The economic crisis in Europe has triggered a great deal of political tensions and reforms in many governments. Unsurprisingly, federal governments experienced particular conflicts due to the need to coordinate crisis management and redistribute resources among government. The pressure to respond to the economic, social and fiscal consequences created a critical juncture, a situation where constraining effects of structures weaken. It is however an open question whether governments use this opportunity to change path dependent development.

In Germany, the shock of the crisis came at a time when federal and Länder governments still tried to adjust federalism to the challenges of German Unification and European integration. The federal government responded to the crisis as member of the Eurozone where it advanced measures to stabilize the Euro. With its relatively comfortable fiscal capacities despite the crisis, it had more room for maneuver than governments in other member states. Thus German federalism provides an excellent case for studying reform and adaptation under intense pressure.

Based on the framework of a “dynamic institutionalism” (Benz and Broschek 2013) and comparative historical analysis, the paper examines the effects of economic crisis on continuity and change in federalism. Although the financial crisis intensified tension within the territorial cleavage which arose since Unification, the critical juncture was not conducive to undertaking extensive reforms. As we will demonstrate, the structure of the federal system persisted and, as things stand, fiscal federalism has hardly changed. Thus, institutional rigidity seems to prevail despite both pressures of the crisis. Accordingly, the case study sheds light on the complex interplay of path-dependence of institutions, society-driven change and institutional policy in federal systems.
1. Introduction

The financial crisis commencing in 2007, which rapidly spread from primarily the U.S. to a great recession of a global scale, has wrought numerous harsh effects in Europe as well. What initiated as a crisis in mainly the banking sector progressed in short time to drastic sovereign debt crises and large-scale economic recessions affecting, virtually all member states of the European Union. The reactions to the crisis witnessed a host of measures from bailouts to stimulus packages, though with mixed results, also with regard to any long-term effects on governmental scope of powers (Parrado 2012). Moreover, in the immediate wake of the bailouts and liquidity injection efforts followed a series of regulatory reforms, but also austerity measures, which would soon be imposed on a number of economies, not least in the Eurozone. Consequently, these developments have triggered intense political contestation concerning not only the policies themselves, but also in some cases, the proper institutional framework of governance. For a number of reasons, it can furthermore be expected that these tensions come to the forefront especially in federal systems.

Precisely because of the division of powers principally inherent to federations, responses and reactions to economic crises can prove particularly thorny (Braun, Ruiz-Palermo and Schnabel 2017). For instance, reactions to severe national economic problems require concerted efforts at national and regional levels. The impacts of financial crisis on federalism thus typically involve a comparatively more complex coordination of fiscal policies at national level as well as between constituent state levels. Furthermore, as the case may be, budget crises and the bailout of indebted regions pose more likely challenges, especially when asymmetries become exacerbated by fiscal and otherwise economic disruptions and may raise specifically jurisdictional issues. Furthermore, federalism can be affected changing conflicts inside society reflected in the party system or increasing conflicts between territories due to fiscal imbalances, which may also lead to a revival of regionalism (Anderson 2004: 5-9). These sorts of conflicts
can unfold fissiparous effects, again especially in federations or federalizing countries where centrifugal tensions may already be at work.

At the same time, crises in general can offer an opportunity for institutional change, for various reasons as well. For one, they can shed light on suboptimal or dysfunctional features of institutional structures and legal frameworks previously undetected, overlooked or underestimated, which has been clearly evident in the context of the recent Euro-crisis (see e.g. Crum 2013; Enderlein and Verdun 2009). On the other hand, such situations can likewise offer favourable conditions for reform ‘entrepreneurs’ who have failed previously, e.g. during times of stability, to assert extensive institutional reforms. Thus, in federal systems in particular, which are fundamentally characterized by, among others, a complex interplay of state-society relations and dynamics of change and continuity interlinked with the division of authority (see e.g. Benz 2013), responses to economic crises may coincide with or become attached to attempts to modify the political order in general. In short, crises situations in federations demonstrate a greater inclination for turning contestation of policy into contestation of polity. Indeed, coping with tensions between achievement of some degree of fiscal equity and the inevitable imbalances in resources and economic capacities represent one of the most fundamental challenges confronting federal systems in general (see e.g. Buchanan 1950; Watts 1998).

Theoretically speaking, the fiscal crisis constitutes a critical juncture in the evolution of federal systems. However, the existence of a juncture does not necessarily lead actors to change a previous course of actions or institutions. In this situation, there is an opportunity for change, but whether change really occurs depends on additional conditions. Critical junctures are embedded in a historical evolution of institutions and practices and they affect how actors respond to pressure or opportunities for change. Therefore, in order to explain the impact of the
crisis on federal systems, we have to consider the interplay of those conditions and mechanisms causing continuity and those triggering change.

It is against this background that Germany presents an especially interesting case of study. As a member of the Eurozone, the federal government has had to deal with numerous issues related to the financial and economic crisis, though this has also entailed a momentous enhancement of its political weight in the EU (see e.g. Bulmer and Paterson 2013). Moreover, in contrast to many of the EU countries which are struggling in the wake of the crisis, Germany has been in a relatively comfortable economic position, in many ways even gaining from the crisis. This has occurred for instance due to low interest rates on public debts, improved investment status on German bonds, and a decrease in value of the European currency, which has boosted the highly export-oriented German economy (Hall 2012; von Hagen, Schuknecht and Wolswijk 2011; Young and Semmler 2011). For these reasons, German government not only felt the pressure for change, it also benefitted from conditions facilitating a reform of the federal constitution. It thus can be considered as a most likely case in a comparative study of the effects of critical junctures.

In the following section, we present our theoretical framework which combines the concepts of critical junctures and dynamic institutionalism (Benz and Broschek 2013). On this basis, the paper discusses the effects of economic crisis on territorial dynamics. Following a society-centred approach to federalism, we should expect these developments have repercussions on the relations between levels of governments and between regions. Like in other EU member states (see e.g. Colino, Molina and Hombrado 2014), the crisis triggered debates about the redistributive effects of fiscal arrangements between subnational units (in Germany the Länder and local governments). Accordingly, they should have driven institutional reform in German federalism designed to re-establish a federal balance. This may be expected all the more so when considering the large discrepancies in the budget situations
among the Länder, many with enormous public debts. However, as we will demonstrate, quite the contrary has occurred. So far, the structure of the federal system has persisted and, as things stand, fiscal federalism has hardly changed. Thus, institutional rigidity more than rapid change has seemed to result from the pressure of the crisis. This outcome can be explained by the particular interplay of institutional constraints and economic and societal conditions that surfaced during the crisis, partly as unintended effects, but partly also due to strategic choice of leading actors.

2. Crisis, continuity and change in federal systems: A framework for analysis

A critical juncture is defined as a short period in time in a historical process which opens a window of opportunity to change an evolutionary path. It does so by weakening the constraining effects of institutions (Capoccia and Kelemen 2007: 342), either because they prevent actors to respond to a crisis or because new conditions lead to a change in effective power structures. However, the existing institutions remain in place, although the situation opens room for manoeuvre for actors. The specific conditions for policy-making make the situation critical, which is a juncture not because causes change, but because it enables change. "If an institution enters a critical juncture, in which several options are possible, the outcome may involve the restoration of the pre–critical juncture status quo" (Capoccia and Kelemen 2007: 252).

In order to produce actual change, actors have to alter the pattern of policy-making and usually resort to a new procedures or arenas of politics. In any case it has to turn from implementation in administration to legislation in parliament. If institutions should be changed, procedures of institutional or constitutional amendment have to be set in motion. Change in a critical situation implies an intervention into those mechanisms causing path dependence, and
this intervention is a political process on its own. It is essential to turn “permissive conditions” into “productive conditions” (Soifer 2012: 2).

Permissive conditions arise due to tensions between existing institutions and state-society relations with the latter expressing different aspects of a crisis. Productive conditions relate to patterns policy-making which are available and prove suitable to manage a crisis. They explain the scope of change. As Dietmar Braun and Philipp Trein demonstrated in their comparative study, institutions in federal systems have on the whole revealed “more continuity than change during the economic crisis of 2008 and 2009” (Braun and Trein 2013: 359-360). At the same time, this would not rule out the possibility of the crisis setting in motion different causal mechanisms in a federal system. Whether the one or the other consequence can be observed very much depends on demands from organized interest groups and opposition parties representing those suffering from the crisis. Moreover, the outcome is influenced by the continuity of institutions and of established patterns of policy-making on the one hand and by strategic choices of actors on the other. Critical junctures are not isolated from but embedded in the dynamics of territorial regimes. Hence they need to be included in a framework designed to analyse the stabilizing effects of institutions, but also the driving forces of state-society relations. The fiscal crisis directly affects state-society relations and consequently triggers responses of policy-makers, but their impact on federal structures and politics is far from uniform. This relates to, to no small degree, the character of institutions.

Institutional frameworks as well as individual institutions basically evolve in sequences of historical development, of periods characterized by continuous evolution and, intermittently, events or critical junctures. (Pierson 2004). During this process, collective ideas legitimizing the allocation of power and relations between levels of government emerge, basic rules become entrenched in constitutional law, and patterns of interaction consolidate through repeated collective action in standard operating procedures. Yet the temporal order is decisive in a
sequential development. In federations, different institutional dimensions like the vertical division and sharing of powers, the horizontal structure of and relations between decentralized governments, and forms of governments in the constituent units often evolved in different historical periods. Over time, they combine to a particular federal system marked by more or less intense tensions and providing various mechanisms to maintain a balance of power (Benz 2013; Broschek 2013).

At the same time, societal developments likewise represent a composite factor coinciding with development, transitions and adaptations in federal orders (Erk 2008; Livingston 1956). State-society relations shape federal structures and politics through loyalties of citizens and their identification with national or regional communities. Moreover, this interlinkage bears fundamental relevance for the political structuring of a society in political parties or interest organizations and the places and spaces of action and resources determined by mobility of actors, goods or capital inside and across the boundaries of territorial jurisdictions. Indeed, patterns of behaviour following logics of appropriateness and thus ways of ‘thinking about’ and ‘making sense of’ everyday politics on the part of political and societal actors, which, though not solely determined, evolve within and become influenced by institutional frameworks (March and Olsen: 1989). Accordingly, the structure of a federation influences the evolution of identities, party systems or the patterns of interest intermediation and territorial structures of society enabling or constraining mobility. Conversely, the state depends on general support from communities of citizens, organizational support from parties and associations, and specific support from mobile tax payers. Therefore, the relations between federal structures and societal dynamics have to be perceived as co-evolution which is not determined by unidirectional causality (see e.g. Smiley 1984; Ziblatt 2004).

In times of crisis, the continuity of institutions is confronted with accelerated changes in society. Whether and to what extent state-society dynamics turn into institutional change
depends, in short term, on institutional policy. In federations, it results from processes of inter-institutional coordination between levels of governments and policy-making in different arenas. While the multiple dimensions of division of powers in federations and thus relatively high number of ‘veto players’ can complicate policy making in general and reforms in particular, coordination can nonetheless result via multiple mechanisms and strategies, from communicative processes, negotiations and joint decision-making or mutual adjustment to arena shifting and establishment of parallel institutions (Benz 2016). While even incremental ‘muddling through’ proves to be more complex than mere piece-meal adjustment, and just as likely to have long-term effects (see e.g. Pal 2011), institutional policy in a federation can lead to intended or unintended change of federal institutions. This occurs through a re-interpretation of ideas and norms, through institutional reform, i.e. the deliberate change of formal rules according to prescribed decision procedures, or through implicit change in processes of normal politics and policy-making.

As illustrated in Table 1 depicting our underlying analytical framework, continuity and change of different dimensions are linked in one way or another. Each particular process can constitute a source of change affecting other dimensions with reinforcing effects. At the same time, each of them can also set constraints for dynamics instigated in a certain dimension. In general, institutions as well as ideas – as paradigms, regulative ideas, frames and so forth – and constitutions tend to continuity compared to dynamic state-society relations (see e.g. Baumgartner 2013; Berman 2001; Schmidt 2010). While loyalties to and identities with constituent units and party systems evolve over a longer time span, the mobility of actors or resources across borders in particular as well as economic parameters may fluctuate more intensely and can evoke critical junctures. In times of crisis, loyalties, values and socio-political associations are likewise susceptible to transformations. Consequently, federations are confronted with serious challenges. Both changing loyalties to central, regional or local units
and changing party systems express rising social conflicts and cause tensions between institutions, established patterns of interaction and demands from society. The a-synchronic developments between continuing institutions and societal transformations needs to be reconciled by adapting or reforming institutions or by safeguarding institutions against threatening instability. In crisis situations, it can be expected that re-interpretation and implicit change come to their limits. Yet institutional reforms turn out as more difficult than under ‘normal’ conditions due to uncertainties of future developments and increasing redistributive conflicts.

**Table 1:** Dimensions of continuity and change in federal orders

(adapted from Benz and Broschek 2013: 371)
3. **Institutions: The development of German fiscal federalism**

Economic crises have immediate repercussions on fiscal federalism. Yet the structural-functional arrangement of fiscal affairs between the federal and the constituent unit governments correspond a great deal with the particular character of a federal system. Accordingly, the particular German variant of fiscal federalism can be characterized as an extensive system of joint-decision making, akin to its cooperative federal model in general (see esp. Scharpf, Reissert and Schnabel 1976).

The roots of this type of federalism lie in a particular historical sequence of state building in Germany during the 18th and 19th century, when the old confederation declined and finally was dissolved in 1806. During the same period, Länder governments established state capacities and modernized their administration. The idea of a unified German nation state persisted during this epoch. When the idea became reality under the leadership of Prussia in 1871, societal cleavages of the industrializing society increasingly shaped politics. Although lacking sufficient fiscal powers, the federal government established social security systems. While the welfare state regime was financed outside the decentralized fiscal federalism by contributions of employers and employees, social justice and security became a guiding principle of the German constitution. The aim of equivalent living conditions in all parts of the country was derived from this idea, which became a cornerstone of the constitution of the Federal Republic of Germany. During the 20th century, the federal government extended its powers to raise taxes, while the Länder governments maintained their power to finance public utilities and to provide public services. The resulting fiscal imbalance between the federal and the Länder levels required some form of transfers. However, the Länder governments used their power in legislation on constitutional amendments to avoid dependence on federal grants. They
agreed on a tax sharing system covering the most important tax resources. Moreover, in order to achieve equal standards of public services and living conditions in all areas, they participated in a system of horizontal fiscal equalization. This way, the historical sequence of decentralized state building followed by the centralizing forces of the welfare state led to a mutual fiscal dependence and power sharing of all constituent units of the federation which was managed in a practice of ongoing intergovernmental negotiation and cooperation.

In the Federal Republic, several pertinent revisions to the constitution have on the whole reinforced joint-decision making. Since 1955, fiscal federalism has constituted a “composite” system of revenue sharing in both vertical and horizontal terms (Rothweiler 1972). In line with the principle of federal comity, the federal order of fiscal affairs aims at an approximate equitable distribution of revenue per capita across levels of government as well as a fiscal equalisation scheme to redistribute revenues among the Länder (see e.g. Kropp 2010: 90-123). This system has weathered economic downturns and crises, such as in the 1970s with the ‘oil shock’, without by and large fundamental alterations. Moreover, it has maintained, even after German Unification (1990) and its enormous pressure on public finances, a comparatively high degree of redistributive effects and strong protection for the Länder against asymmetric shocks (Hepp and von Hagen 2012).

Of course, cooperative federalism in Germany and its “financial constitution” has not been without its critiques, and demands for reforms increased especially in the wake of Unification. Yet attempts to shift the system toward competitive federalism have mostly failed, not least on account of the prominent institutional embodiment of joint-decision making, the Bundesrat, which equips the governments of the smaller and poorer Länder with strong co-decision and veto powers in both ordinary legislative and constitutional decision making (see e.g. Adelberger 2001). Indeed, the developments after Unification largely upheld the complex system of vertical and horizontal distribution of revenues, while also introducing an additional
‘Solidarity Tax’ to help finance numerous projects to build up the newer Eastern Länder toward convergence with Western Länder infrastructure and living standards. This has ultimately contributed to strengthening the harmonizing, cooperative character of German federalism in general and fiscal federalism in particular (Benz 1999).

With regard to revenue raising, the Länder in Germany have by comparison with constituent units in other federal systems such as the U.S., Canada and Switzerland limited scope of autonomy (see Egner 2012: 90-120). However, the same applies to the federal government as well. While each level of government has responsibility over a few tax types, the vast amount of tax revenues (e.g. income tax, value-added tax, capital gains tax, corporate tax) are shared. Legislation on these taxes requires the consent of the Bundesrat. As a consequence, the federal government depends on the support of Länder governments for decisions on shared taxes, which made up anywhere between 70 to 75 percent of all tax revenue in Germany for several decades (Conradt and Langenbacher 2013: 314-317). Consequently, with the exception of slight variance among some municipal levies, tax competition plays essentially no role in German federalism (Hepp and von Hagen 2012). At the same time, nearly all taxes in Germany (all shared taxes between Länder and federal levels, as well as Länder and municipal taxes) are collected by Länder authorities, while the federal government administers only a comparatively small tax bureaucracy. This structural-functional disposition of collecting, distributing and administering shared revenues illustrates the principally vertical and horizontal cooperative character of fiscal federalism in Germany.

Beyond the raising and distribution of tax revenues, the German scheme of equalisation payments among the Länder constitutes a key component of the fiscal federal order and the most salient expression of its horizontal dimension. Widely understood, equalisation as redistributive balancing applies as an organizational principle to German fiscal federalism in general, as the allocation of fiscal responsibilities and the complex regulation of proportions of
revenues pursues precisely balance and fair distribution, both in horizontal and vertical perspectives. In a stricter sense of horizontal equalisation, the *Länder* equalisation scheme (*Länderfinanzausgleich*) adds to the distribution of revenue portions to the *Länder*. Without elaborating the rules in detail (for extensive overview, see Renzsch 1991), two basic steps of equalisation need to be mentioned. A share (25%) of the total *Länder* VAT-portion is reserved by the federal government to distribute to *Länder* whose receipts from all revenues are lower than the *Länder* average. The more strictly horizontal equalisation scheme entails redistribution from financially stronger *Länder* to weaker *Länder*, which follows a complex formula (see esp. Art. 10 of the Fiscal Equalisation Law, but also Art. 4 to 9) to determine recipient and contributor *Länder* based on remaining discrepancies (after receiving entitled revenues) between average per capita fiscal capacity and actual per capita fiscal capacity among the *Länder*.1 On top of this, the federal government provides general grants to *Länder* in need. These grants are also determined by the law on fiscal equalization, which was negotiated between federal and *Länder* governments in order to achieve the necessary consent of the Bundesrat.

Given the extensive rules and mechanisms of redistribution, coupled with a strongly limited scope of independent revenue-raising capacity, the system of fiscal federalism and not least its horizontal equalisation scheme have been recurring objects of contestation and reform demands. Especially since Unification and in connection with Europeanization and globalization processes, reform pressures on the German federal system have been increasing in multiple ways (for overview, see e.g. Benz 2005: 206f.). Adding to this the growing public

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1 The basis of calculation is even more complex. As a (also particularly politically contested) example, the formula does not assume that the necessary public expenditures per capita are the same for each Land. The city-states (Berlin, Bremen, Hamburg) are presumed to have expenditures that are disproportionately higher (relative to population) than the larger scale *Länder*, so that their populations are multiplied by a factor of 1.35. This is referred to as the ‘city-state privilege’ (*Stadtstaatenprivileg*). Several Eastern *Länder* populations are also multiplied by a slightly increased factor for the purpose of calculation for the equalization scheme.
debt since the 1990s, but also intensified asymmetries among the Länder, have evoked attempts or at least demands to shift fiscal federalism toward more fiscal authority (Heinz 2014: 182-186). Various political actors, especially from the more fiscally well-off states, have called for enhanced capacities for competition and innovation in German federalism, and, with particular regard to fiscal affairs, for changing the equalisation scheme and allowing for more tax autonomy in order to reduce the incentives for fiscal irresponsibility (Braun 2007; Hildebrandt 2009).

In fact, reform demands have addressed another aspect of German fiscal federalism, namely instruments and institutions of financial planning (Heinz 2014; Kropp 2010: 92ff.). As structural-functional counterpart to the cooperative federal order with regard to revenue raising and distribution, the German federal system has in turn developed a complex system of joint expenditure oversight and planning, though the mechanisms had long come to be viewed as inefficient for reigning in public spending and preventing the accruement of public debts. Consequently, the German federal system in general and its fiscal federal arrangement in particular came under tremendous pressure for reforms in the early 2000s. A series of reform efforts aimed to disentangle joint-decision making and readjust several aspects of fiscal federalism. The fiscal crisis and the resulting repercussions on German society politics significantly affected these reform processes exactly at a time when fiscal federalism was on the agenda. Thus enhanced federal dynamics came to a critical juncture.

4. Fiscal crisis, regional economic disparities and changing political structures

The fiscal crisis is usually described as a crisis of the banking sector followed by a sovereign debt crisis. In Germany the first the recession of 2008 primarily hit the car industry, with particular impacts on German locations of General Motors (Opel) in Hesse and North Rhine-
Westphalia. Second, the banking crisis threatened institutes in Germany, not the least regional public banks (*Landesbanken*) in Hamburg/Schleswig-Holstein, North Rhine-Westphalia and Bavaria. Thus *Länder* with relatively strong economic and fiscal capacities had to confront major effects of the turbulences in the global market. The federal government responded to these problems in close cooperation with *Länder* governments. It established a stimulus package determined to induce public investments of local and *Länder* governments especially in infrastructure projects, but also demands in the ailing automobile sector such as a ‘scraping bonus’ for buying new cars, while also designing measures to stabilize the banking sector including several major bailouts (see e.g. Zolnhöfer 2011).

The sovereign debt crisis did not hit Germany like other European states. However, policies designed to overcome the recession developed at a time when debates about the level of public debts intensified and governments independent of party complexion fell under public pressure to reduce the debt load. Therefore, public expenditures to maintain private firms or stimulate demand appeared to contradict the new consent on budget consolidation. It was therefore no coincidence that German governments soon returned to this path of fiscal policy, when they realized the rapid growth of public debts (from 65.2 per cent of GDP in 2007 to 82.5 per cent in 2010\(^2\)). Crisis management turned into a policy of budget consolidation, before the EU responded accordingly.

However, the conditions for consolidation changed due to the crisis. As it hit the well-off Western *Länder* even more than the economically weaker *Länder*, the fiscal policy predominating since the turn of the century revealed deeper imbalances in the federal system. Still, the fiscal capacities (revenues by own sources) of the *Länder* differ significantly, with Bavaria, Baden-Württemberg, Hamburg and Hesse profiting from strong regional economies

\(^2\) Statistisches Bundesamt, Fachserie 14, Reihe 5, 2013, p 192
https://www.destatis.de/DE/Publikationen/Thematisch/FinanzenSteuern/OeffentlicheHaushalte/Schulden/SchuldenOeffentlicherHaushalte2140500137004.pdf?__blob=publicationFile
and tax resources. The fiscal equalization scheme contributes to minimize these disparities. However, when we take account of the expenditure side of the budget and the risks for future budgeting, a different divide appears since a number of Western Länder are confronted with excessive debt loads and have to face future payments for pensions of their civil servants (Hildebrandt 2009).

Table 2: Fiscal imbalance between German Länder (in bold: Länder declared as in budgetary crisis by the Stability Council in 2011³)

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<th>Fiscal capacity (before fiscal equalization)</th>
<th>above average</th>
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<td>below average</td>
<td>– Bavaria</td>
<td>– Saxony</td>
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<td></td>
<td>– Baden-Württemberg</td>
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<td>– Rhineland-Palatinate</td>
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<tr>
<td>above average</td>
<td>– Hamburg</td>
<td>– Berlin</td>
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<td></td>
<td>– Hesse</td>
<td>– Bremen</td>
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<td>– North Rhine-Westphalia</td>
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(based on ARL 2015, tables 1 and 2)

These fiscal imbalances have been deepened during the crisis, in particular since the debt level increased in these Länder also in local governments. So far, these developments have not

dramatically changed the terms of economic competition between Ländere. Nonetheless, the terms of political competition have changed not the least due to changes in state-society relations, which evolved during the last two decades and which found expression in the party system.

On the whole, the economic and fiscal crisis has certainly had controversial effects on political discourse and mobilization. Moreover, the Eurozone crisis has played a significant role in increasing the overall politicization of the European Union, though with mixed effects among and even within the member states (Grande and Kriesi 2015; Stratham and Trenz 2015). In general, the crisis has played particularly into the hands of populist parties. This applies all the more so given that the crisis discourse represents one of the few common denominators of such parties across party systems (Rooduijn 2014; see also Kriesi 2014; Mudde 2013).

While there has been fragmentation and electoral volatility in the German system, at the outbreak of the crisis, the party system still seemed to demonstrate an overall stability in the 2009 federal election, especially in comparison to other national party systems (Decker and Sonnicksen 2010). But since then, Germany has witnessed substantial changes in party system, ranging from the decline of the liberal party, FDP, but also the rise and fall of the newcomer Pirate Party. The most impressive shift has derived from the electoral successes of the Anti-Euro party, the Alternative for Germany (Alternative für Deutschland, AfD), which has been one of the most successful newcomer parties in the German party system, though its success rests not only on growing critiques of the Euro and the EU, but also (if not more) the party’s ability to have channelled right-wing populist inclined voters (see e.g. Berbuir, Lewandowsky and Siri 2015). At the same time, the Euro-crisis has not instigated any significant changes in contestation among the established parties in the German political system, which have by and large supported the EU bailout packages and austerity measures (see e.g. Miklin 2014).
However, they are confronted by increasing internal disputes, and some of them adopted populist positions.

One important change in party politics has been underestimated in public debates so far. This is the regional fragmentation of the party system. What has been acknowledged are particular developments in the East German Länder, where the Left party has a strong base, but where also right-wing populism attracted voters. Mainly ignored has been the new role of the Bavarian CSU in German Politics. Traditionally, this party is linked to the Christian Democrats at the federal level by a contract. However, during the crisis, the party reinforced its position as defenders of Bavarian interests against the federal government. This way it contributed to a decline of the solidarity between Länder in the federal system, which in general resulted from populist reactions to the crisis. Certainly, societal diversity in Germany does not find expression in a cultural regionalism like in multinational federations. Scholars have observed a tendency towards multilevel citizenship rather than demands for regional authority or autonomy (Overhofer, Stehlin and Sturm 2011). However, there are at least first signs that an economic regionalism in the fiscally and economically strong Länder, in particular Bavaria, turns into a political regionalism. Independent of the parties in power (and due to a decline of federal-Länder-linkages inside parties), governments of Baden-Württemberg, Hesse and Bavaria question the need for horizontal fiscal equalization, at least in the intensity required by the existing law, and demand more fiscal autonomy. By reshaping public discourses towards “competitive federalism”, i.e. a decentralized federal system rewarding performance and solid fiscal policy by increasing revenues, they influence public opinion in favour of their regionalist policies.

These tendencies in the party system have contributed to a dissolution of the predominating unitarist paradigm of German federalism. However, neither did they promote institutional decentralisation nor have they had any significant impacts on patterns of
intergovernmental policy-making. Quite the contrary, the crisis constrained the ongoing reform of German federalism that started in 2003, it reinforced federal-\textit{Länder} coordination in fiscal policy, and it prevented significant modification of fiscal equalisation. Regarding the consequences of the critical juncture, the crisis created in 2008/9, the territorial dynamics in Germany appeared to contradict the assumptions of theory.

5. Institutional policy: the reinforcement of cooperative federalism?

As a rule, the impact of an economic crisis on federalism goes beyond fiscal policies or intergovernmental fiscal relations. In principle, the whole architecture of a federation including the basic constitutional principles, the allocation of powers between levels of government, and the effectiveness of decentralized or intergovernmental policy-making may become objects of dispute. Economic and fiscal crises in particular can turn out to present profound challenges precisely because of the rules on distribution of funds or even on bailing out constituent units in economic dire straits (Rodden 2006). Indeed, a great deal of historical experience with severe economic downturns including in Germany’s various systems of the past century would suggest that drastic changes in federal orders may follow in the wake of the economic crisis (see e.g. Crafts and Fearon 2010; Hefeker 2001; Raess and Pontusson 2015; Wagschal 2000). However, in the course of the recent global recession, German federalism remained comparatively stable (see e.g. Krampf and Fritz 2015; Lane 2012).

Initially in the 1980s and throughout the 1990s, economic reforms became a dominant factor across OECD countries. They aimed at an overall shift toward liberalized markets, privatization of public utilities and services decentralization of government and decreasing public expenditures (Keman 2010). While German Unification could have presented the sort of perfect ‘critical juncture’ for dramatic reform, its changes to economic, labour and fiscal policy were characterized by much more continuity at this stage, while significant changes in social
policy took place around the turn of the century (see e.g. Jackson and Sorge 2012). These reforms involved most prominently the “Agenda 2010” reform package under the SPD-Green Coalition (1998-2005). Designed to improve competitiveness of German firms, it implied a substantial revision of unemployment and social welfare provision system (most notorious the “Hartz IV” legislative package). Indeed, Germany, as some argue, may have been able to weather the crisis not only due to a number of fundamental features of its economy but also on account of its painful reforms already undertaken in the mid-2000s before the outbreak of the crisis (Bonatti and Fracasso 2013; Young and Semmler 2011).

Experiences of the difficult negotiations and decision-making gained during these welfare state reforms in cooperative federalism, and frustration with many compromises between federal and Länder governments and between majority and opposition parties in the federal parliament led leaders of governments and parties to initiate a reform of German federalism. The first reform step ended with the 2006 constitutional amendment changing mainly legislative powers, but excluding matters of fiscal powers and fiscal equalization (Jochimsen 2008; Scharpf 2009: 69-116). Therefore, a second round of negotiations began in 2007 addressing exactly these aspects. It was during this reform process when the economic crisis broke out.

As it has often been the case in German federalism, a decision of the Federal Constitutional Court influenced the agenda of constitutional policy. In 2007, it was a decision on a proceeding initiated by the government of Berlin requesting special federal subsidies due to its budgetary problems. The Court ruled against Berlin, but demanded appropriate mechanisms to prevent Länder governments from running excessive deficits. The second commission established by the Federal Parliament and the Bundesrat committed to revise fiscal federalism and elaborated reform proposals focused on this issue, in particular after the impact of the economic crisis on fiscal policy was becoming apparent.
Thus the commission narrowed down its original agenda. Confronted by increasing conflicts between Länder governments and the erosion of the integrative effects of the federal party system, any ambitions to disentangle the system of shared taxes turned out as unfeasible because Länder governments feared the risk of tax competition. In order to avoid redistributive effects, the commission was not able to reach a compromise on a renewal of fiscal equalization, either. Instead, it finished its work by proposing a new debt rule and monitoring system for budget policy of the federal and Länder governments (Renzsch 2010, Heinz 2016). Both proposals passed legislation on the required constitutional amendment.

This amendment of the Basic Law compels the federal government to balance its budget as of 2016 and the Länder governments to follow suit in 2020. Under specified conditions, new debts are possible, but they have to be cleared after a limited period of time according to a precise plan. As some Länder considered themselves in no economic position to meet the deadline, the federal government conceded additional grants for these Länder. With the establishment of the Stability Council, federal and Länder ministers of finance regularly meet to evaluate the budget of each government, based on data to be delivered by the responsible administrations (Heinz 2016). If the Stability Council discovers an imminent budget crisis according to a set of criteria, the respective government is committed to report annually on its efforts to consolidate its budget.

At first glance, this coordinated action and particularly the institution of the Stability Council seem to signify a return to the traditional pattern of joint decision-making in German federalism. Indeed, federal and Länder governments not only maintained the shared powers in taxation, they now coordinate their budget in an institutional setting similar to those of the old “Joint Tasks”, i.e. those areas of policy making where the federal government was compelled to work together with Länder governments in order to help them fulfil these tasks (see Art. 91 of the German Basic Law). In line with the practice of intergovernmental policy-making in
cooperative federalism, decisions are regularly based on an agreement, and they are not binding for parliaments. Governments refuting to implement the recommendations cannot be sanctioned. Actually, the monitoring mechanism in budget policy deviates from former intergovernmental coordination of fiscal policies. It implies a process of naming and shaming of governments, and enables comparative evaluation of policies by parliaments, private interest groups or the public. This way governments and majority parties in parliaments have an incentive to avoid budget crises. For the Länder this implies the need to cut expenditures. Despite high tax revenues currently collected by German governments due to an unexpectedly positive economic development, the room for new public services, investments or an increase of payments for civil servants is limited. These limitations, furthermore, may have been exacerbated, certainly unwittingly, by several previous changes in the federal order achieved in the federalism reform prior to the economic crisis. For one, several changes to the German constitution were geared toward disentangling competences between the federal and Länder levels. This has meant, for example, that the instrument of ‘framework legislation’ has disappeared, which once belonged to the federal government and allowed it not only to set basic guidelines in otherwise Länder policy areas (education being the most prominent) but also to help finance them. In addition, while the Länder gained more autonomy in some legislative areas, this transpired without nearly any counterpart with regard to revenue raising. For these reasons, the Länder (and their municipalities no less) face severe and, at least in parts, self-incurred pressures to balance budgets.

In this situation, Länder governments consider payments for fiscal equalization also as an expenditure that needs to be addressed. In consequence, the reform of fiscal equalization revealed a considerable amount of controversy. So far decisions on reworking the equalization scheme are still pending. In addition to its high contestation, this reform is urgent since the current law expires at the end of 2019. Since 2013 at least, experts of finance departments of
the Länder have prepared the positions of their Land. Experts or working groups of parties have also been putting forward different proposals. At a certain point, the federal minister of finance and the mayor of Hamburg drafted a paper outlining the contours of an amended equalization scheme. However, meetings among all ministers of finance and heads of federal and Länder governments ended without any result. Negotiation positions still diverge. In December 2015, the Länder governments achieved an agreement on a reform of fiscal equalization, but still the federal government opposes this proposal. At the same time, ministers and heads of governments also resist any changes to the negotiation procedures that may lead out of the joint decision trap. All governments maintain their veto power in negotiations of decision proposals. Therefore, a significant change of the existing system of fiscal equalization is unlikely.

Thus institutional dynamics in German federalism triggered by the crisis reveals two faces. The surge in public debts contradicting the declared goals of fiscal policy leads governments to entrench the principle of balanced budgets in the constitution and to establish an effective monitoring mechanism. At the same time, governments maintained and stabilized the institutional rules and practice of joint decision making. Given the changed cleavage structures between German Länder and those expressed in the party system, institutional reforms aimed at reducing fiscal imbalance turned out as extremely difficult and ended with more continuity than change. As a result, German fiscal federalism revealed more rigidity than flexibility.

5. Conclusion:

Despite the economic crisis, dynamics of federalism in Germany has been more driven by institutional continuity and established patterns intergovernmental policy-making than by institutional reform. Change in society, expressed by economic divergence between Länder,
the erosion of the integrative effects of party politics, and the waning of federal solidarity seem to have only limited repercussions on institutions, even so these changes combined to a critical juncture during the economic crisis in 2008/9. Apparently limited negative effects on German economy can explain this stability. However, our framework of federal dynamics reveals a more multifaceted development.

The societal conditions of German federalism change in the same direction that is observable in other states: We observe a regionalisation of economics, society and political structuration, though regionalist movements have not emerged in Germany. In politics, the territorial dimension of cleavages has become stronger since German Unification, and the crisis reinforced this trend.

However, this change has not been accompanied by a rise of regional authority (Hooghe, Marks and Schakel 2010). The 2006 reform of German federalism had some decentralising effects, but this has not led to consequent amendments of fiscal federalism. The institutions of cooperative federalism evolving in a long history and the routinized patterns of intergovernmental negotiations not only remained intact, they even have been fortified during the economic crisis, at first by the second reform of federalism passed in 2009 and finally by the negotiations on fiscal equalization. German federalism was not rendered more centralized, but continues to operate under institutional conditions working towards joint decisions and uniform solutions. This institutional continuity contrasts with changes in society, and it may not be exaggerated to argue, that instead of a decentralized state in a centralized society (Katzenstein 1987), changes in German federalism tend towards uniform policies in a decentralizing society.

As a critical juncture, the crisis increased pressure for change of fiscal policy, but at the same time, it has triggered intergovernmental cooperation despite a decline of solidarity. Under these conditions, the results of institutional reform passed under pressure turn out limited.
Germany has now a strict debt rule, which the federal government managed to become uploaded to the European level. However, German constitution still grants both Länder governments and the federal government very limited tax powers or fiscal autonomy. Consequently, cooperative federalism enforces austerity policy by curtailing expenditure, all the more so since the establishment of the debt rules and stricter monitoring by the Stability Council. Furthermore, this constellation favours blame shifting for expenditure cuts and increasingly undermines redistributive policies to reduce fiscal imbalances. Therefore, in view of the current successes in budget consolidation, risks for the future of federalism inherent in the amended constitutional rules should not be ignored.

Apparently, historical legacies of institutional principles and rules stabilizing intergovernmental patterns of joint policy-making prevented political actors to exploit the opportunities of the critical juncture which opened during the economic crisis. Like in previous situations which appeared as critical junctures, e.g. the first oil crisis in 1974, German Unification in 1990 (not to speak of post-war crises; see Thelen and Karcher 2013), governments preferred continuity to change. Change has redistributive effects and therefore intensifies political conflicts. In the established patterns of cooperative federalism redistribution is difficult to achieve, since policy-makers tend avoid the rising conflicts. Thus the tensions between institutions and state-society relations generate pressure for significant change, but the tensions between political conflicts and need for consensus prevent change to materialize. For this reason, critical junctures do not signify turning points in the territorial dynamics of German federalism.

References


