

UNIFICATION, RECONSTRUCTION AND FEDERALIST REFORM IN GERMANY

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Today, German reunification is a historical truth. The consequences of this unique event, that instantaneous unification of two states with completely different developments, are almost exclusively perceived for eastern Germany, for the “new” states. That is why the issue of “eastern reconstruction” has largely disappeared from supra-regional debates in the Federal Republic. Yet, it remains the central issue of the country’s future. This future will not be determined by military and only to a small extent by transatlantic relations: Germany’s self-assertion, its identification with its social and cultural traditions and their importance in Europe and in the world, will have to be economically sound or not be at all. An economically weak Germany would also quickly lose its cultural position in Europe and the world and would thus be taken in tow by other powers in its own German-speaking area with its social structures and finally also with its political potential.

The consequences of unification, however, are, in a dramatic way, putting the country’s economic strength at risk. Last May, the European Commission, in a comprehensive report on the state of the German economy, came to the well founded conclusion that up to two thirds of the economic weakness of the present Federal Republic could be traced to the consequences of unification; another reason given for the condition of the German economy was the convergence dynamics following the introduction of the euro, because Germany’s traditional price stability could no longer benefit the national currency as a revaluation potential and Germany therefore had to cope with relatively high real interest rates within the euro area. Finally, and note should be taken of this assessment of the Commission: West Germany had not lost any of its former high com-

petitiveness (data base 2001). Further: Germany would only overcome its economic weakness if it succeeded in containing the follow-up costs of unification.

In a similar vein, the German Council of Economic Experts made this assessment in its 2004 Annual Report: An “essential” or a “substantial” cause of Germany’s economic weakness is to be found in the consequences of unification.

This assessment of the state of the German economy is a far cry from the tenor of the intra-German and international debate regarding the causes of German stagnation: stalled reforms take centre stage there. The Commission Report does not fit the tenor of this debate, in which – as mentioned – “eastern reconstruction” and the consequences of unification are in fact no longer an issue. But the Commission and the Council of Experts base their assessments on unquestionable and public data used in German discussions: The “new” states, which account for one third of the total area of unified Germany, host around one fifth of the German population, but produce only about one tenth of German gross domestic product and only about one twentieth of German exports. At the same time, unemployment in the eastern states, corrected for job creating measures and the like, amounts to more than 20 percent. This high level exists despite the fact that 600,000 to one million citizens, mostly young people, have migrated to work in the “old” states, another 40,000 per year “are moving west”, and, in addition, around 400,000 people commute to work daily from the “new” to the “old” states, not counting the long-term commuters.

Even this, very disquieting, situation of the eastern states is politically and socially stable only because west Germany transfers between 80 and 90 billion euros p.a., or around 4 percent of its national income, to the eastern states – in various ways, direct and indirect – and thus finances a substantial part of the east German economy and its jobs, for example in

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Unification is one of the causes of weak economic activity in Germany

retailing, the crafts, etc. About one third of east German national income depends on these transfers. An annual drain of 4 percent of west German gross domestic product since 1990 could not and cannot leave its performance unaffected. Since 1990, every single west German (including the unemployed and the little children) has worked for almost one year exclusively for “eastern reconstruction“. Today, the west is feeling more and more painfully the long-term withdrawal of financial resources. Universities, schools, transport systems, hospitals, cultural institutions: the greater scarcity of financial resources can be noticed everywhere. Those, however, who – at times even maliciously – point at united Germany as the laggard or the country that is bottom of the league, should consider what the “old” Germany might look like today if the level of the public debt of about 40 percent of GDP until 1989 (today: 69 percent) had been maintained and if the funds of the eastern transfers had not been “invested” in the ramshackle east German infrastructure, in eastern health services, pensions and unemployment benefits, but in the expansion and renovation of the “old” Federal Republic. To be sure, the west would still have problems today like any other industrial country. But this “old” and still competitive west Germany would certainly not be the economic laggard.

Direct and indirect transfers from west Germany finance eastern reconstruction

Eastern reconstruction has *also* been financed via “non-insurance” benefits of the social security systems. The German Council of Economic Experts (2004) estimated that for this reason the non-wage costs in west Germany are about four percentage points (i.e. 42 percent instead of 38 percent) higher today than would have been expected; IAB (Institute for Labour Market and Occupational Research) estimates even say five to seven percentage points! Example: According to IAB, from 1992 to 2002, the east German labour offices had deficits totalling around 167 billion euros that had to be offset by west German surpluses of unemployment insurance contributions of about 111 billion euros and other tax subsidies.

The high level of east German unemployment could initially be contained by investment (in construction) and transition measures. The “high” present level of unemployment in Germany also hides an admirable achievement, however: In 1989, the “old” Republic had a labour force of 29.7 million people; today’s Federal Republic has a labour force of 43.8 million! No other country has experienced such an increase. The number of gainfully employed also rose from

27.7 million (west Germany, 1989) to around 39 million (2005). Since the “new” states failed to bring along “customers”, especially foreign customers, for their products that were unattractive in open markets this achievement is also remarkable.

In view of the political necessity to organise Germany, which no longer had any domestic borders and despite the massive differences in economic output, as *one* bigger country now, the challenge for economic policy presented by unification was tremendous from the beginning. Today, nobody denies that many things could and should have been done differently. But today, “money” is no longer an answer. In 2019, Solidarity Pact II will not be followed by a Solidarity Pact III; shifting the unification costs, for example via the value added tax, will also affect eastern Germany. Other instruments with other dimensions must therefore be found.

Especially critical from the beginning was the sweeping adoption of the west German regulatory system. On the one hand, it was certainly essential to create clear legal conditions as soon as possible. But it should have been evident early on that the “old” Federal Republic would not have been able to develop successfully in the 1950s and 1960s under the tight regulations of the 1990s. Günther Krause, former Federal Minister of Transportation and a former GDR citizen, at least created easier planning conditions for construction; in fact, the Investment Acceleration Law remains the only regulatory advantage of east Germany, today.

Especially negative for the east was the adoption of numerous labour market regulations. Parity with the west would not have been “just” here: Any equalisation of competitive conditions has always particularly negative effects on those who must still cope with existing structural disadvantages. The “unjust” consequence of “parity” in the east, demanded primarily by the unions, was persistently high future east German unemployment. Is working longer hours in the east “unjust”? Have you ever heard of a young tennis player who considered it “unjust” having to train more every day than today’s number one seed on the tennis courts of the world?

It was not only a “mistake”, it was “unjust” vis-à-vis the people of east Germany to demand (as is still done by some politicians today) a general alignment of wages and regulations with those of west Germany before east Germany had at least caught up

with west German competitiveness. After all, the adoption of similar regulatory systems is primarily of advantage to the stronger competitors: It was they – especially western dominated unions – who consciously pushed the process of aligning wages and regulatory systems much too fast and too far out of fear of eastern low-wage competition.

Serious mistakes were made here, which are still waiting to be corrected today and quickly so. East Germany only has *one* more chance to catch up: states and local communities must be able to act more flexibly there, become more cost-effective, more imaginative and entrepreneurial than in western Germany. Today the “new” states urgently need a wider legal scope. That is why a fundamental reform of federalism is also in their interest.

But substantial mentality hurdles stand in the way of reform. In March 2005, the *Frankfurter Allgemeine Zeitung* posted the following headline: “Constitutional judges: Germans suffer from an equality syndrome.” The text reported on an interview with Udo Steiner, a Federal constitutional judge responsible for social law, who certified Germans to having a “mentality problem”: Germans are nearly “equality sick”. The newspaper further cited from the interview: “In this country, if somebody else owns more than oneself, it suggests wrongdoing; inequality is not taken as an incentive.”

Shortly before, the Federal Government had presented the report on “Living Conditions in Germany – Second Poverty and Wealth Report”, which says on the one hand that “Germany belongs to those EU countries with the lowest poverty risk ratios ...”, but on the other hand it attests “a trend ... toward increasing inequality”. And we know: introducing college fees; deductibles regarding health risks and parts of old age insurance; pension cutbacks, etc. are likely to cause additional inequalities in Germany. We also know, however, that there are massive regional differences in employment, income, and prosperity between east and west Germany; but also, for example, between the urbanised Ruhr area and areas like Frankfurt, Munich, Hamburg and Stuttgart. Migration from east to west and north to south suggests further disadvantages for the depopulating regions.

Where regional differences are so spectacular there are always two possibilities: convergence via financial transfers or convergence essentially via the exploitation of advantages achieved competitively.

The Federal Republic of Germany, as a federally organised state, is an exception among the countries of the European Union.

Federalism is said to be a German tradition. Germany’s historical tradition, however, was rather that of a loose network of authoritarian, German speaking states, i.e. of small states with centralised administrations. In the small German states, government was always very close to the people, it was a paternalistic top-down relationship. Only the citizens of cities and local communities had some autonomy, in particular following Stein’s community reforms at the beginning of the 19th century.

Historically, German “federalism” thus had a very different origin than that of the United States or Switzerland. In those countries, the people had created small entities that later grew together. The people of these member states then closely watched over their freedoms, responsibilities and rights. In Germany, however, kingdoms and principalities were simply united in a national federal state in 1871, a federal state that cared little about strengthening the democratic grass roots or to promote policies in the member states that were responsive to the needs of the people.

The purpose of federalism, however, is to anchor people’s rights of self-determination as close to the grass roots as possible: The people are to be entrusted with the implementation of their freedoms at the regional level, for which they must also assume responsibility, however. Regional differences as the result of regional freedoms and the consequences for regional responsibilities are characteristic of true federalism.

People’s freedom and responsibility for their region are also the only justification for a federalist state. For the remainder, federalism has only disadvantages: it is more expensive and slower than centralised state solutions; it usually results in provincial elites and can cause a fatal inclination to be bound up in oneself, to global short-sightedness and petty bourgeois behaviour. The only advantage that federalism has to offer – but this is a decisive advantage – is closeness to the people and people’s own responsibility. They permit the federal state to pursue policies that are characterised by people’s understanding and pragmatism, and in this way permit regional competition for ideas, followed by the observation of the results of different policy approaches in the fed-

Regional competition instead of transfers, differences instead of equalisation should be the freedoms granted by federalism

eral states and thus continuing learning from these different results. This means: federalism is always competitive federalism. The freedom implied by federalism is necessarily the freedom to have differences between the states in the federal nation. Without this freedom to compete, federalism is nothing but a hindrance.

Today, a structurally most differentiated, growing global competition undermines the fixed national regulatory systems of the economic and social German state. This demands very different and often very rapid reactions by firms and regions. Laws with too much attention to policy similarity will then turn out to be less and less able to meet the spontaneous, often unpredictable challenges of this global multifaceted competition. Where regional, or also national, flexible adjustments to new conditions are required, German politics and businesses run up against a dense network of country-wide laws and regulations, frequently supplemented by state rules that are defended nail and tooth by barricaded interests. Necessary changes fail at least just as frequently because of the complicated decision-making process between the federal government and the states; because of the partisan conflicts between the upper and lower houses of parliament (Bundesrat and Bundestag). And instead of meeting present and future challenges with a positive outlook on life, with imagination and the forces of competition, the people, sullenly and resigned, shift their responsibilities to the federal level which in turn cannot by itself and without strong support of the states bring about change.

In the final analysis, it is different policies with different results that constitute the only chance for more “equivalent living conditions” across the nation, and thus also for “eastern reconstruction”. Existing regional inequalities will, if at all, only be made to converge by employing different policy approaches at the regional level. It may sound paradoxical, but we need more policy differentiation in order to suffer fewer inequalities across the Republic. Given regionally differentiated starting positions, we can only achieve regionally “equivalent” results by granting more freedoms at the regional level.

If Germany’s constitutional structure is to be utilised productively at all, the states must be able to follow different avenues in many details within the framework of a more loose-knit federal system: live feder-

alism is Germany’s only hope in global competition. And this federalism will then also be suited to Europe. For it is hoped that the European Union itself will finally understand that variety is Europe’s strength and that for this reason subsidiarity and European differences must be the basic principles. In such a Europe, new regional networks will come into existence anyway that will not respect the old national borders.

Federalism reform in Germany is thus the “mother of all reforms”. Today, eleven of the sixteen states are recipients of fiscal equalisation funds: all six “new” states as well as Schleswig-Holstein, Lower Saxony, Rhineland-Palatinate, the Saarland und the city state of Bremen. At present, their different financial strengths are largely and comfortably levelled by fiscal equalisation. This means, however, that the financially weak states have hardly any incentive to be financially responsible. Leaving them to such a fate would not work for the sole reason that there are common country-wide social standards (remember the Poverty Report) that at present must be met by social transfers.

In view of these fundamental regional differences, would it be possible to utilise German federal structures more productively?

Indisputably, it is the very economic gap between eastern and western Germany that makes different measures necessary to close this gap. Let’s take the unions’ demand of “equal wage for equal work in the public sector in east and west”. This seemingly plausible sentence is more than problematic; the result would of course be highly unfair. For one thing, this principle applies nowhere in the private sector, not even in the west. After all, the level of real wages depends on productivity and the competitiveness of each individual firm. In the east, however, limiting the demand “for equal wages” to the public sector would result in the greatest inequality of all: for wages in the eastern business sector are substantially lower than in the west for competitive reasons (in manufacturing they are presently at 75 percent of the western level). A general solution of “equal wage for equal work” in the public sector at the western level would thus lead to an unbearable gap between the incomes in the east German administration on the one hand and the factories of the “new” states on the other. In order to catch up with the west in the long run, to offset today’s inequalities, the east German states would have to be able to determine

Regionally undifferentiated over-regulation stands in the way of flexible adjustment

their wage and income structures themselves within given limits and to set them substantially more flexibly, and that means mostly lower than in the west. And – furthermore – they would also have to tolerate greater differences between firms in different competitive positions.

Beyond this it would be helpful if German regulatory systems offered more regional differences. This is also demanded by the prime ministers of the east German states, who then shy away from the necessarily resulting financial consequences, however. And their colleagues in the west fear unilateral “deregulation competition” in case of deregulation advantages in the east. Therefore: Why not have more freedoms for all 16 states?

This will be opposed by the east, especially regarding the important consequence, i.e. the need to combine this with more tax responsibilities of the states, e.g. with surcharges and deductions on wage and income taxes. To be sure, in view of the commuter movements across state lines, this would require a revision of the presently unilateral assignment of wage and income taxes to the places of residence. Thus, it is a most complicated task.

If a levelling of the existing regional inequalities is truly to be furthered, a reform strategy would have to be chosen that entails more regionally based responsibilities. It would have to permit regionally differentiated social policy instruments. This means that, on the one hand, the states would have to be subject to clear long-term quantitative limits regarding the amount of needed social transfers, on the other hand, they would initially have to be granted the funds to comply within their own responsibility in this sector, and do so with their own administrations. Denmark and states in the United States could be models. In the United States, for example, important parts of the design of the welfare system (under President Clinton) combined with lump-sum revenue transfers were left to the states. In Germany, too, differentiated – over time degressive – cost ratios per inhabitant could be calculated for the states on which lump-sum financial transfers could be based, whose use would no longer be subject to a rigid, country-wide distribution system. Their total amount would not be allowed to be supplemented. There would no longer be “additional funds” – as presently demanded by Bremen and the Saarland. “Budget crisis” would have to be redefined.

It could then be left to the decision of the states to employ excess funds elsewhere (e.g. in investment), which would constitute a marked incentive for successful regional labour market and social policies. The success of option models in the present implementation of the rules of unemployment compensation, i.e. shifting the task to the local communities, confirms my optimism. For the United States, this solution was obvious because US states conceive their federalist task as their own responsibility and because they have utilised their regional sovereignty most successfully in economic terms, too, as impressively described by Fosler in *The new role of the American states*.

Would Germany, the federal state, then become a confederation of states, as feared by some in Berlin? Not so, if it were at last carefully determined what is truly essential at the central level to guarantee internal cohesion and the ability to act externally. But the anxiousness is regrettable with which attention is focused on the very theoretical question of “federal state or confederation”, instead of directing it at the positive consequences of greater freedom. It is a problem of mentality. Here, too, we say: More courage, Germany! Mistakes can usually be more easily corrected than omissions can be made up. More federalism is the most urgent demand of the day.

More federalism patterned after the U.S. would provide for more regional policy differentiation to reduce inequalities