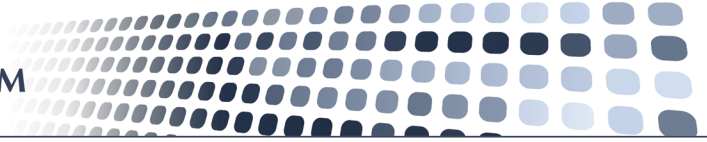




CENTRO STUDI SUL FEDERALISMO

PERSPECTIVES ON FEDERALISM



ISSN: 2036-5438

Federal Reform II in Germany

by

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Perspectives on Federalism, Vol. 2, issue 2, 2010



Abstract

Recently Germany experienced yet another federal reform shortly after a previous modification to the German federal system. This paper explains agenda setting, negotiations and ratification of this recent federal reform. With regards to the case of the most recent federal reform in Germany the issue of debt limits had been effectively agreed upon as a package deal between political parties and Bund and Länder alike.

The Grand Coalition of CDU/CSU and SPD managed to quickly gather a qualified majority in the Bundestag, making the qualified majority of Länder the crucial negotiating point. At the end, stronger Länder forced weaker Länder either to accept the new debt regime suggested primarily by the federal government, forcing Bund and Länder to uphold balanced budgets until 2020 or to be responsible for a failed reform. In this situation weaker Länder saw the new constitutional debt regime as more acceptable than rejecting a reform.

Key-words:

Federalism, reform, Germany, financial crisis, balanced budget



1. Introduction ¹

Germany recently experienced a second federal reform.. This paper considers the agenda of the reform commission; the negotiations within the commission and their result; and the ratification of the commission's conclusions. The paper concludes that this reform is a solution of the smallest common denominator that leaves open crucial questions of German federalism. A further commission is foreseeable.

2. Setting the Agenda

A bicameral commission composed of Bundestag and Bundesrat representatives negotiated the first round of federal reforms in 2006, leading to some disentanglement of competencies between the Bund and Länder. Disentanglement was seen as a necessary step for reducing Bundesrat participation in federal legislation and federal involvement in jurisdictions of Länder (Benz 2005). Finances between Bund, and Länder had been excluded in the reform.

For dominating actors the separation between competences and finances was supposed to make compromise easier.

In the second stage of federal reforms, a second bicameral commission dealt with the financial relationship between Bund and Länder from 2007-2009. Negotiations started a year after the German Constitutional Court (Bundesverfassungsgericht – BVerfG) decided that the Bund must only pay additional finances (Bundesergänzungszuweisungen - BEZ) to Länder in case of a budgetary crisis causing a danger for the federal level (Bundesstaatlicher Notstand). This decision stood in contrast to previous decisions of the Court. The FDP (Free Democratic Party) played a crucial role in setting the agenda for the commission because of a personal agreement between current chancellor Angela Merkel (Christian Democratic Union - CDU) and Guido Westerwelle (FDP) that a second federal commission about finances would have to follow the first stage of federal reforms (Westerwelle 2006). For the FDP every reform of the federal system offers the opportunity



to promote their ideological position of a moderately competitive form of federalism. At the same time Länder branches of the FDP were coalition partners in important Länder governments of which consent was needed in the Bundesrat to ratify the first federal reform.

Table 1
Bundesrat distribution of votes.

Time	Bund <> Länder (Governments of SPD-LINKE, SPD-GREENS, CDU-GREENS)	Governments with CDU, CSU-FDP	Bund = Länder (Governments of SPD, CDU and CSU)
11/05-05/06	11	22	36
05/06-11/06	7	18	44

(Source: Own Calculations)

The number of total votes in Bundesrat is 69; therefore a qualified majority would consist of 46 votes. Länder governments led by Bund governmental parties only held a simple majority of 44 votes in Bundesrat at the time of voting for the first stage of federal reforms. Since the newly elected federal government wanted to succeed in passing legislation at this early juncture of its term it was in its interest to pass the first stage of federal reforms quickly. The federal government could then move to set up the second commission, helped by the consent of Länder governments with FDP participation in Bundesrat.

The decision to set up the commission was accompanied by a list of topics to be debated in the commission, these topics focussing on the regulation of the budget crisis and rules regarding debts (Bundesrat 2006). Concerning the financial relationship between Bund and Länder this subject is important, but not central to the arrangement of fiscal federalism in Germany. Another subject which is central to fiscal federalism is the fiscal equalisation scheme (Länderfinanzausgleich - LFA) which discourages high populated Länder from increasing their resources because they will be distributed among weaker Länder up to 95 % of the federal mean. Weaker Länder, like city states and less dense populated Länder argue that they face higher costs for providing public services compared to the federal mean. In this controversy a BVerfG decision (Maßstäbe Urteil) of the year 1999 obliged the legislative bodies to adjust the LFA. This adjustment took place shortly before the second federal commission and fixed the LFA for the period between 2005 and



2019. Therefore the commission did not want to discuss this matter anew. The focus of the commission lay on another problem, that relating to state indebtedness.

3. Results and Negotiation Patterns

The so-called golden rule in the old Article 115 of limiting state debts to investment was abolished in the second reform and a new mode of regulating debts and amortisation was introduced into the Grundgesetz. Under normal economic circumstances it is now forbidden to make new debt, a prohibition designed to achieve the goal of balancing the debts of the Bund and Länder. This general prohibition has four exceptions. Firstly, according to the second federal reform the federal budget is considered as balanced even if there is a structural deficit of 0.35 % of annual GDP growth. Furthermore the maximum amount of debts Bund and Länder are 0.5 % of annual GDP growth, leaving the possibility for all Länder to take up debts for 0.15 % of annual GDP growth. The second exception pays attention to the cyclical nature of economic development. In times of economic recession tax revenue decreases and higher national debts are necessary to stimulate the economy. If the economy is booming again, these debts must be cleared in a limited period of time. To this end a new stability council (Stabilitätsrat) was set up consisting of the ministers of Bund and Länder for finance and the federal minister for economic affairs. The same persons already form the financial planning council (Finanzplanungsrat), but this institution proved to be without any impact on budgetary behaviour in the past. The new stability council acts as a guardian for the budgets and evaluates federal and Länder budgets according to financial indices which should lead to create pressure of the public to avoid debts, although neither of the two councils may take binding decisions. For determining the economic cycle a position of economic normality will be determined referring to macro-economic indicators. Based on this determined position of normality, it will be decided whether the Bund or a Land faces a recession or if the economy is booming. Depending on this evaluation the council considers whether new debts can be made, or if old debts must be paid back. Thirdly the debt regulations do not apply in cases of emergency or, fourthly, in cases of crisis over which the state does not have control. Despite the four exceptions, the general prohibition of debts is supposed to result in



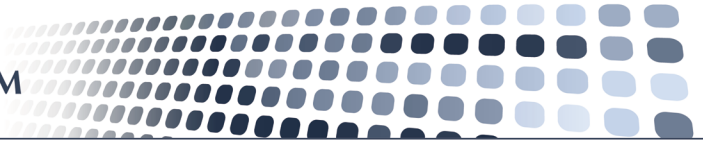
balanced budgets by 2020 at the latest for the Länder and by 2016 for the Bund. For some Länder this task is particularly difficult.

Until 2020 Bremen, Schleswig-Holstein, Saarland, Sachsen-Anhalt and Berlin will receive a consolidation assistance totalling 7.2 billion € for the consolidation of their budgets but only under the condition that their budgets will be balanced by 2020 at the latest and that they cooperate with the newly established stability council. In addition to the reforms of national debt regulations the second stage of federal reforms included administrative issues such as public IT cooperation, benchmarking, motorway provisions and a national cancer registry.

The results of the financial reform were largely as the federal minister of finance had outlined in his position papers (Kdrs.98; Kdrs.96 2008)^{II}, although these papers had not considered the question of the 7,2 billion € designated to help struggling Länder. At the end of the negotiations both Bund and Länder agreed they will pay half of the total amount each of the consolidation assistance, with an exemption for those Länder benefitting from the assistance. For Länder that had benefitted from the LFA this was particularly taxing as it meant that they would now have to pay towards the five poorest Länder so that these Länder can consolidate their budgets (Oettinger 2009).

In this second round of federal reform, the “grand coalition” of SPD and CDU/CSU had the chance to show that they could address substantive problems. In Western Germany a grand coalition at the federal level had governed only once before, from 1966-1969, and had so far been associated on the one hand with large constitutional change, but change achieved by back door compromises neglecting the interests of the voter.

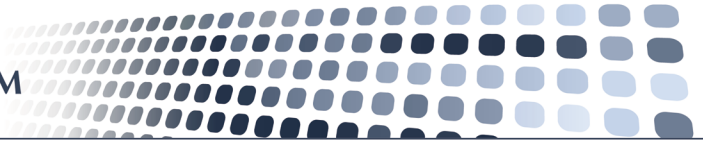
In 2005 the second grand coalition at the federal level seemed to have particularly low legitimacy because its two participants, the CDU/CSU and the SPD, achieved notably poor election results compared with their previous performance in general elections. It was a preliminary success of the grand coalition that the second federal commission presented an outcome and did not declare failure of negotiations. The first stage of reforms had been revitalized through the grand coalition of 2005. A failed second federal commission would have increased voters distrust in the entire political elite and facilitated the rise of populist parties. For the Bund and for the chairs of the second federal commission, Günther Oettinger (CDU) and Peter Struck (SPD), any outcome was better than nothing. It was in



the personal interests of both leaders that the commission did not fail and could present a text before the general elections in 2009. For Struck (SPD) this commission was the last political project of his career and he did not want to retire with a failed federal reform. The second federal commission provided an opportunity for Oettinger (CDU) to overcome isolation in his party and to underpin his political ambitions in the Bund (DPA 2007).

The ideal outcome for the Bund and commission chairs was a federal reform that would avoid further state debts for Bund and Länder. The second best outcome for the Bund and the chairs was merely debt limits for the Bund only. Consent of Länder governments would have been necessary in both cases. From a legal point of view the Bund needed the Länder for introducing debt limits in the constitution, because changing the constitution requires a 2/3 majority in Bundesrat. But Länder did not need the Bund for reforming their debt regulations in their Länder constitutions.

In the event, Bund and commission chairs pursued their prime interest of establishing debt limits for Bund and Länder. The federal government was supported by governmental parties, because governmental parties assigned two delegates in the reform commission from the federal government. This institutional entanglement improved the position of Bund vis-à-vis Länder. The four members of opposition parties were not able to formulate an alternative policy position at the federal level. These four commission members belonged to three different parties with heterogeneous positions on debt limits, which made alternative policy formulation rather difficult. The FDP favoured a liberal conception of federalism with competing Länder instead of a strong federal regime, as did the LINKE. Hence the FDP position as laid down in position papers contained a certain degree of tax autonomy for Länder with enhanced possibilities to deviate from federal legislation (Kdrs.94, Kdrs. 116 2008). The FDP also argued that the possibility for Länder to unite should be made easier. Throughout the last decades constitutional reforms made the possibility for Länder to unite very difficult. The process foresees a complex mechanism in Article 29 of the Grundgesetz of a combination of a legislative process with referenda with a high quorum. The FDP suggested either reducing the necessary quorum for referenda or through agreement between the Länder at stake (Kdrs.119 2009). The LINKE, on the other hand, supported the status quo (Kdrs.47 2007). At best for the LINKE debts should be cleared by selling gold reserves (Kdrs.139 2008) but under no circumstances should debt limits be included in the constitution (Kdrs.150 2008). In



agreement with all other parties except the LINKE the GREENS also favoured debt limits. But the party recognized that by introducing debt limits the Länder would lose a source of revenue. If debt limits were to be set up the Länder would have to get other sources of revenue. Therefore Länder should get the right, argued the GREENS, to raise overhead taxes (Kdrs.95 2007).

Positions of key political parties show that debt limit is far more than merely a technical question. Whether a state should be able to make debts for public spending or whether the state should not be allowed to make debts is at the centre of party political ideology.

While left wing political ideology argues that the state has to intervene to ensure equality, right wing ideology emphasises that individuals should act free from state interventions. State debts become important when state interventions must be financed and raising taxes is politically too costly. Hence the discussion of debt limits in the commission was influenced by general conceptions of state-economy relations. The small parties had a particularly clear cut ideological conception regarding debt limits. These were the FDP and the LINKE. The SPD and CDU, CSU position was mixed with the SPD tending towards the left, the CDU and CSU more towards the right.

The financial crisis in autumn 2008 brought about the paradoxical situation wherein even economic right-wing parties launched economic stimulus packages due to economic problems of certain Länder. Such measures should fight the recession that followed the financial crisis. The crises developed at the moment when the commission was supposed to present its final results, in autumn 2008. The commission session scheduled for October 2008 was cancelled and the negotiations stagnated until spring 2009. Some leftist Länder declared the commission a failure because under the condition of a financial crisis it would be irresponsible to limit a state's capacity to act by constitutionally prohibiting state debts (Funk, Höll 2008). In January 2009 the coalition committee of Bund decided to set up the second economic stimulus package (Konjunkturpaket II) causing even more state debts after setting up a bail-out for banks. CDU/CSU and FDP dominated Länder followed the national example by announcing their own economic stimulus packages (Soldt 2008). CDU members of the budget committee in Bundestag tied their consent to a second Bund stimulus package to the introduction of debt limits in the constitution (STEB 2009). The first commission session since summer 2008 took place in February 2009 and dealt with



questions of how to proceed with the introduction of debt limits and bringing about the above mentioned compromise. The situation became more complicated than before, because Länder elections in the intervening period had reinforced CDU/CSU and FDP representation in regional government. Those parties are usually opposed to economic stimulus packages, but saw no alternative to launching them because of the financial crisis

Table 2
Bundesrat distribution of votes.

Time	Bund <> Länder (Governments of SPD-LINKE, SPD-GREENS, CDU-GREENS)	Governments with CDU, CSU-FDP	Bund = Länder (Governments of SPD, CDU and CSU)
11/06-06/07	4	18	47
06/07-05/08	7	18	44
05/08-10/08	10	18	41
10/08-01/09	10	24	35
01/09-07/09	10	29	30

(Sources: Own Calculations)

Finally, elections in Länder caused divided government meaning that state organs are dominated by different political parties at a time when the results of negotiations had to be ratified. Länder governments were not only opposed to the federal government, but were also not in favour of state interventions through economic stimulus packages. The world wide recession forced Governments also in the Länder to drop their political aim of balanced budgets and to set up economic stimulus packages. Of course this led to a higher state indebtedness. CDU/CSU and FDP governments in particular criticised state indebtedness most. This gave rise to the paradox that the most determined critics caused highest increase of state indebtedness. Out of strategic calculations CDU/CSU and FDP supported the reform of the federal structure in a way that was perceived more restrictive regarding state debt regulations, even if the regulation would only apply for the Bund. That meant CDU/CSU and FDP could not achieve their so far proclaimed political goal of balanced budgets, but replaced this goal with the new proposed debt prohibition.

Until February 2009 the situation for weaker Länder was strategically good, because the Bund needed their consent even if debt rules would not apply for Länder. But in the first session of the federal commission after the financial crisis in February 2009 the stronger Länder were widely dominated by CDU/CSU and FDP coalitions, who doubted



the use of the planned new debt rules, if they were only valid for the Bund. Hence strong Länder and foremost the Bavarian CSU made clear that the envisaged new debt rules should apply for both Bund and Länder. If it did not apply to both they would reject a proposed reform.

In face of this package deal of the stronger Länder, weaker Länder were forced to choose between the lesser of two evils: Either they could reject a federal reform for Bund and Länder that would force them to balance their budget by 2020. Or they could reject the entire reform against the will of the Bund and stronger Länder. In this case open conflict among Länder would have arisen, which would have put in question the legitimacy of the German federal structure.

4. Ratification of the Results

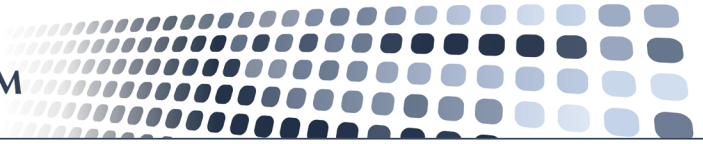
The second federal commission could not entirely unify Länder positions on debts limits. That resulted in vote abstention of the Länder Berlin and Schleswig Holstein; although both benefit from the consolidation assistance included in the second stage of federal reforms.

Abstention has the same effect as a rejection, because the absolute majority of votes are required to pass legislation. Mecklenburg Vorpommern rejected the financial reforms. Its criticism is that it has significant structural problems, with the highest unemployment rate among German Länder, and nevertheless has to pay for the consolidation assistance for other Länder as well (Pergande 2009). Länder that have so far considered themselves as poor now have to contribute to the reduction of new indebtedness of the five poorest Länder.

Table 3
Bundesrat distribution of votes.

Time	Bund <> Länder (Governments of SPD-LINKE, SPD-GREENS, CDU-GREENS)	Governments of CDU, CSU-FDP	Bund = Länder (Governments of SPD, CDU and CSU)
07/09-08/09	10	29	30

(Sources: Own Calculations)



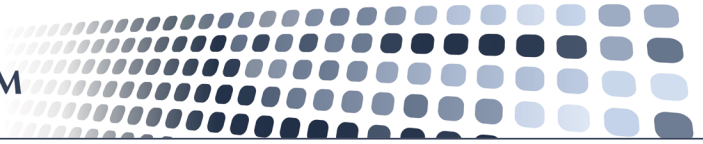
Since elections in Bremen on 13 May 2007 the parties of the federal Government had lost their qualified majority in the Bundesrat. Since the elections in Hessen on 18 January 2009, governmental parties have not had a majority in the Bundesrat because the former absolute majority of CDU had been replaced by a coalition of CDU and FDP. Just as during agenda setting between May and November 2006 the FDP could in 2009 influence Bundesrat decisions through its participation in coalition governments in six Länder.

This meant that FDP was not only a pivotal player during agenda setting but also during ratification of the reforms in the Bundesrat. The ideological aspect of debt limits was close to FDP conceptions of economic policies, which are sympathetic to limiting state interventions in the market.

For some weaker Länder the consolidation assistance provided incentives for consent to the reform. Government parties held 30 votes in Bundesrat and with 29 votes of Länder with FDP government, the 2/3 majority of 59 votes was achieved for ratifying the reform. But Bundestag consent was necessary too. The reform was introduced into the legislative process in May 2009. Surprisingly the FDP group in the Bundestag did not vote for the second stage of federal reforms even though their colleagues in the Länder governments were in favour. Whereas the FDP held a powerful position in Bundesrat this was not the case in the Bundestag. In the Bundestag the “grand coalition” held a comfortable 2/3 majority of her own, without the need for any other party’s consent.

5. Conclusion

The paper explained how the commission of Bundestag and Bundesrat was established and how the issue of debt limits came on the agenda. Since the Bund wanted to pass legislation quickly it depended on the consent of governments with FDP participation in the Bundesrat. The FDP only agreed to the reform on the condition that a second bicameral commission would be set up dealing with fiscal federalism. The task was to reform the financial relationship between Bund and Länder, so that Länder should be placed in a better situation to carry out their constitutional obligations.

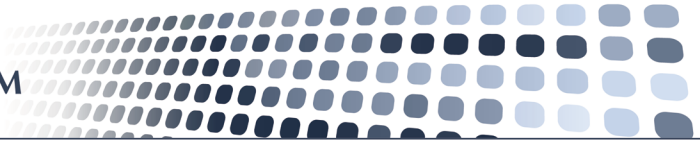


When the second commission began its work, the provisions of LFA had been agreed upon recently, which meant that this subject was off the agenda. With the new territorial organization of Länder the issue of tax autonomy and regulations regarding state limits were a natural focus of discussion. During the negotiations of the commission the financial crisis hit Germany and was followed by a recession. As an answer to the crises the Bund and right-wing Länder governments launched economic stimulus packages resulting in the highest annual rise of state indebtedness in recent German history. Those right-wing governments that had previously criticised state indebtedness most before the financial crises were responsible for increasing state debts. This did not prevent those governments from arguing that, to support balanced budgets Bund and Länder must not in future take up state debts and instead should cooperate with a newly established stability council consisting of Bund and Länder governments.

From the case of the second stage of federal reforms in Germany it can be seen that the issue of debt limits has been agreed upon as a package deal between political parties and between Bund and Länder. In the first step the negotiations consisted of a proposal of the federal government supported by CDU/CSU and SPD as the major parties holding the qualified majority in the Bundestag. Elections brought the FDP in a stronger position, and against the backdrop of the financial crisis stronger Länder also doubted the usefulness of debt brakes applying only to the Bund. Therefore stronger Länder forced weaker Länder either to accept the new debt brakes -chaining them to balanced budgets until 2020 or to be responsible for a failed reform. In this situation weaker Länder saw the new constitutional debt regime as the lesser of two evils and agreed to the reform.

¹ The research presented here was conducted within a research project funded by the German Research Foundation (GRF), see <http://www.constitutional-change.de>. Earlier versions of the paper were presented at conference of the European Consortium for Political Research, the German Studies Association and the Political Studies Association. Thanks to two anonymous reviewers, Nathalie Behnke, Arthur Benz, Jörg Broschek, Andrea Fischer, Bettina Helbig, Henrik Scheller and Christina Zimmer. Mistakes remain mine.

¹¹The abbreviation Kdrs. means printed matter of the second federal commission (Kommissionsdrucksache).



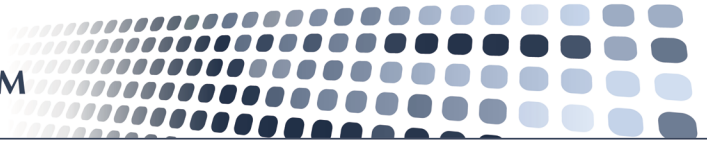
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