chamber sends 16 delegates (one member for each State for the *Bundesrat*). The *Bundesrat's* representatives of the Mediation Committee are not bound by the directives of their governments (as is the case for their voting in the *Bundesrat*). The Committee's sittings are confidential and its minutes are published only after the consecutive parliamentary session—i.e. after 5 years the earliest. This is motivated by the need to establish consensus without single members of the Committee being pressurized by their peers to adopt a certain policy stance.

The frequency of appeals to the Mediation Committee is a good indicator of the conflict potential between the Federal government and the States. It varies enormously according to the political composition of the two parliaments. For instance, during the period of 1972-76 (social-liberal coalition at the federal level), the Mediation Committee was activated 96 times; during 1983-87 (Christian-democratic-liberal coalition), it was called upon only 6 times. More recently, both in the preceding and the present legislative periods, the number of appeals to the Mediation Committee has risen again significantly.

The purpose of mediation is to review the draft law in a way as to allow both chambers of parliament to support it. The result is cast in a formal proposal (*Einigungsvorschlag*) submitted to the *Bundestag* and the *Bundesrat*. Where political agreement between the two chambers is not reached, a law cannot be enacted. If a law requiring the consent of the *Bundesrat* is passed in the *Bundestag* in spite of objections made by the States' House (which is possible if there is a conflict on the nature of the legislation, whether it is "consensual" or only "objectionable"), the *Bundesrat* may appeal to the Constitutional Court to resolve the issue. The Court may declare federal legislation null and void if state interests are found to

have been infringed without their representative body having been involved in federal legislation.<sup>9</sup>

### Box 3: Coordination in German federal legislation: An example

Federal legislation and coordination among the Federation and the States is exemplified by the passage of the 4<sup>th</sup> Law to amend the status of the *Deutsche Bundesbank* of July 15, 1992 (Law Gazette part I of 1992, page 1287).

The purpose of the Law was to adjust the organizational structure of the central bank to the new conditions after unification. The main issue was, *inter alia*, whether there was a need to create regional departments of the central bank (*Landeszentralbanken*) in the new States, which would have increased the number of existing institutions to 16. The Federal government proposed to consolidate these institutions and retain only nine bodies. This question could be considered to affect the interests of States. An “iron” post-war principle (that each State had to have its own branch of the central bank) was going to be abandoned.

The draft law was issued by the Federal government and directed to the president of the Federal parliament (December 1991). At the same time, the States—through the *Bundesrat*—had also submitted a draft law for consideration by the Federal parliament. In a first reading (January 1992), the Federal parliament decided to submit both drafts to a Standing Parliamentary Committee (in this case, the Finance Committee with the cooperation of the Economics Committee and the Budget Committee) for deliberations and recommendations.

In the example case, the Committees proposed (11<sup>th</sup> of March 1992) to accept the draft law of the Federal government (with minor amendments), and to reject the draft of the *Bundesrat*. The proposal was explained in detail in a written submission, with the reactions of the Federal government and the *Bundesrat* attached. The proposal contained the statements of all parties involved in the Committees’ deliberations.

If a draft law has a significant impact on the federal budget (which was not the case in the case in point), the procedure is more complex. In this instance, the Budget Committee has to ascertain that the legislation conforms with the financial position of the Federation’s budget. This may constrain the deliberations of the Committees because the budget has to be balanced according to Article 110 of the Constitution. It is essential that any proposal that increases spending ought to be combined with a proposal to finance such spending, and legislation has to cover both aspects simultaneously. Otherwise, a draft law cannot pass the legislature.

After the Committees completed their task, the fractions (parties) decided on their positions, and the Council of the Elders asked for a second reading. The Committees presented their positions, and the president opened the debate. Then parliamentarians cast their vote. As no further amendments were proposed, the Federal parliament could immediately proceed to a third (and final) ballot (20<sup>th</sup> of March 1992).

In the case of the Bundesbank Law, the Federal government had taken the position that cooperation of the Upper House was not required. The *Bundesrat* held the opposite view (which the government ignored in its first statements). So there was a dual conflict between the two chambers of parliament: the *Bundesrat* had drafted an own piece of legislation rejecting the position of the Federal government; and it insisted that the federal law required its consent in order to become effective. It therefore called for the Mediation Committee (3<sup>rd</sup> of April 1992).

This inter-parliamentary committee proposed to amend the law that had passed the *Bundestag* in a number of points (3<sup>rd</sup> of June 1992). The statement reveals that the *Bundesrat* did not succeed in

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<sup>9</sup> The *Bundesrat* also appoints half of the number of judges to the Constitutional Court; the other half is appointed by the *Bundestag* by an election committee consisting of 12 parliamentarians.

having his view adopted that the law needed its consent. This was for political reasons. If the representatives of the *Bundesrat* in the Mediation Committee had insisted that consent was mandatory, and the proposal of the Committee would not have been accepted by the *Bundestag*, the *Bundesrat* would have had no other choice then to reject the law for that motive. Eventually it would have to seek a ruling of the Constitutional Court. On the other hand, if it accepted that the law did not require its consent, and the *Bundestag* did not follow the Committee's proposal, the *Bundesrat* would have had the right to appeal, and the *Bundesrat* would have had to invalidate that appeal. There was a slight chance that this could have happened.

Both chambers of parliament were now free to decide. In the present case, the *Bundesrat* accepted the proposal by the Mediation Committee, however the *Bundesrat* rejected it retaining its position that its consent was required (10<sup>th</sup> of June 1992), alternatively—as the issue was controversial—to appeal. The *Bundestag* rejected that appeal (12<sup>th</sup> of June 1992) by a majority of its members (in this case 365 of the necessary 332 votes).

The Law was published on the 15<sup>th</sup> of July 1992. The *Bundesrat* did not challenge the law at the Constitutional Court. The conflict was thus resolved.

### 3.2 Vertical coordination of policy implementation

The *Bundesrat* is a typical example of institutionalized vertical cooperation within the German federation. There is a general trend to formalize cooperation within and among authorities in order to enhance the transparency and clarity of intergovernmental relations. Where cooperation is effected via bilateral negotiations or “log-rolling”, consensus may be easier to achieve among the negotiating partners. Yet it may also jeopardize the political cohesion of the Federation if excluded governments deem to have been treated unfairly. Undoubtedly, formalized and institutionalized cooperation, and a legalistic and transparent political process, have fostered national cohesion in Germany after the war. There is a general consensus that these gains should not be put at risk haphazardly.

Nevertheless there were a few (yet important) incidents where the Federal government would “buy votes” of decisive state governments by reaching deals in the corridors of the *Bundesrat*. Political and/or financial favors were handed out to tip the power balance in the Upper House. This was criticized by some as eroding the transparency and fairness of democratic processes, and praised by others as being a pertinent instrument of collective choice for establishing political consensus. The controversy reveals a fundamental conflict of philosophies on coordination within a federation. Whereas a traditional (corporatist) view would favor coordination through institutions—with transparent and non-discriminatory, symmetrical rules—, a more modern (contractual) approach would emphasize the economic benefits of effective coordination through bilateral consultation and “side payments”—with the acceptance of possibly asymmetrical outcomes.

The *Bundesrat* is only one, albeit the most important, coordination body of the German federal machinery. Other institutionalized forms of formalized vertical coordination between the different political levels are the following:

- The Business Cycle Council (*Konjunkturrat*) in which the Federation, States and municipalities reach a consistent view on macroeconomic policies and coordinate government borrowing to some degree.
- The Financial Planning Council (*Finanzplanungsrat*) which establishes guidelines and recommendations for policy action as to the financing of budgets in the short and medium term.

## Institutional Cooperation Among German Governments

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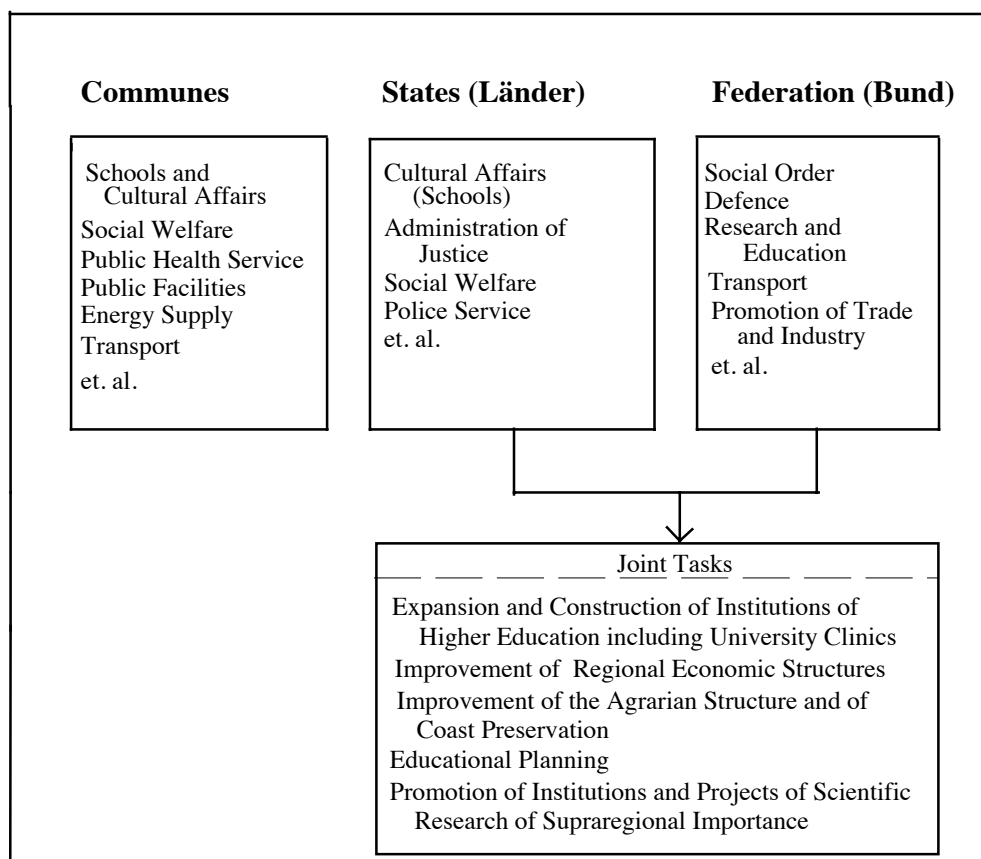
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- Specific bodies of more specific responsibilities such as the Science Council (*Wissenschaftsrat*) where policies relating to the promotion of science and higher education are debated and coordinated among the States and the Federation.

Such councils are formally assigned to the Federal government with participation of the States and other organizations. For instance, the Financial Planning Council includes the Federal Ministers of Finance and of Economics, the State Ministers responsible for Finance, four representatives of the municipalities (appointed by the *Bundesrat* on proposals by the municipal associations). The chairperson and coordinator of the Council is the Federal Minister of Finance. (For a further discussion of the functions of the Financial Planning Council and the Business Cycle Council in the context of budget preparation see point 5.1 below.)

Certainly, coordinating agreements reached within these councils are not without problems. They tend to restrict the room for political decisions in federal and state parliaments as they are often induced to accept a compromise reached by such councils—deemed to be expert in these matters. On the other hand, it is a normal procedure to delegate functions to specific committees in order to restrain the costs of collective decision making.

**Figure 1: Distribution of Tasks**



### 3.2.1 *The vertical coordination of administration*

The German model of federalism emphasizes the administrative role of the States not only in areas of their own responsibilities (Art. 30 GG), but also in areas of federal responsibilities: The States execute most of the federal laws *as matters of their own concern* (Art. 83, 84, for instance social welfare and environment protection), and in some special cases they execute federal laws *as agents of the Federal government* (Art. 85, *Bundesauftragsverwaltung*, for instance federal highways). In this case, the Federation can give directives, but it also assumes political responsibility, and the costs.

Similarly, local governments have safeguarded the right to regulate their own affairs within certain limits (Article 28). Besides their own responsibilities (see Figure 1), they also shoulder the tasks that are assigned to them by law (for example, registration offices). The municipalities are supervised by the States. However, the same model of a horizontal division of functions applies to the relationship between States and their municipalities.

Thus, central administration is less developed in general (except for specific functions like defense, foreign affairs etc.), and the States bear the brunt of administrative responsibilities (including for tax administration). On the other hand, municipalities have to spend a large share of capital expenditure in such fields as communal services (sewerage etc.), health, sports and recreation, schools, housing and road construction. As a rule, municipal infrastructure investments represent roughly two thirds of all public investment in Germany. This highlights the importance of the lowest tier for public service delivery and infrastructure.

The Basic Law also determines which layer shall be responsible for the administration of taxes (Article 108 GG, fiscal administration), i.e. who is in charge of collecting, handling and spending the budgetary means. In principle, the right to administer a tax follows the right to appropriate the yield from that tax. Tax administration is a typical example of vertical coordination of administration in general. It is therefore outlined below in more detail.

### 3.2.2 *The vertical coordination of tax administration*<sup>10</sup>

As already said above, the States bear the brunt of tax administration. The Federation only administers customs duties, fiscal monopolies, excise taxes subject to federal legislation, including VAT on imports, and charges imposed within the framework of the European Union. All other taxes are administered by state revenue authorities. To the extent that taxes accruing wholly or in part to the Federation are administered by the States, these act as agents of the Federation (for instance for joint taxes, but excluding capital transfer taxes or the insurance tax). As regards taxes the revenue from which accrues exclusively to municipalities, their administration may wholly or in part be transferred by States to local governments (in particular taxes on real property and businesses, and revenues from local excises taxes). Most of the States have made use of this right. As a rule, municipalities are not authorized to determine the tax base (*Steuermessbetrag*) of the business and property taxes—which is uniform throughout the nation. They may, however, legislate on a leverage factor (*Hebesatz*) applicable to this base.

The German fiscal administration is dominated by two principles. For one thing, authorities are classed into customs and excise administrations on the one hand, and tax administrations on the other—which follows international principles of fiscal administration. For another,

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<sup>10</sup> For further details see Spahn, Paul Bernd, Wolfgang Föttinger, and Imke Steinmetz (1996).

fiscal authorities are divided vertically into three levels. This is true for federal as well as state administrations.

These three levels are:

- supreme guiding authorities
- intermediate supervisory authorities
- local executive authorities.

The supreme authorities have the leading function as to organization, staffing and factual fields of tax administration. The Federal government establishes principles of taxation (in the sense of Art. 108 (7) GG) as far as taxes fall under the purview of federal legislation. To the extent that administration is incumbent upon State revenue authorities or municipalities, these principles of taxation require the consent of the *Bundesrat*.

The Regional Finance Offices (*Oberfinanzdirektionen*) are, as intermediate authorities, in principle both federal and state authorities at the same time. They carry departments for taxes which are assigned to the federal as well as to state governments, and they are thus composed of federal and state public servants. These Regional Finance Offices supervise, within their realm, the local revenue authorities of the Federation (Main Customs Offices, Customs Investigation Offices) as well as the local revenue authorities of the State (*Finanzämter*). The Federation assumes the costs of the Regional Finance Offices as far as they are related to administering federal taxes; in all other instances, the costs are taken over by the States.

However, a closer look onto the practice of Regional Finance Offices reveals that federal and state departments, although under the supervision of the same authority, are strictly divided as to their tasks and their organizational, staffing and budgetary affairs. In particular, the customs and excise departments (federal) and the tax departments (state) work independently of each other. Yet this does not exclude mutual inter-authority assistance and the exchange of information.

The local Tax Offices (*Finanzämter*) have to bear the brunt of administration through processing individual tax files. All tax offices are divided into two areas of work: One deals with tax assessment (*Steuerfestsetzung*), the other with tax collection (*Steuererhebung*). Put simply, the tax offices render tax legislation effective. What renders these offices even more important is the fact that they also act as extra-judicial authorities in the case of litigations by taxpayers against an individual tax assessment, and they are also involved as counterparts in the case of judicial objections against tax bills.

The Main Customs Offices are responsible for the administration of excise taxes subject to federal legislation (including VAT on imports, and the state beer tax) as well as the administration of customs duties. Customs Investigations Offices are concerned with tax offences and irregularities.

Given the division of tax administration between the Federation and the States, cooperation in tax affairs is mandatory. Ordinarily, this cooperation is based on free teamwork without written agreements. The organization of the coordination process follows three steps:

- The *bottom level* is formed by conferences between the officials responsible for the State Ministries of Finance and those for the Federal Ministry of Finance.
- At the *intermediate level*, the heads of the tax departments of the State Ministries of Finance confer with those of the Federal Ministry of Finance.

- The *superior authority* is the conference of Federal and State Ministers of Finance. Resolutions of the coordination bodies are published in the Federal Tax Law Gazette (*Bundessteuerblatt*), and the respective authorities are legally bound to it.

Such provisions are of great importance as to the uniformity in applying the law. They mitigate the problems of a decentralized organization of tax administration through the fact that all German tax offices follow uniform procedures. This is to guarantee impartiality in taxation and equal treatment of taxpayers throughout the nation.

In addition to the coordination machinery based on free agreements, there are several possibilities of federal interference into state tax administration as laid down in the Constitution. Although the priority of administration rests with the States, the Constitution restricts these competences in favor of the Federation.

Such administrative procedures to be applied by state revenue authorities may be established through federal legislation requiring the consent of the *Bundesrat* (Art. 108 (5), 2 GG). Less incisive is the possibility that, as to the administration of taxes, federal legislation may provide for collaboration between federal and state revenue authorities if, and to the extent, that the execution of tax laws is substantially improved or facilitated (Art. 108 (4), 1 GG). So far, federal legislation has made little use of this possibility however. Preference is given to uninhibited cooperation.

The Federal government is also given the possibility to interfere with the tax administration of States: The heads of taxing authorities at the intermediate level—important posts within the state departments—shall be appointed in agreement with the Federal government (Art. 108 (2), 3 GG). Of great importance is the privilege of the latter to issue pertinent general administrative rules (*Verwaltungsvorschriften*, Art. 108 (7) GG). This leads to an intensive and far-reaching participation of the Federal government in state tax administration. But, owing to the fact that administrative rules require the consent of the *Bundesrat*, the sovereignty of States as to tax administration is maintained.

Finally, there is the authority of the Federal Minister of Finance to issue directives (*Weisungsrecht*) whenever States act as agents of the Federation (Art. 108 (3), in combination with Art. 85 (3) GG). But this privilege is not often used and therefore hardly perceptible.

### 3.2.3 *Joint decision making and co-financing: joint tasks and federal grants-in-aid*

One important instruments of policy coordination established by the Basic Law is a joint-decision-making and responsibility-sharing machinery combined with joint planning and joint financing and/or grants-in-aid. It represents a peculiarity of German federal arrangements although similar models are now being used in other countries (e.g., in Portugal for municipal infrastructure investments) and, notably, in the European Union (e.g., the European Structural Funds). As regards the co-financing aspect, the instruments are also somewhat similar to the matching grants in the United States, although joint decision making is typically not formal in this country.

Such institutions of co-operative federalism and co-financing among tiers of government were established in Germany in 1969, when it had become clear that federal legislation alone was not sufficient to coordinate policies at the central level. The federal division of functions—with framework legislation assigned to the center and the implementation of policies to the lower tiers of government—had become deficient, because the central government had increasingly penetrated areas of state responsibility without constitutional backing. The

interplay of federal and state government budgets was then also viewed against a background of the (then more important) goals of coordinated stabilization policies.

The two major coordinative instruments created in 1969 were:

- the ‘joint tasks’ (*Gemeinschaftsaufgaben*) according to Articles 91a and 91b GG;
- and grants-in-aid (*Finanzhilfen*) according to Article 104 a (4) GG.

*Joint tasks* are defined in the Basic Law for five policy domains (see Figure 1). In these areas the Federation participates in the discharge of the respective responsibilities of the States, provided that such responsibilities are important for the society at large, and that federal participation is necessary for the improvement of living conditions in the nation. The Federation takes part in the planning of joint tasks, and it normally assumes half of the costs.<sup>11</sup> In the case of framework planning, the Federal government and the governments of the States form a Standing Planning Committee, in which the Federation shares the votes with all of the States, so that neither the Federal government can outvote the States, nor can the States outvote the Federal government.

It must be stressed that the Planning Committees do not only function as information gathering and consulting bodies; they also have the constitutional power to take decisions that are binding for the Executives of the States and the Federal government. Each Planning Committee sets up an annual framework plan (*Rahmenplan*), which has to be integrated into medium-term financial planning of both the Federation and the States. This medium-term plan is to be updated annually. The implementation of the framework plan is a prerogative of the States, however.<sup>12</sup>

The precise meaning of framework planning is not specified by the Constitution. It entails that specific regulations have to be defined by federal legislation with the consent of the *Bundesrat*. These regulations may differ for each task. For instance, the Regional Act (1969) reserves the following aspects to be defined by the joint federal-state machinery: (i) the definition of “depressed areas” that qualify for subsidies; (ii) the specific planning goals of regional policy; (iii) the definition of eligibility criteria for investments to receive support; (iv) limits to the subsidy rates; and (v) the allocation of the subsidies to individual States.

*Grants-in-aid* are given to the States for regional and local investments, provided that such investments are necessary “to avert a disturbance of the overall economic equilibrium within the federal territory, or to promote economic growth”. The uniformity-of-living-conditions principle as embedded in the German Constitution is again perceptible in these arrangement. The Federation is entitled to determine the type of investment only. It has no further say in planning and administration. For grants-in-aid, no specific provisions were made to institutionalize joint planning (as in the case of the joint tasks with its Planning Councils). All the federal legislation has to do is “to specify the funds of investment to be promoted under these conditions, to fix a maximum share of investment costs to be covered by federal grants, and to determine in which way federal grants should be allocated to the States and to individual investment projects” (Reissert 1978, p. 31).<sup>13</sup>

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<sup>11</sup> The matching conditions may vary by task, however.

<sup>12</sup> See, for instance, Regional Act (1969), p. 1861.

<sup>13</sup> However, the allocation of funds to individual projects is normally left to the States except in certain instances (such as urban renewal and local public transportation).



### **Box 4: Federal grants-in-aid, and joint tasks: A historical perspective**

The German model of horizontal responsibility sharing initially precluded the Federal government's ability to set guidelines or prerogatives in policy areas that cannot be controlled by legislation, i.e. service delivery and public infrastructure. In these domains, planning and spending functions had been assigned to the States by the Constitution. As these functions became increasingly more important after World War II, however, the Federal government had begun, as early as the beginning of the 1950s, to allocate grants-in-aid to the States, trying to exert some control over State policies for low-cost housing assistance. Several other grant-in-aid programs had followed in areas such as regional policy, agricultural structural policy, university construction, and local public transportation investments—all areas of exclusive state responsibility without being sanctioned by the Constitution.

Such interference was neither objected by the States, because they received financial support from the Federal government, nor even by constitutional lawyers. Initially, the general perception was that federal involvement was necessary in these policy areas because of large regional inequities of needs (such as, initially, housing and regional policy, and, later, local public transportation), as well as uncompensated regional spillover effects (such as for university education). Federal support was of course particularly welcome by the smaller and financially weaker States.

However during the 1960, federal grants for state functions had increasingly stirred criticism. Over the years, the Federal government had become more and more involved in program administration, and administration remained a typical state function by Constitution. Moreover the matching requirements attached to the federal grants were more and more perceived as violating state sovereignty. Both facets were hard to reconcile with the Constitution. Moreover, some larger States instigated a more transparent and legalized system of vertical cooperation that was better controllable and predictable than the specific, segmented, negotiable (and therefore often clandestine) format of federal grants.

During the mid-1960s, an inquiry into intergovernmental fiscal relations was initiated, and a Commission for Finance Reform (1966) proposed to render federal-state relations more transparent by defining and regulating specific policy areas in which both levels would interact in planning and spending. The Constitution was to define such "joint tasks" as exceptions to the principle of independent and separate planning and budgeting. This triggered a discussion on whether joint policy areas should be explicitly mentioned in the Constitution, or whether the federal Legislature was free to define such areas by simple laws. Finally, a compromise was reached by which five policy areas were established formally through an amendment of the Constitution (Articles 91a and 91b GG); and a new constitutional provision (Article 104a (4) GG) was introduced allowing the Federal government to continue granting financial aid to the States for state and local investments within policy areas to be defined by federal laws or federal-state agreements.

The introduction of a legal basis for joint tasks and grants-in-aid implied joint planning and decision making as well as joint financing between the tiers of government.

The allocation rules for grants-in-aid are even more stringent than for joint tasks. In 1975 the Federal Constitutional Court (*Bundesverfassungsgericht*) had ruled that all States must agree on decisions about the allocation of Federal grants to the States; that the funds should be allocated to all States "according to equal standards"; and that, in cases where the Federal government has the formal right to allocate funds to individual projects, selections among projects proposed by the States had to follow the project priorities formulated by the States (Federal Constitutional Court 1975, pp. 118-26).

Grants-in-aid were typically used as federal policy instruments (for instance for the promotion of urban planning, for hospital construction, for low-cost housing (*sozialer Wohnungsbau*), for local public transportation, and, mainly during the late 1960s and early 1970s, for global

demand management). The federal shares of co-financing ranges from one third (for urban renewal and hospital investment) to 60 percent (for local public transportation investments).

### 3.2.4 *Joint decision making and co-financing: criticisms and further developments*

Joint decision making has been criticized almost from the beginning of its institutionalization (see, for instance, Reissert (1978), pp. 33-41). The main critical points are the following:

- A main characteristic of joint tasks and grants-in-aid is said to be the tendency to distribute resources per capita uniformly among States.
- Another characteristic is said to be the reluctance to allocate funds selectively to program subcategories or individual projects. And, more importantly,
- joint decision making and grants-in-aid are said to obfuscate the accountability and the responsibility between Federation and States, and this would touch upon the very essence of state sovereignty.

The first two points are not specific to joint tasks and federal grants-in-aid. The tendency to distribute resources evenly on a per capita basis is deeply entrenched in German intergovernmental fiscal relations more generally, notably in the interstate equalization scheme, the *Finanzausgleich* (see Box 2 above). Given past attitudes of the Federal Constitutional Court on equalization and the aforementioned ruling on grants-in-aid of 1975, it is not easy for politicians to deviate from this non-discriminatory, and hence conflict-minimizing, strategy in favor of a more needs-related allocation rule. Although the Court—in its ruling on the *Finanzausgleich* of 1999—has more recently taken a more open position on discriminatory policies, provided they are based on objective and transparent criteria, this is unlikely to break a circle that has proven to be prone to consensus forming and conflict avoiding among governments in the past.

Although political scientists heavily criticize joint tasks in Germany on the grounds that they blur the accountability within a democratic system, this institution can also be seen to represent a pertinent approach to dealing with interjurisdictional spillovers and externalities in a framework of interjurisdictional negotiations and contracting. Indeed, negotiations and contractual agreements between the Federation and the States resulting from bargaining could be used to internalize spillovers that can never be compensated by non-discriminatory grants. One may well call such interjurisdictional bargaining processes, and institutionalized forms of cooperation and coordination “contract federalism”. While the basic constitution remains untouched, new institutions are set up and function on the basis of single- or multi-purpose contracts between the Federation and the States, as well as among States themselves, and eventually only for a limited period. Negotiated solutions within existing cooperative arrangements and institutions tend to account for possible regional spillovers and constitute an appropriate response to coping with market inefficiencies. Therefore, contractual forms of federalism can significantly improve the quality of service delivery in the public sector. They can also contribute to interregional solidarity.

It must be stressed that the German model of cooperative federalism has indeed functioned remarkably well in the past: the quality of public service delivery is high, and governments are responding to regionally differentiated voter preferences while maintaining a certain “uniformity of living conditions” throughout the nation. What is at stake now is to open up such institutionalized forms of interjurisdictional cooperation, which are henceforth formal and subject to legal procedures, and thereby limited. Conventional budget procedures have to

be opened up by focusing democratic control on budget outcomes rather than on inputs in the form of rigid allocations of funds, and on formalities of the budgetary process. They have to be replaced by more open contractual forms of interjurisdictional cooperation. It would certainly improve the quality of public services and could lead to a greater variety of such services. Open forms of contractual intergovernmental relations would also be reflected in interregional resource flows as counterparts to the costing of providing public services through greater interjurisdictional cooperation.

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

#### 4. Horizontal policy coordination among the States

Apart from the need to coordinate action between higher and lower level authorities, there is also the need to cooperate *horizontally* at any one level of government. This is true for international economic and political relations as well as for interjurisdictional cooperation within any one nation, be it at the state or at the municipal level.

Among nations, horizontal coordination is typically developed on the basis of treaties, and is confined to specific issues of common interest (e.g., defense, or pollution control of rivers or the sea by bordering regions or nations). Therefore, international intergovernmental relations and their development always develop according to a contractual approach. International cooperation may be long-term and then require the creation of coordinative administrative institutions (such as NATO, the OSCE, the Council of Europe, the Council of Baltic Sea States, etc.).

At the national level, three different philosophies can be distinguished for horizontal policy coordination:

- Horizontal policy coordination is totally effected on a *contractual basis*. Such contracts respond to spillover effects that warrant collaboration among jurisdictions in specific policy areas. Rivalry among governments is welcome because it is expected to bring about effective policy coordination—like market forces—, and to constrain government at the same time. Moreover, competition among governments is thought to realize static efficiency gains and to foster dynamic welfare improvements through experimentation and innovation. General policy issues are typically addressed by employing the principle of reciprocity. Central government interference is hardly needed under this approach. This model of competitive horizontal coordination is typical for the Anglo-Saxon world, notably the United States.<sup>14</sup>

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<sup>14</sup> Competitive federalism may eventually be appropriate for highly industrialized economies with a large public sector, especially where horizontal regional inequalities in fiscal capacity are small. In transition economies, however, such organization is likely to fail. Vertical competition may have negative effects due to weak administrative capacities at lower tiers of government. At the horizontal level, it is likely to perpetuate existing regional inequities and/or induce impoverishing regional migration. And horizontal tax competition among governments can eventually reduce the scope for public policy action well below efficient levels.

- Horizontal policy coordination is effected on an *institutionalized basis*. The institutions aim at “harmonizing” or even “unifying” policies among the different jurisdictions within a federation. Their objective is to create similar living conditions throughout the nation as to public service delivery and infrastructure. This is seen to be a prerequisite for national cohesion, social justice among regions, and fairness toward citizens through the equal access to basic public services such as education. Competition among jurisdictions is rejected because it is regarded to put social harmony at risk. With harmonized or even uniform policies, reciprocity is superfluous. However strong guidance at the central level is needed under the approach. The central government would interfere as a broker (e.g. through national legislation) and establish common rules that are perceived to be fair and equitable from a national point of view. This model is characteristic for the Federal Republic of Germany.
- There are, of course, intermediate forms of horizontal policy coordination, where some competition among jurisdictions is tolerated or even welcome, the principle of reciprocity is used more generally, but harmonization is accepted for some policy areas. For these policy areas “national objectives” are defined, and central authorities attempt to inject these objectives into the policies of subnational governments through constitutional constraints and rulings of the High Court (all federations, including the United States), through institutionalized policy debates (such as the European Council in the EU, the Premiers’ Conferences in Australia, or the First Ministers Conferences in Canada), and, indirectly, through financial incentives (such as matching grants and other subsidies, again in all federations). A notable example of this “mixed approach” is represented by the European Union.

In Germany, horizontal cooperation among States is particularly important for functions that are exclusively assigned to the middle tier of government. On the one hand, the States are fully autonomous as to their own constitutional responsibilities (such as education); on the other hand there is the constitutional mandate of the Federal government to “maintain the uniformity” (now “similarity”) “of living conditions” within the nation. This calls for coordinated action notably in the field of education where equal access is seen to represent a basic precept of democracy.

In Germany, the most conspicuous example (Box 5) of institutionalized horizontal policy coordination is, perhaps, the Standing Conference of the States’ Ministers of Education and Culture (*Ständige Konferenz der Kultusminister der Länder*). It aims at coordinating and harmonizing education policies despite potential political differences among States.

### **Box 5: The Conference of the States’ Ministers of Education and Culture**

The Conference of the States’ Ministers of Education and Culture (short: Conference) was established in the Western zones in 1948 even before the creation of the Federal Republic of Germany. After German unification in 1990, and the creation of the Eastern States, the Conference now comprises all 16 States as its members.

Since education and culture are pure state functions in Germany, the Conference attempts to coordinate state policies in these areas without interference by the Federal government. According to its statutes, it regulates, within the realm of its policy domains, all affairs of supra-regional importance with the aim of establishing consensus among State governments and of representing common interests. One objective is to assure, through cooperation, a certain degree of harmonization in education, science, and culture, which is deemed to be necessary to assure the free mobility of pupils, students, teachers, and researchers throughout the national territory. It is also committed to

guaranteeing high quality standards in schooling and university education, to fostering the cooperation among institutions of higher education and science, and to rendering the education more flexible through standardized rules for exams and the mutual recognition of degrees.

Coordination is effected through (non-binding) recommendations, (formally binding) contracts, and state treaties. As a general rule, detailed regulations are to be avoided in order to encourage policy experimentation and innovation for individual States. However, the Conference has often created institutions that are overly regulated and, once in place, are difficult to dismantle. It has also created impediments to experimentation and innovation through narrow standards and inhibitions to flexibility.

Moreover the Conference represents the States jointly in matters of education and culture vis-à-vis higher levels of government: the Federation and the European Union. For instance, in the area of professional education, there is need to cooperate vertically with the Federal government, the latter being responsible for policies regarding vocational training in firms. And with regard to international action, the Federal government would represent the Federation in matters of foreign policy, defense, commerce, and other federal responsibilities, but it cannot represent her in matters of education and culture, which are pure state responsibilities. The States would therefore represent the Federation jointly through their Conference.

The Conference has an established Secretariat, and its policy decisions are taken by organs such as the assembly (*Plenum*) of all Ministers of Education and Culture, and an Executive (*Präsidium*) with its President. Executive and President are “elected” annually by the assembly from its members, whereby a rotating principle applies.

The agenda of the Conference is prepared by Standing Working Groups (*Ausschüsse*) and, eventually, by Commissions of experts as established from time to time on major reform topics. There are Working Groups for schooling (with a Subgroup for vocational training), for universities and science, for culture, for continuing education, for the dissemination of German culture and education in foreign countries, for European and international affairs, for sports, and for administrative issues.

The costs of administering the Conference and its Secretariat are shared among its members.

## 5. Budget coordination and the limitation of public debt

### 5.1 Formalized budget coordination

The coordination of budgets within a federation has to be discussed under two different aspects: material and formal coordination. As to material coordination, the institutional framework of the German federal machinery is extremely weak: Each jurisdiction is essentially free to manage its own budget without direct interference by other governments.<sup>15</sup>

The Constitution stresses the total separation of budgets for the Federation and the States (Art. 109 a): “The Federation and the *Länder* (States) shall be autonomous and independent of each other in their fiscal administration.” As to more formal aspects of budget coordination, however, Germany provides an interesting example on how this could be achieved.

A Law on Budgetary Principles of 1969<sup>16</sup>, attempts to coordinate the budget process and its performance by guidance through uniform principles to be observed by all authorities. Such principles extend from very general provisions (such as the budget principles of gross

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<sup>15</sup> This principle even applies to municipal governments, although they are subject to some formal supervision by their respective State.

<sup>16</sup> This Law was published in English, together with other relevant material under the title ‘Federal German Budget Legislation’, by the Federal Ministry of Finance, Bonn, November 1988.

estimates, comprehensiveness, unity, clarity, periodicity and antecedence (the budget should be ready before it is executed), efficiency and cost effectiveness, authorization to spend and to commit resources) to more specific rules regarding the preparation of the budget, to accounting and the rendering of accounts (including the classification of the budget), to auditing and discharge, and to rules applying for special funds set up under federal or state legislation. Also, the budget process was made more transparent in order to promote the assessment of the budget's effects on the general course of the economy. The second part of the legislation contains regulations that are generally and directly applicable to the Federation and the States—such as requirements for multi-year financial planning and the exchange of budget-related information.

The Law starts from the premise that uniform national policy goals can only be realized if public budgets of central and subcentral governments can be monitored effectively and in a standardized fashion. Otherwise the coordination of budgets is bound to fail. This has led to a uniform framework of budget classification and outline whereby the need to form economic categories and to relate budget items to categories of the National Accounts has played a prominent role. Nevertheless, the accounting principles of the budget remain cash-oriented while the National Accounts attempt to realize an accrual concept. A cash-based budget concept is, however, closely related to financial statements which record sources of financing the deficit and the net financial position of governments vis-à-vis the private sector. Obviously, given a harmonized framework of budget classification, this must facilitate comparison and amalgamation of budgets across different authorities at various layers of government.

Although the annual budget is cash-oriented, i.e. only income and expenditure items are accounted for that are expected to lead to financial operations during the budget year, all authorities are obliged to assess, in separate accounts, the expected need for spending authorizations for future budget years (*Verpflichtungsermächtigungen*).

The Law has reemphasized the classical principles of comprehensiveness of budgets and of accounting in gross (rather than net) terms. *All* public expenditure and revenue should appear on public budgets and be subject to national consolidation, and, ideally, no special funds should be tolerated that, once established, escape democratic control<sup>17</sup>. 'Off-budget' funding is indeed a prominent instrument for circumventing budget constraints and protecting special interests. Moreover, expenditure items should appear in full cost terms, and consolidation of such expenditure with specific revenue items is ruled out. There are exceptions to this precept, however. Financing of public budgets through capital markets and the redemption of public debt are shown in net (rather than gross) terms. The net terms are seen to be more relevant for evaluating the impact of budgetary policy on capital markets and, eventually, on monetary policy.

Other rules for budget coordination are of a procedural nature, as for instance, those relating to the preparation, the establishment and execution of the budget as well as formal budget

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<sup>17</sup> The only typical exception to this rule are social security funds. Moreover, temporary funds (such as the *Treuhandgesellschaft*, an institution which was to privatize Eastern Germany's state firms and property, or the Germany Unity Fund which managed East German public debt) were established in the context of German unification, but later integrated in government budgets. In Latin America, there is often an excessive reliance on special funds and on earmarking of taxes and transfers for specific purposes, based on purely sectoral considerations (e.g. Colombia). This implies severe inefficiencies.

control and auditing<sup>18</sup>. Also, the annual budgets (calendar year) have to be embedded in a medium-term financial plan which is established jointly by the Financial Planning Council representing all three tiers of government. The Council's objective is to reach agreement on the coordination of general budgetary policy and to support the federal government in its statutory task of achieving a harmonized stability-oriented budgetary and fiscal policy. The Financial Planning Council is, however, bound by the Constitution to respect the autonomous and independent fiscal administration of States and the self-governance of municipalities. It therefore acts through recommendations which are non-binding, yet have a strong impact on budget estimates and budget execution (including the level of borrowing). This requires, however, a cooperative environment in which independent budgetary authorities are willing to implement such recommendations within the realm of their responsibilities.

Medium-term financial planning is of prime importance in a situation where budgets are more and more determined by financially open-ended welfare programs. Such programs tend to establish eligibility criteria for certain transfers and services without regard to their long-term impact on budgets, because eligibility is difficult to anticipate (e.g. the need for old-age care).

Another important topic is macroeconomic management in a decentralized system. Toward the end of the 60s, Germany pioneered legislation in this area. A *Stability and Growth Law* was enacted, which commits the Federal government to attain certain macroeconomic targets and provides specific instruments enabling authorities to pursue demand management policies effectively. The intergovernmental Business Cycle Council (*Konjunkturrat*) was established to guide governments in coordinating their budgets (apart from medium-term planning), and an attempt was made to influence trading partners through concerted action (*Konzertierte Aktion*). Yet formal coordination essentially failed (except in the very beginning) as the crises of the early 1970s were found to be structural in nature and the arsenal of policy instruments provided by legislation to be inappropriate for dealing with these structural problems.

### 5.2 Limiting public borrowing and debt

Limitations on government deficits and control of the level and structure of public debt are of key importance for the stability of an economy. Decentralization of government entails the risk that autonomous territorial governments—States and municipalities—will incur debt without regard to an overall constraint on public sector borrowing.

There are various experiences to constrain public borrowing and debt in a multi-authority environment. One of the more prominent examples is the Maastricht Treaty, which attempts to restrict government deficits and debt by establishing and monitoring corresponding budget criteria. A lesser known example is the Australian Loan Council that aims at coordinating public sector borrowing of the Commonwealth and the Australian States. More recently, interesting experiences have been made, for instance in New Zealand, in the micro-managing of public sector budgets with hard budget constraints for subentities, in order to enhance the efficiency and quality of public service delivery. As a side-effect, such new instruments have

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<sup>18</sup> Before the budgetary reform of 1969, not a single federal budget law was established before the beginning of the relevant fiscal year, and, even after the reform, the implementation procedure did not function satisfactorily since the legislature tended to delay adopting the budget. A decision of the Constitutional Court of 1977 obliging parliament to approve the budget within the prescribed time limits was successful, however, and the federal budget is not published before the beginning of the fiscal year. Detailed instructions on financial and budgetary administration are entrenched in administrative regulations pertaining to the Budget Law.

also been useful in constraining global public sector borrowing and debt. (Some further explanations are given in Box 6.)

Against the background of international experience, the institutional coordination of public sector borrowing and debt is rather weak in Germany. In particular there is no instrument that would allow the Federal Minister of Finance to “allocate” the comprehensive constraint on national public borrowing and debt to the entities of the Federation: States and municipalities, and social security funds. The Federal government has agreed to a commitment in the context of the European Union without being able to meet it within the federal machinery. At the moment, it has no means of enforcement to restrict state or municipal borrowing.

However, there are other types of constraints on public sector borrowing to be stressed: market discipline, and attitudes.

Public debt is permitted in Germany both for central and subcentral levels of government. The institutional limitations that apply are the following:

- Par. 20 of the Law on the *Bundesbank* restricted borrowing from the central bank for all tiers of government (local governments have no access to this type of financing at all). There were ceilings for this rather unimportant type of borrowing (for example, the maximum amount of loans that could be accorded to the Federal government was DM 6 billion)— which was reduced to zero in 1994 in order to conform with the prohibition of central bank financing as expressed in Art. 104 of the Maastricht-Treaty. This imposes budgetary discipline by borrowing from capital markets (rather than from dependent central banks).
- The Constitution restricts Federal government borrowing in Art. 115 of the Basic Law to the “amount of projected outlays for investment purposes in the budget” (“golden rule”). Similar rules apply to state budgeting in accordance with State Constitutions or legislation. Local government borrowing is tied to their cash flow and subject to State supervision. The modalities of control may vary from State to State, however. The “golden rule” is sensed to be important, although it does not impose an upper limit onto public borrowing. The higher public investment is, the higher can be the level of borrowing.

Budget constraints, although comparably weak, seem to have worked well in Germany. Notably the “quasi-constitutional” limits to central bank financing were often praised as being the reason for low inflation, a strong currency and financial stability of the German public sector. In principle, this nexus cannot be denied, and the independent status of the *Bundesbank* was, as is generally known, a model for the design of the European Central Bank. Yet it has to be kept in mind that not only legal limits but also an overall consensus formed by all major political parties and interest groups was necessary to achieve a comparably high degree of fiscal stability. The “test” of German unification made it clear, however, that judicial control of budget deficits is difficult to achieve even with constitutional limits. Gross public debt of general government rose from about 40 per cent of GDP at the end of the eighties to about 60 per cent of GDP in the mid-nineties.

The budget constraint had however been „softened“ in many respects even before unification:

- It is far from clear what is meant by “investment purposes”. There is plenty of room for maneuver to declare single outlays to be investment expenditure, and thus fulfill the mandate of Article 115. Because public budgeting is still simple cash accounting in Germany, and because a capital budget does not exist, a useful application of the „pay as you use“ financing of public investments is virtually impossible.



- Furthermore, the norm of the Constitution is weakened by an exception clause according to which the borrowing limit only applies in the case of “general economic equilibrium”. Article 1 of the German „Stability and Growth Law“ of 1967 defines this equilibrium to reflect price stability, a high level of employment, external balance and steady economic growth at the same time. However, budget-making politicians can easily claim any existing state of the economy to be „out of equilibrium“.

The rule of Article 115 is thus hardly of practical relevance to economic policy and does not constitute an enforceable constraint for public deficits. Attempts of parliamentarians, during the 1980s, to force the Federal government to reduce loan financing by appealing to the Constitutional Court were unsuccessful.

### Box 6: International models to constrain public borrowing and debt

**The European Union.** The European Union attempts—through the Maastricht Treaty—to coordinate sovereign budgets of its Member States through statistical indicators relating the *public deficit* and the *level of debt* to GDP. These are to fall within certain quantitative limits (60 percent of GDP for public sector debt, and 3 percent of GDP for the combined annual budget deficit) for Member States to qualify for entry into the European Monetary Union. The same criteria are supposed to guide budget policies even after entry<sup>19</sup>. In the case of non-compliance, the Council can even apply financial sanctions to its Member States. The more *formal* budget orientation has helped to focus the discussion on the causes of precarious budget performance—whether they are structural or cyclical, and whether budgets are sustainable. This can be expected to have a *material* impact on public policy over the longer term. The threat of potential sanctions can reinforce this trend.

**The Commonwealth of Australia.** Another example of coordinating deficits and debt within a federation is through cooperation in *financing the budget*, i.e. when accessing capital markets. The Australian Loan Council, for instance, was set in place to optimize the timing of bond flotations by the States and the Commonwealth, and it later developed the competence to limit competition among governments for deficit funding. After the ascent of Keynesian stabilization policies, the Loan Council even acquired—under the supremacy of the Commonwealth—competencies in the area of macroeconomic management of state budgets. This may have made sense as long as Australia’s capital market was ‘captured’ and poorly integrated in world financial markets. After the liberalization of capital market this concept did no longer make sense, and, more recently the power to borrow has been returned to the States (*Financial Agreement Act* of 1994)<sup>20</sup>. The Loan Council now acts as a purely informational coordination instrument.

**New Zealand.** New Zealand has introduced reforms (*Fiscal Responsibility Act of 1994*) that require the government to follow principles of responsible fiscal management, and to assess their fiscal policies publicly against these principles. It also requires the government to publish fiscal intentions and objectives and to publish a range of reports resulting in a comprehensive set of fiscal information prepared under generally accepted accounting practice (GAAP). Furthermore, it has to refer all fiscal

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<sup>19</sup> The criteria are 3 per cent of GDP for the current budget deficit, and 60 per cent of GDP for the level of public debt. The deficit and the level of debt are defined comprehensively including not only lower tiers of government, but also non-private social insurance institutions in order to prevent budget items from being shifted strategically between the various public budgets or funds.

<sup>20</sup> Countries such as Australia and Canada (where there have also been attempts to regiment government borrowing in the past) are small open economies. This means that their actions should not be able to influence the price of capital they borrow. However, coordination of loan flotation tends to reinforce the belief of lenders that senior governments are guaranteeing junior government debt. It is likely that the Australian arrangements were changed in order to dispel the impression of this implicit bail-out guarantee by the Commonwealth government.

policy reports required under the Act to a parliamentary select committee. New Zealand (and, later, the Australian Capital Territory) are possibly the only jurisdictions in the world that apply accounting standards which are neutral as between the public and private sectors. The reporting system is accruals based<sup>21</sup> but it also reports on cash flows. Moreover, it attempts to monitor net public debt as well as the impact of the budget's operating balance and revaluation changes on net worth. The purpose of such reporting is to add to the integrity and credibility of the government's financial statements. It also provides critical information for borrowing in capital markets<sup>22</sup>. Such comprehensive and standardized reporting and financial planning—the rationale for which is provided by the principal-agent model—could also be used for fostering intergovernmental coordination and cooperation in a multi-layer government setting.

**Brazil.** Brazil has recently also passed legislation, which attempts to coordinate public sector budgeting and public borrowing and debt in particular (*Lei de Responsabilidade Fiscal* of 2000). It essentially combines the experience of the European Union, the United States, and New Zealand. The application of this Law in practice still has to pass the test of coordination governments within a highly fragmented and uncooperative political environment.

## 6. Summary

German federal financial arrangements convey the impression of a rather unitary state: uniform tax legislation, extensive tax sharing and horizontal financial settlement arrangements may be interpreted in this fashion. Yet this impression is essentially misleading. The role of the States' House—allowing the States to inject their voice into federal legislation, responsibility-sharing and co-financing arrangements in important areas of state responsibility, and the horizontal design of the federal machinery by which the center coordinates through “framework legislation” whereas the States are free to implement their policies within that framework, all constitute a complex ensemble of political checks and balances requiring a high degree of cooperation.

Formalized and institutionalized forms of intergovernmental cooperation can be found both among the Federation and the States conjointly (vertical cooperation), and among jurisdictions at lower levels of government, among States and among municipalities (horizontal cooperation). However, formalized institutional cooperation has recently been suspected to hinder the society's pace of reform. Indeed, formalized forms of cooperation appear to be less flexible in responding to a changing environment than contractual intergovernmental relations. There are first signs of an opening-up of the German federal machinery as bilateral interjurisdictional negotiations are used to complete the formalized fiscal coordination machinery.

It is interesting to observe which avenue the German federal arrangements will take in view of globalization and European integration. Most likely they will be rendered more responsive to the pending challenges although it is unlikely that the basic philosophy of institutionalized cooperation will be sacrificed as long as it provides a robust and coherent framework for establishing consensus and interjurisdictional solidarity.

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<sup>21</sup> An example of the implications of shifting from a cash to an accrual basis is that if the Crown planned to dispose of an asset below fair market (necessitating a write-off of part of the value) this would be recognized explicitly in the budget projections.

<sup>22</sup> David Sewell has drawn my attention to this point. He emphasizes that accruals accounting is particularly important for municipalities when studying the revenues that come from local utilities.

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