FROM COHESION POLICY TO FINANCIAL EQUALISATION?

LESSONS FROM GERMANY FOR WAYS OF REDUCING REGIONAL DISPARITIES IN THE EUROPEAN UNION

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ABSTRACT

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Since the late 1980s, the European Communities have seen rapid developments towards economic and political integration. This thesis argues that the institutions and decision-making structures of the European Communities resemble those of a union of states at an early stage of federal integration. However, as an entity with more than one level of government, the Communities are subject also to the main objective of federalism: how to simultaneously achieve the contradictory aims of unity and diversity. At the heart of this conflict lies the issue of regional disparities and to what extent within a federal framework such disparities should be reduced.

To answer this question, the thesis undertakes a comparison of the European Communities with a federal entity of similar character, yet one at the opposite end of the process of integration: the Federal Republic of Germany. As a highly integrated federation within which the centre and the constituent units co-operate strongly with one another, the Federal Republic of Germany provides a good example of how authority may be shared and divided between the Community level and the Member States in future. The degree to which a federal union is politically integrated has a direct effect on the quality of its redistributive policies, and on who will be responsible for those policies.

If the European Union is indeed heading towards more integration, it may one day decide to compensate for more general political unity by shifting responsibility for regional redistribution back to its constituent units. This would mean the adoption of a horizontal financial equalisation scheme amongst the Member States instead of a centrally organised cohesion policy. However, the main lesson from Germany is that financial equalisation does not reduce regional disparities, and that the EU has already found, in the form of the Cohesion Fund, a preferable approach.
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0. INTRODUCTION

0.1 Towards European Union: Cohesion, Solidarity, Equalisation?

After more than a decade of what has become known as ‘eurosclerosis’ the Single European Act (SEA), which came into force in 1987, set out to transform the European Communities (ECs)\(^1\) from a customs union to a common market, the Single European Market, by the end of 1992.\(^2\) With the abolition of restrictions to the free movement of not only merchandise, but also people, capital and services, many opportunities were expected to arise for the Member States’ citizens. The Cecchini Report, a study into the benefits of the Single Market conducted for the Commission of the European Communities, claimed that significant economic improvements would result from the establishment of the Single Market, such as higher economic growth and lower unemployment for the whole of the ECs.\(^3\) While it makes sense that more competition leads to more specialisation and economies of scale, and eventually could lead to an overall economic improvement for the Communities as a whole, this does not mean that such a development would affect all areas and people in an equally positive way - quite the contrary. A number of areas would in fact find it more difficult to compete. Most affected by the negative impacts of economic integration are the areas situated at the periphery of what is now the European Union (EU)\(^4\). The reason for this is a combination of distance from the core markets and structural backwardness, which makes it particularly hard for countries like Greece, Portugal and Ireland to reach a level equal to that of Germany, France or the Benelux countries which are centrally located and have a much more fully developed infrastructure.\(^5\)

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\(^1\) European Coal and Steel Community (ECSC), European Economic Community (EEC), and European Atomic Energy Community (Euratom).

\(^2\) Even though there had been sectoral common markets within the European Communities (agriculture, coal, steel, iron ore, etc.) they - overall - began as a free trade association, and in 1968 became a customs union. For a reading into the theory of economic integration, see: Peter Robson, *The Economics of International Integration*, 3rd rev. ed. (London: Unwin Hyman, 1989).


\(^4\) Created on 1st November 1993 by the Treaty on European Union (also known as the ‘Maastricht Treaty’).

However, one of the basic guiding principles at the founding of the European Economic Community (EEC) in 1957 was to strengthen the unity of the Member States' economies and to ensure their harmonious development "by diminishing both the disparities between the various regions and the backwardness of the less favoured regions". The SEA acknowledged the potential difficulties the Single Market could bring to the Community's poorer areas, and with the new Title V, Articles 130a to 130e EEC Treaty, introduced a new concept to the Community: the strengthening of economic and social cohesion. This objective has as its aim to gradually diminish the differences between the Member States' economic and social data, as measured by key indicators such as inflation rate, public debt, interest rates, unemployment, maximum working hours, and so on. The new provisions confirmed the Community's commitment to reduce "disparities between the various levels of development of the regions and the backwardness of the least-favoured regions, [including rural areas]". In order to reach these goals not only were national policies to be directed towards stronger economic and social cohesion, but also to be coordinated where possible. In addition to this, the Community was now to support the achievement of the aforementioned objectives "by the action it takes through the structural funds (European Agricultural Guidance and Guarantee Fund, Guidance Section; European Social Fund; European Regional Development Fund), the European Investment Bank and the other existing financial instruments".

The gradual emergence of a Single Market not only brought about the need for more regional assistance provided by the Community, but also resulted in calls for common action in other policy fields, such as economic, monetary and social policy. It was argued by some that a common market would be incomplete without a common monetary policy, if not a single European currency, and socially unjust if at least some degree of harmonisation of working conditions and workers' rights were not realised. A top-level Commission working group was set up which produced the 'Delors Report'. This paper became the blueprint for an intergovernmental conference (IGC) on transforming the ECs from a common market to an economic and monetary union, to be initiated at a European Council meeting in Rome in December 1990. The changes sweeping central and eastern Europe, German unification, and the end of the Cold War also soon led to a parallel IGC on political union for the Communities. The negotiations in the IGCs culminated in the

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6 The EEC, since 1st November 1993 European Community (EC), is by far the most important of the three European Communities.
8 SEA, Art. 130a.
9 SEA, Art. 130b.
Treaty on European Union (TEU), signed at Maastricht on 7 February 1992. In this, the most far reaching amendment to the Treaties establishing the European Communities to date, the signatories declare that “the Union shall be founded on the European Communities, supplemented by the policies and forms of co-operation established by this Treaty. Its task shall be to organise, in a manner demonstrating consistency and solidarity, relations between the Member States and between their peoples”\(^\text{11}\). For the first time in the ECs’ history the principle of solidarity had entered the text of the - by then - European Community (EC) Treaty, making it to all intents and purposes a constitutional objective.\(^\text{12}\)

The full meaning of solidarity becomes apparent in the Treaty’s new Article 2. This gives as one of the many tasks of the Community the promotion throughout the EC of economic and social cohesion and solidarity among Member States. Mentioning solidarity in the context of economic and social cohesion can mean little else but a commitment by the richer Member States to help their poorer counterparts in their efforts to catch up with the rest. In this respect, the approach to strengthening economic and social cohesion appears to have slightly changed direction since the SEA. The Structural Funds, linked to economic and social cohesion, represent a centrally organised display of solidarity among the Union’s citizens, whilst solidarity between the Member States and between their peoples, as laid down in the TEU, would seem to refer to a more decentralised way of balancing out regional disparities. The emphasis here is on the Member States to get actively involved in the Union’s regional efforts by taking over more direct financial responsibility for EU regional policy.

However, this apparent move towards a more decentralised approach to tackling the Union’s regional imbalances results not only from the adoption of the idea of solidarity between the Member States and their peoples. Tendencies to shift responsibilities back to the Member States also have to do with two other concepts new to the Treaty: convergence among the member economies, and the principle of subsidiarity. The latter was adopted to prevent ‘Brussels’ from taking over more and more areas of responsibility from the Member States. In a very general sense it is supposed to ensure that decision-making takes place as closely to the citizen as possible which means that decisions should only be taken at a higher governmental level if this can be expected to be more beneficial to the citizens. Consequently, subsidiarity does not so much stand for active decentralisation, but more for limiting centralisation to the core policy areas. In contrast

\(^{11}\) TEU, Article A.

\(^{12}\) The European Union does not have statehood status itself, and does not have a written constitution either. As will be explained later in this dissertation, the Treaties establishing the three European Communities, together with the Acts and Treaties amending and supplementing them, represent what will be referred to as the Union’s ‘constitutional framework’. This term is also used by Neill Nugent in *The Government and Politics of the European Union*, 3rd ed. (London: Macmillan, 1994) 48.
to this, convergence among the member economies is regarded as a prerequisite for economic and monetary union (EMU), and as such aims to align the economic performance of the Member States. It could, of course be argued that such a requirement necessitates centralised decision-making. However, according to the Treaty, economic policies are only to be co-ordinated at Union level, and thus basically remain a matter for national legislation.\textsuperscript{13}

This notwithstanding, EMU does mean further integration, thus exacerbating the negative side-effects already witnessed by the creation of the Single European Market (SEM). Monetary union alone, for instance, will deprive the Member States of the important policy tool of exchange rate management, with which they could defend their markets from intra-Union competition.\textsuperscript{14} In a similar fashion, the Agreement on Social Policy, commonly referred to as the Social Charter, which is only becoming part of the EC Treaty following the June 1997 Amsterdam summit\textsuperscript{15} takes away flexibility from the Members' labour markets.\textsuperscript{16} However, losing their sovereignty in these two crucial policy areas is more of a problem for the poorer EU countries than it is for their richer counterparts, because the former lose room for manoeuvre in their attempts to catch up with the latter. The principle of solidarity calls for such side-effects to be limited, if not reduced. A straightforward increase in regional aid to keep the efforts to strengthen economic and social cohesion within the EU would thus have been the logical response.

The TEU, however, went for a different solution and thereby added another dimension to the problems faced by the poorer Member States. The approach to achieve EMU, as prescribed by the Treaty, is based on the idea that such a union should only be formed by sub-units with a high degree of convergence, in order to prevent lasting structural

\textsuperscript{13} Art. 102a EC Treaty (ECT).

\textsuperscript{14} For more detailed argumentation on the likely impact of economic and monetary union, see for instance: Maurice F. Doyle, "Regional Policy and European Economic Integration"; J. Delors, "Regional Implication of Economic and Monetary Integration," both in: ECs, Commission, Committee for the Study of Economic and Monetary Union, 1. Report on Economic and Monetary Union in the European Community 2. Collection of Papers Submitted to the Committee for the Study of Economic and Monetary Union 69-89.

\textsuperscript{15} The ‘Agreement on Social Policy’, annexed to the TEU, was originally signed at the December 1991 Maastricht summit by all but one of the ECs' Member States, following fierce opposition to any form of EC social policy by the British Government. The position of the United Kingdom only changed after the May 1997 general election in which the conservative government was replaced by a labour administration. The latter almost immediately signed up to the Social Agreement, enabling the Amsterdam European Council to include respective provisions into the EC Treaty proper.

\textsuperscript{16} Exactly how much flexibility there could have been is arguable, since the Community’s objectives also include a high level of employment and of social protection, and the raising of the standard of living and quality of life, TEU, Art. G (2). For further details of the likely effects of social integration, see for example: Pierre Maillet and Serge Dormard, “Social Europe and Economic Cohesion,” and “A New Role for the Structural Funds?,” a comment by Achilleas Mitsos, both in: The European Community at the Crossroads, ed. Alfred Pijpers (Dordrecht: Martinus Nijhoff, 1992) 71-90 and 119-25.
imbalances from occurring.\textsuperscript{17} The Treaty even goes one step further. To ensure a sound future EMU, so-called ‘convergence criteria’ were agreed upon and enshrined in the Maastricht Treaty. This means that all candidates wanting to qualify for a future EMU will not only have to have similar indicators concerning price stability, public debt and interest rate levels, but low inflation, low interest rates, and a limited government deficit and restricted public debt.\textsuperscript{18} This presents the poor Member States with a real dilemma. On the one hand they have to invest if they want to benefit from a future single European economy. This requires them to find substantial financial means to pay for structural measures such as building roads, airports and waterways, extend and modernise telecommunications and to retrain the long-term unemployed, in order to make their economies more competitive \emph{vis-à-vis} their partners in the Union. The convergence criteria on the other hand restrict the Member States’ scope for borrowing. This leaves them in a catch-22 situation if they seriously want to qualify for membership of a single EU economy. Aware of the fiscal implications the convergence programme entails, Spain, Portugal, Greece and Ireland demanded a doubling in regional aid in order to assist them. The negotiators at Maastricht addressed this difficult issue by creating a new instrument, the Cohesion Fund.\textsuperscript{19}

Before the new cohesion instrument was set up, the strengthening of economic and social cohesion was sought mainly by means of the Structural Funds, responsible for which is the European Commission in Brussels. This form of regional policy can be seen as an act of solidarity between the \emph{citizens} of the EU, because tax-payers’ money is redistributed centrally to assist clearly earmarked and narrowly defined projects with the aim to alleviate problems in small, structurally and socially backward, areas of the Union. Even though it also redistributes tax payers’ money, solidarity among the \emph{Member States}, nevertheless, points into the direction of a financial commitment by the richer members to help the poorer ones catching up, with little or no involvement of the Community institutions, and no direct link back to the citizen. In its most extreme expression, solidarity between the Member States would take the form of a financial equalisation.


\textsuperscript{18} Art. 109j TEU in conjunction with the \textit{Protocol on the Convergence Criteria Referred to in Article 109j of the Treaty Establishing the European Community}, and the \textit{Protocol on the Excessive Deficit Procedure}.

\textsuperscript{19} As the TEU laid down in the Treaty’s new Article 130d, the Cohesion Fund had to be established by the end of 1993. Due to delays in the ratification process, the Maastricht Treaty only came into force on 1st November 1993. In order to meet the deadline, a temporary Cohesion Financial Instrument was agreed upon in March 1993.
scheme. Such a mechanism is the ultimate sign of solidarity as its participants are prepared
to balance out their revenues, resulting in more or less the same per capita income for
everyone. In contrast to centralised structural policy, the decentralised nature of
equalisation means that there is no labelling or earmarking.

The Cohesion Fund combines elements of both structural policy and financial equalisation.
As such it brings together the concept of solidarity among the Member States\(^\text{20}\) and the
strengthening of economic and social cohesion, as it is a more flexible instrument than the
Structural Funds. While money from the latter is given to co-finance projects which aim
to alleviate problems in six clearly identified objective areas\(^\text{21}\), the rules for the Cohesion
Fund have a different emphasis. Its objective areas are much more vaguely described as
environmental protection and trans-European networks in the field of transport
infrastructure, and this way there is plenty of room left for national decision-making.
However, money will only be allocated if the Member State in question has "a
convergence programme examined by the Council, designed to avoid excessive
government deficits."\(^\text{22}\) The other main distinction between the Structural Funds and the
Cohesion Fund is the difference in their geographical targets. The former tackles the
welfare imbalances between \textit{sub-national areas and regions}, whilst the latter is designed
to support poorer \textit{Member States}.

This shift of emphasis has of course partly to do with the convergence requirements the
Maastricht Treaty imposed onto the Union’s members. The main reason for tendencies
towards more decentralised decision-making in the EU remains, however, the adoption of
the principle of subsidiarity.\(^\text{23}\) This term was agreed upon after the word federalism, in the
first drafts of the TEU, was not acceptable to some of the negotiators. The British, for
instance, seem to regard federalism as synonymous with centralisation, while subsidiarity
is supposed to prevent just that from happening. This notwithstanding, subsidiarity and
federalism are generally seen as complementary rather than opposite ideas. While the
latter implies a division of power between vertical governmental levels, the former rules
that decisions should be taken as closely to the citizen as possible within such a system.
The Maastricht negotiations were strongly influenced by the British position to limit the
surrender of sovereignty to the Community, which resulted - among other things - in the

\(^{20}\) See: Peter M Schmidhuber, "Der Kohäsionsfonds: Zeichen der Solidarität in der künftigen
Europäischen Union," \textit{Europa ohne Grenzen: Monatlicher Brief}, ed. ECs, Commission, Directorate-
\(^{21}\) For further reference, see: EU, Commission, \textit{Structural Funds and Cohesion Fund 1994-99:
\(^{22}\) ECs, "Council Regulation (EEC) No 792/93 of 30 March 1993 Establishing a Cohesion Financial
\(^{23}\) For a first introduction to the issues involved, as far as the EU is concerned, see: Axel R. Bunz
adoption of subsidiarity, the concession to the British to opt-out of stage three of the EMU process should they wish, the inter-governmental structure of two of the Union’s three pillars (as compared to the supranational nature of the Communities, the EU’s other pillar)\(^\text{24}\), and the exclusion from the Treaty proper of the Social Charter.

The concept of subsidiarity is a key constitutional issue, and as such deserves further attention. The general idea behind subsidiarity has been mentioned already, and in the context of the EU can be found in the Common Provisions of the TEU: “This Treaty marks a new stage in the process of creating an ever closer union among the peoples of Europe, in which decisions are taken as closely as possible to the citizen”\(^\text{25}\). In other words, only those policy areas which cannot (any longer) be sufficiently dealt with at lower levels should be transferred to higher levels of government. In this respect subsidiarity not only affects the relationship between the Member States and the Union - the main reason for the British government to support this principle - but can also be applied, potentially at least, to the sub-national, regional and local levels. The latter consideration, however, seems not to have been followed through into the altered EC Treaty. According to Article B of the TEU’s Common Provisions subsidiarity is defined in the new Article 3b, which reads as follows:

The Community shall act within the limits of the powers conferred upon it by this Treaty and of the objectives assigned to it therein.

In areas which do not fall within its exclusive competence, the Community shall take action, in accordance with the principle of subsidiarity, only if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States and can therefore, by reason of the scale or effects of the proposed action, be better achieved by the Community.

Any action by the Community shall not go beyond what is necessary to achieve the objectives of this Treaty.

This explanation seems to raise more questions than it answers. Nanette Neuwahl calls the principle of subsidiarity one of the most elusive concepts in EC law.\(^\text{26}\) She wonders how, on the grounds of Article 3b, the best level of decision-making for a particular policy field can be established; whether subsidiarity is about effectiveness, competence, or necessity; and whether the principle can ultimately be enforced by a competent court.

\(^{24}\) The three pillars of the EU include the EC, a Common Foreign and Security Policy (CFSP), and Cooperation in Justice and Home Affairs (JHA).

\(^{25}\) Art. A TEU.

The whole discussion surrounding subsidiarity basically comes down to the fact that this principle has potentially conflicting aims. Obviously, according to what has been said so far, subsidiarity has to do with bringing ‘Europe closer to the citizen’. In this respect, Neuwahl believes, subsidiarity is closely connected with the ideas of transparency and democracy. On the other hand, there is the question of which governmental level produces the more effective results. To this end Neuwahl warns that “effectiveness per se can be the anti-thesis of both democracy and transparency.”

0.2 Federalism, Germany and the European Union: Hypotheses

The principal aim of this thesis is to evaluate competing mechanisms through which the EU might optimally reduce regional disparities. ‘Optimal’ here refers to the most acceptable solution to the conflict between a high degree of effectiveness, usually thought of as requiring centralised decision-making, and demands for more democracy and transparency, as expressed through calls for more decentralised action. In this respect, the task ahead might be described as the application of the ‘subsidiarity test’, enshrined in Article 3b of the EC Treaty, to the policies aimed at reducing regional disparities in the EU. In other words, it will have to be examined whether the objective of strengthening social and economic cohesion “cannot be sufficiently achieved by the Member States and can therefore ... be better achieved by the Community.”

The conflict between centralising and decentralising tendencies is - of course - one of the main characteristics of federalism, due to the existence of more than just one level of government. While the link between subsidiarity and federalism has already been made in the previous section, nothing has been directly said about the conflicting aims the federal principle embodies. Clearly, the mere existence of two (or more) governmental levels opens the question as to which level should be responsible for what - and subsidiarity is but a guiding principle. Federalism as a concept aims to combine two general, and rather conflicting, tendencies: unity and diversity.

Figure 1 is an illustration of the apparently contradictory goals of federalism. It compares reasons for keeping decision-making at the lower levels of government, shown on the left hand side, with arguments for giving powers to the centre, as depicted opposite. Subsidiarity, although not actively promoting decentralisation, nevertheless stands for a

28 Art. 3b ECT
cautious approach towards centralising tendencies. It is in this capacity that it ranks among the decentralising forces, all of which mean to maintain diversity in a federal entity, and as such pluralism. Democracy, as understood in the present context, stands for more than mere direct responsibility towards the electorate. The closer to the citizen decisions are taken, the closer they will usually reflect their opinions. In other words, the smaller the community represented the least likely the threat to having to impose a majority decision on a large section of those represented who may disagree.

*Figure 1: Conflicting Tendencies in Federations and Federal Unions*

| Diversity | Unity |
| Pluralism | Social Equality |
| Subsidiarity | Solidarity |
| Democracy | Efficiency |
| Decentralisation | Centralisation |

There are, however, areas of authority which are better conducted by a central decision-maker - or else a higher level of government would not be needed. The question though is, and herein lies the challenge of federalism, which decisions require central authority, and which are better left with the governments in the constituent parts of a federal entity. This is nothing less than the ‘subsidiarity test’ mentioned earlier. Central decision-making is generally seen as being more effective than what could be regarded as a piecemeal situation in which every member of the union does things differently, sometimes wastefully doubling their efforts, at other times perhaps even contradicting each other’s policies. For many, modern society also has as one of its tasks the promotion of social equality. This requires a measure of solidarity among the citizens which stands in contrast to the potentially self-centred notion of subsidiarity. Social equality also contrasts a truly pluralistic society.

The narrower aim of this thesis focuses on the issue of tackling regional disparities, and where within the cobweb of centralising and decentralising forces decisions on the subject should be located. Clearly, objectives such as strengthening economic and social cohesion have a stronger tendency to serve the social dimension than they do to maintain pluralism.
Reducing regional disparities, by definition, works against diversity. Consequently, the most effective policies are arguably the least democratic ones. Attempts to shift policymaking towards a more decentralised way of reducing regional disparities, in order to accommodate pluralism, are likely to weaken its effectiveness accordingly. These conflicts, as shown in Figure 1, are - as has been said already - in this form only to be found in entities with a vertical division of powers, i.e. federations and federal unions.

With the existence of at least two governmental levels, a Union and a Member State (national) level, the first hypothesis in this study is that the EU has to be seen as a federal entity too. Evidence to support this claim can be found in many other features of the Union, such as - arguably most prominently - its institutional structure. However, the Union is a relatively young federal system, and as such only at the beginning of a process of federalisation. This means that, far from being a merely static theory, federalism also stands for a dynamic process of integration (or disintegration), which affects all federal systems to a greater or smaller extent almost constantly. With this in mind the second hypothesis is that it makes sense to look, in detail, at the experience of another federal system in order to be able to draw possible lessons from its experience of trying to accommodate the conflicting tendencies of effectiveness on the one, and diversity on the other hand.

The third hypothesis is that, for various reasons, the Federal Republic of Germany (FRG) lends itself as a federation from which the EU could fruitfully draw useful conclusions. Germany is not only the largest and arguably most influential Member State, but also the Union's only long-standing federal component part. As in western Europe after World War II, the process of German unification last century proceeded from an economic rationale. Lastly, as has just been noted, the EU is only at the beginning of a process of political unification, which is not least reflected by the strong position the Member States still hold in the decision-making procedures at Union level. In contrast to this, the FRG is one of the most centralised federations in the democratic world. The German experience with integration holds a number of keys for the study of how decision-making in federal

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29 A similar view is held by Klaus H. Goetz and Peter J. Cullen in: "The Basic Law after Unification: Continued Centrality or Declining Force?" German Politics, ed. Klaus H. Goetz and Peter J. Cullen, Dec. 1994: 24. For more details on federalism and the EU see Chapter One.

30 The use of federalism to disintegrate a formerly centralized state is relatively rare. One example, however, is that of Belgium. For details see: André Alen, Belgium: Bipolar and Centrifugal Federalism (Brussels: Ministry of Foreign Affairs, 1990).

31 Belgium formally became a federation in 1993, and Austria only joined the Union in 1995.

32 Some even argue that Germany is in effect a unitary state with a federal structure, so for example: Konrad Hesse, Der unitarische Bundesstaat (Karlsruhe: Müller, 1966); or in a more entertaining way: Heidrun Abromeit, Der verkappte Einheitsstaat (Opladen: Leske + Budrich, 1992).
systems develops in general, and how the resulting policies affect regional disparities in particular.

The Grundgesetz (Basic Law), the German constitution, declares a whole catalogue of areas of decision-making as matters for ‘concurrent legislation’\(^{33}\). This means that decisions in these fields remain in the hands of the Länder unless there is particular need for federal legislation. One justification for the federal authorities to take over decision-making is “when, and to the extent to which, the establishment of equivalent living conditions in the federal territory, or the maintenance of legal and economic unity, make it necessary, in the interest of the entire country, to have a federal law.”\(^{34}\) The interpretation of this has been the bone of contention between proponents and opponents of further centralisation.\(^{35}\) Although the word subsidiarity cannot be found in the Basic Law, the conflicts surrounding the issue of concurrent legislation in the FRG very much resemble the difficulties identified with Article 3b EC Treaty. Germany and the EU are, of course, at different stages of federalisation. One consequence of this is that the two entities tackle their regional disparities in different ways, heavily influenced by which actors are involved in the decision-making process.

According to the Basic Law, the FRG is a ‘social federal state’.\(^{36}\) This phrase embodies the very conflict between centralising and decentralising tendencies in Germany’s political structure. The social dimension calls for more harmonisation, because it requires central decision-making in order to be effective in reaching its goal of maintaining equal living conditions throughout the whole of the Republic. The federal aspect meanwhile is supposed to ensure pluralism, which in the German context means decision-making by the Länder, thus accepting a degree of diversity among them.

The Finanzausgleich (financial equalisation) scheme in place in Germany is the product of accommodating this apparent contradiction for the field of tackling regional inequalities. By way of leaving the federation out, the Länder are instructed by the Basic Law to balance out their revenues with the effect that they all eventually have about the same per-capita financial strength to fulfil their constitutional duties. This could be interpreted as creating the foundations for uniform, or at least equivalent, living conditions. What it

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\(^{33}\) Art. 74 GG.

\(^{34}\) The author’s own translation of the following quote from Art. 72 (2) GG: “... wenn und soweit die Herstellung gleichwertiger Lebensverhältnisse im Bundesgebiet oder die Wahrung der Rechts- und Wirtschaftseinheit im gesamtstaatlichen Interesse eine bundesgesetzliche Regelung erforderlich machen.”

\(^{35}\) Before its amendment, in October 1994, Art. 72 (2) GG was even more controversial. It read as follows: "The Federation has the right to legislate where ... the maintenance of legal and economic unity, especially uniform living conditions beyond the territory of any one Land, calls for federal legislation."

\(^{36}\) Art. 20 (1) GG.
means in practice is a *nominal* harmonisation of Länder income that avoids centralised intervention.

The mechanism with which the Länder even out their per capita revenue is commonly referred to as ‘horizontal financial equalisation’. There also exist what are called federal complemental grants (*Bundesergänzungszuweisungen, BEZ*)\(^{37}\): financial assistance given to the poorest of the Länder from the federal coffers to bring (some of) them up to 99% of the all-Länder average per capita revenue. The central authorities give the money without any earmarking which means the Länder can decide for themselves on how to spend it. Because the federation has no say in what the allocations are used for, BEZ also belong to the equalisation mechanism, if only as a kind of ‘vertical top-up’. There are, however, also policies in place in Germany aimed at tackling the *causes* of regional disparities. Federal structural aid\(^ {38}\), and the Joint-Tasks of Bund (Federation) and Länder\(^ {39}\), clearly target specific projects, thus requiring agreement between Bund and Länder at central level. These can both be summed up under the heading ‘federal structural policy’.

Structural policy and financial equalisation may be two distinct alternatives to reach one general objective, i.e. the reduction of regional disparities. What is of interest to this thesis, however, is the effectiveness with which respective policies or mechanisms manage this goal. Structural policy requires central planning to be effective in reducing inequalities throughout. In contrast to this, financial equalisation represents a decentralised nominal display of solidarity among the constituent parts of a larger unit. This might lead indirectly to a reduction in the underlying disparities, but does not necessarily have to. The reason for the latter is that money redistributed through the horizontal equalisation mechanism come with no conditions attached, so they can be spent on anything by the recipient Länder. However, the fact that they are structurally weaker not only leads the poorer Länder to have lower incomes, it also - as a rule - causes them to have higher than average expenditures, due to their requirement to provide for largely equivalent living conditions throughout the FRG. This in turn means that the recipients from financial equalisation usually need the additional income, provided by the mechanism, for social expenditure rather than investment into projects which would help them overcome their structural backwardness.

The conflict between structural assistance and financial equalisation thus amounts to more than just a struggle over whether to choose a centralising policy or to opt for a

\(^{37}\) Art 107 (2) GG.
\(^{38}\) According to Art. 104 (4) GG.
\(^{39}\) See: Chapter VIIIa, Art. 91a-b, GG.
decentralised way to reduce regional disparities. It represents - and this is the fourth hypothesis in this study - a decision for or against more genuine equality among the component parts of a federal entity. Exactly how pluralism, one of the cornerstones of federalism, is affected by any such decision is - of course - not without importance.

Figure 2 shows how decision-making and policy outcome for the field of tackling regional disparities interrelate in Germany. The constitutional objective, the maintenance of equivalent living conditions, is located at the centre of the graph. The policies in place to reach this constitutional target are grouped around it. Shown on the left-hand side are the policies aimed at reducing the *structural* imbalances prevalent in the FRG. They serve to lead to more lasting equality among the Länder which requires central decision-making to be effective. Structural policies clearly represent the social dimension of the Basic Law. On the right-hand side of the graph those mechanisms which are supposed to support the federal, i.e. pluralistic, dimension can be found. Here, maintaining uniform living conditions is done in a decentralised way by *nominally* equalling out the Länder’s per capita incomes.

*Figure 2: Decision-Making and Equalisation Policies in the FRG*

![Diagram showing decision-making and equalisation policies in the FRG](image)

The EU, of course, also experiences a conflict between centralising and decentralising tendencies. The question here, however, is one of Union-wide harmonisation versus national sovereignty. Although the Social Charter is not part of the Treaty, other concepts, such as economic and social cohesion and solidarity between the Member States, call for centralised action, albeit at present on a rather low scale. Federalism is not mentioned in the Treaty either. Instead, the principle of subsidiarity appears to have been adopted to keep as much policy-making as possible away from the central level. In this
respect, efforts to reduce regional disparities within the EU take place in a similar framework of decision-making competences and policy outcomes to the one in place in Germany.

By using the same approach as in the graph before, Figure 3 shows where the similarities and differences between the German and the EU system to reduce regional disparities lie. The obvious distinction between how regional disparities are tackled in the EU as compared to Germany is that the Union does not have a financial equalisation scheme, indeed no single Union-wide decentralised policy to reduce regional imbalances. Instead the EU uses an altogether different tool, the Cohesion Fund. This instrument is a cross between structural policy and financial equalisation, because it requires some central decision-making, but leaves substantial room for manoeuvre at national level over the use of payments from it. Such compromise policies highlight the fact that it is not only the conflict between central and sub-central levels of government, but also the mostly differing opinions among the members of a federal system themselves which influence policy outcome. Divisions like these are particularly transparent in an entity such as the EU, where the Member States are the dominant decision-maker at central level. In the absence of a strong central institution, the Member States have to find compromises which accommodate, and thus best serve, national interests. The interest of the Union as a whole is then only of secondary importance.

**Figure 3: Decision-Making and Equalisation Policies in the EU**

The Cohesion Fund was agreed upon, because the rich and the poor Member States had to find a solution to their differing positions on equalisation goals and policies. At the same time this compromise signifies the Union’s departure away from pure structural policy, and into the direction of financial equalisation. This is shown in Figure 4 which
demonstrates how centralising and decentralising tendencies, and the degree of earmarking attached to regional payments, are interlinked in a federal system: apart from the Cohesion Fund, there are two extreme forms of policies aimed at reducing regional disparities within a federal entity. The first is structural policy, which requires central decision-making as a high degree of earmarking is required to make sure the money allocated under respective schemes is used effectively to tackle existing imbalances. The second is nominal financial equalisation which represents the decentralised way to reduce regional disparities, because the recipients have the freedom to decide for themselves what to do with the money given to them under the scheme. Although these two policies look impossible to combine, the EU appears to have managed just that.

Figure 4: Equalisation Policies in a Federal Entity

The fifth, and final hypothesis - summed up by Figure 4 - is that the Cohesion Fund accommodates all the tendencies of redistributive policies within a federal entity. So this, still rather recent, instrument looks like the perfect solution to the conflicting goals of federalism, i.e. social equality on the one hand, and pluralism and diversity on the other. Structural policies only tackle the social equality side and thus directly contradict the notion of pluralism and diversity. The German system of financial equalisation stands in stark contrast to this. It is the way in which the Länder balance out their revenues with the effect that they all end up with about the same per-capita financial strength. In the absence of any earmarking, either from the federal government or otherwise, this mechanism represents the ultimate show of solidarity among the Länder. However, financial
equalisation does not necessarily lead to a reduction in regional disparities and as such may serve to maintain the diversity among the Länder.\textsuperscript{40}

Oddly enough, the link between solidarity and social equality seems to be broken here. Despite the rather low scale on which both the Structural Funds and the Cohesion Fund operate, they at least attempt to tackle the underlying reasons for regional and national disparities. The German system of financial equalisation, despite its much larger size, has no such impact. This discovery reveals that the conflicts within federal entities are more complicated than hitherto thought. The links between centralising and decentralising trends, between subsidiarity and solidarity, between social equality and pluralism, diversity and unity, and/or democracy and effectiveness, are not as straightforward as might be assumed.

The Union's Structural Funds are centrally controlled redistributive instruments which directly serve the goal of achieving more regional and social equality. Because they represent a pin-pointed effort to eradicate welfare disparities between regions and individuals, the Structural Funds are - arguably - quite effective. Yet, because this efficiency requires central decision-making, the Funds can also be seen as comparatively undemocratic, due to their lack of proximity to the voter. The Cohesion Fund depicts a show of solidarity too, this time between the Member States instead of the regions and citizens of the Union. The Fund serves to reduce regional disparities only, and has to be regarded also as a little less effective than the Structural Funds, since it focuses on the relative wealth of the Member States, rather than that of sub-national regions or even smaller areas. Although the Cohesion Fund is more decentralised/subsidiaristic than its older relatives, its rules are still decided upon by both the EU and the Member States, which both represent levels of government still quite removed from the voter. Horizontal financial equalisation does not attempt to lead to social equality \textit{per se}, but in fact maintains the structural disparities within the FRG which cause the differences in income between the Länder in the first place. The mechanism is, however, very much decentralised as it is controlled entirely by the Länder themselves. In this respect, horizontal equalisation is more democratic than the EU's above mentioned regional instruments. Horizontal financial equalisation is also an act of solidarity, since the rich Länder give up parts of their income to lift their poorer counterparts to within 5\% of the all-Länder average.

\textsuperscript{40} The reason for this is that most of the Länder's spending is pre-determined by their role as administrators of federal law. As such they have very little room for financial manoeuvre anyway. The reason why some Länder are poorer than others lies, of course, in their structural weakness. This is why they need more financial means than their counterparts in order to have some spare money to invest.
Given the dynamic nature of federalism in general, and developments within the EU in particular, the Cohesion Fund is unlikely to be the final word on the issue of more economic and social cohesion. As Figure 4 shows, the shift away from structural policies into the direction of the Cohesion Fund signifies a trend that could continue to go further and towards a German-style financial equalisation mechanism. Currently this appears quite unlikely, as it seems hard to imagine that such a mechanism would find the necessary political support in the richer Member States (particularly with eastern enlargement looming). It seems unlikely also because of the sheer volume it would amount to. The principle of subsidiarity is already being used, by those who believe in the forces of an undistorted market, to argue against any involvement of the Union level in regional policies. The rather negative experience with financial equalisation in Germany, at least as far as the permanent reduction of regional disparities is concerned, would actually add weight to such claims. However, the question is not whether to have a policy to reduce regional imbalances. The Treaty clearly demands the strengthening of economic and social cohesion within the EU. The real issue is to find the right instrument with which to reconcile the apparently contradictory goals of federalism, whilst still achieving a reduction in regional disparities. In other words, the main aim of this thesis is to find the best way in which to work towards more regional equality, without undermining the political pluralism within the EU.

0.3 Academic Context and Approach

The main basis upon which this thesis is being constructed is a comparison between two federal entities, with the aim to learn lessons from one of them for the other concerning one particular issue: the way in which regional disparities in the European Union can optimally be reduced. In this respect the study clearly belongs into the general category of comparative federalism. However, whilst a lot has been written about the federation from which this thesis is attempting to draw useful conclusions, the FRG⁴¹, the very notion that the EU is itself a federal entity is, at present, still very much contested.

It should hardly be surprising that the anti-Europe lobby would claim that the Union may not be a federation yet, thus warning of the ‘dangers’ that federalism would bring with it42, and that there is the acute risk of this situation either changing, or already having begun to change since the Maastricht Treaty on European Union43. But even the most outspoken supporters of a ‘federal Europe’ fall short of actually referring to the Union as a federal entity. John Pinder, one of the most prominent writers on federalism and European integration in the United Kingdom (UK), talks of “many federal elements in the powers and institutions of the EU,”44 thus clearly acknowledging a degree of federalism, but equally as clearly pointing out that this does not amount to enough for the Union to have a federal system of government. The reason for this becomes clearer when looking at Andrew Duff’s interpretation of the current situation. In his view, “the European Union has many of the characteristics of a federal system of government, although it is not yet fully democratic and not working very well - particularly in the pillars relating to internal and external security, which are considerably more intergovernmental than the Community itself.”45

The distinction between the three pillars forming the European Union represents the key to why there is controversy over whether the EU is in fact a federal entity, or whether it is merely an international organisation. As Duff makes clear enough, the pillars dealing with the Union’s Common Foreign and Security Policy (CFSP) and with Co-operation in Justice and Home Affairs (JHA) are mainly based on intergovernmental co-operation, and thus unanimous agreement which is - of course - the way in which decisions are made in international organisations. This realisation is only further supported by the exclusion of these two pillars from the jurisdiction of the European Court of Justice in Luxembourg. However, all this leaves the remaining pillar to be looked at, the European Communities. It is here that the federal elements and characteristics, Pinder and Duff are referring to above, can be found.46


46 At the June 1997 Amsterdam summit, the heads of state or government decided to bring asylum and immigration policies from the third pillar (JHA) into the Communities pillar within five years following the ratification of the Amsterdam Treaty. For details, see: “The Devilish Details,” The Economist 21 June 1997: 38; “Bonn Stalls on Asylum and Immigration,” European Voice 19-25 June 1997: 5; or: the Amsterdam European Council website at: http://ue.eu.int/Amsterdam/en/treaty/treaty.htm.
In line with the thinking by Andrew Duff and John Pinder\textsuperscript{47}, and many other scholars in the field\textsuperscript{48}, this thesis regards the supranational structures of the three European Communities as advanced enough for them to be looked at as representing their own layer of government, similar to those found at the highest level within the vertical division of power that usually signifies a federal system. In order to establish this ‘federal quality’ for the ECs, the thesis thus undertakes to apply the theories of federalism, as developed - among others - by Wheare and Riker\textsuperscript{49}, to the way in which power is divided between the Community level and the Member State level of government, the institutional structures involved, and the policy areas affected. This will lead to the realisation that the ECs are, in fact, an example of a ‘union of states’\textsuperscript{50} in its very early stages of a process of federal integration. Even though the other two pillars of the European Union are distinctly intergovernmental, it can nevertheless be said that the EU does itself have federal qualities - by way of association, if nothing else - because of the federal nature of the ECs.

This notwithstanding, it is only the European Community pillar that this thesis concerns itself with, for the focus of this study is not to compare the EU with the FRG \textit{per se}, but to look at the German experience with federalism and to learn lessons for the European Union of how to reduce its regional disparities within the contradictory framework of simultaneously having to work towards equality and diversity, which is - of course - one of the key aspects of the federal idea. Any approach towards narrowing regional disparities, however, falls strictly outside the jurisdiction of the two intergovernmental pillars of the Union, so that such matters are exclusively being dealt with by the ECs - at least as long as supranational solutions are being sought. The reason why this thesis will, nevertheless, continue to refer to the EU, rather than merely the ECs, is firstly because the


\textsuperscript{50} To use Forsyth’s term which aims to include all forms of federal entities.
EU as the wider concept encompasses the ECs anyway, and secondly to distinguish between the pre-EU and the post-Maastricht Communities.

So, if this thesis only concentrates on one particular aspect of comparative federalism, it may be rightly asked which aspect this might then be. The aim of the study, the finding of an optimal way to reduce regional disparities within the EU, only hints at an answer, but certainly does not give it. This is because the current investigation is not a simple and straightforward, one-dimensional, comparison of regional policies in Germany and the EU. The thesis may be looking for an optimal way of reducing regional disparities within the EU, but it does so by acknowledging and tackling the difficulties posed by the conflicting demands a federal system inflicts on decision-makers at both central and member state level. In other words, this study is not only guided, but also restricted, by the parameters of federalism: the vertical division of power between decision-makers at central and member state level, and the conflicting demands of trying to achieve a degree of equality whilst at the same time maintaining a degree of diversity as well. Within the confines of this framework, a simple comparison between the regional policies applied in the FRG and the EU would have made little sense, since - as will be argued in more detail later on in the thesis - centrally determined regional policies mainly serve to achieve more equality, but they directly undermine the diversity aspect of federalism.

Another approach that could have been chosen for this study, and one which quite invites itself, given the unique example the FRG represents in this field, would be to use the system of horizontal financial equalisation (with which the German Länder balance their per-capita revenues) and extrapolate it to the EU and its Member States. Something very similar, however, has already been done by Dieter Biehl, an expert on both the German Finanzausgleich and fiscal redistribution in the ECs.51 In accordance with the theories of fiscal federalism, he - like other writers in the field52 - explains regional policies mainly


from a budgetary perspective. Yet what distinguishes Biehl from other thinkers on EC fiscal federalism is that he uses his own ‘reference system’, derived directly from the German example of financial equalisation. This system takes into account the added complication that a federal system brings with it when it comes to determining the financial situation of not only the central level of government, but also the fiscal positions of the constituent units within a federal entity. Without going into too much detail, Biehl’s reference system highlights the multi-layered, and thus complicated, nature of fiscal federalism. In a nutshell, it establishes which actors have the power to set tax levels, who allocates and distributes revenues, who determines expenditure, and - finally - who pays for what.\(^3\)

However, despite the importance of Biehl’s reference system to the present study, this thesis is not set out to follow along the path of tackling the issue of regional disparities by way of fiscal policy instruments alone. Just as it was considered to be too simplistic and one-sided to merely compare regional policies in Germany and the ECs to come to a decision as to what would be an optimal way of reducing regional disparities within the European Union, a simple extrapolation of the German mechanism of horizontal equalisation to the EU would equally be as unsatisfactory in coming to an acceptable conclusion.

In order to find out how ‘best’ to reduce regional disparities within the complicated and often contradictory framework the EU’s, like any other, federal system provides, it has thus been decided to enter new academic ground, and compare what appears at first sight incomparable: the German mechanism of horizontal equalisation and the EU’s current instruments with a primarily regional effect, the Structural Funds and the Cohesion Fund. The reason why these seem at first incomparable is that financial equalisation represents a nominal balancing of the books with the possible side-effect of also reducing regional disparities, whilst regional policy instruments function the other way around, i.e. they aim towards reducing regional disparities and thereby represent a degree of financial redistribution. So, even though financial equalisation and the EU’s respective funds aim towards different ends, they all entail aspects of financial redistribution and - at least

potentially - reducing regional disparities. What ultimately makes them comparable is the question of what exactly they are aiming for.

Within a federal system, 'reducing regional disparities' is a relative objective, since it has to take place within the framework of achieving equality whilst simultaneously maintaining diversity. This is where the vertical division of power returns to the current discussion. In a simplified version of Biehl’s four-way split of power in federal systems, Figure 5 demonstrates the basic division between legislative and executive authority in a union of states in which the vertical levels of government not only coexist, but also cooperate with one another, such as the FRG and the EU, and shows what this means for the conflict between equality and diversity.

**Figure 5: The Framework for the Reduction of Regional Disparities**

It is within these parameters that this thesis aims to find the solution to the question of which of the three policy instruments looked at will eventually emerge as the optimal way for the EU to tackle its regional disparities. In order to achieve this, a number of individual studies will be undertaken, the first of which is - crucially, of course - to establish that the EU is, in fact, a union of states of the federal kind. To this end both the Union’s constitutional structures and its practices will be compared to the theories of
federalism as developed by - among others - Wheare, Riker and Forsyth. The findings will then be compared to, and confirmed by, the writings of other researchers into the federal nature of the European Communities, mainly those of John Pinder.

Once the federal nature of the EU has been established, the next step is to identify the FRG as a suitable example for the Union to learn possible lessons from, and explain and justify its selection. Even though many scholars may regard the European Communities as a form of federal entity, very few recognise the close structural resemblance between the institutions and practices of the EU’s supranational pillar with those in place in federal Germany. This thesis thus undertakes to establish the usefulness of a comparison between EU and FRG, which it bases on the assumption that the latter is the one federal entity which most closely resembles the way in which decisions are being made and carried out in the Union. The case of structural resemblance between the Federal Republic and the EU will then be supplemented by a set of three history-based comparisons - all of which are aimed to show that the similarity between German and ‘European’ federalism is not limited to the static issue of structures, but extends to the dynamic processes of federal integration too.

Only with these fundamental issues firmly established is the stage set to begin the real investigation into the search for an optimal way of reducing regional disparities in the EU. The general approach is to remain with the comparative theme, this time contrasting, rather than likening, respective EU issues to their corresponding counterparts from the FRG. This will be done in mainly three steps. First the constitutional objectives behind the three chosen schemes (financial equalisation, structural policies, Cohesion Fund), as well as the schemes themselves, will be looked at. Comparing them with one another will require the study of a combination of primary and secondary sources in order to establish both the framework within which the three schemes function, and the way they themselves work.

The evolution of financial equalisation in Germany, and the chronology of regional, structural and cohesion policies in the European Communities will be the foci of the next examination. Its aim is to divert the attention away from the mere constitutional/structural, and thus static, approach to explaining policy instruments with regional effect, and to expose the role played by the dynamic nature of federalism, in

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54 Again, see: Wheare, Federal Government; Riker, Federalism; or Forsyth, Unions of States.
55 Such as, once again, Pinder, Duff, or Burgess, but also Murray Forsyth in: Political Science, Federalism and Europe, Discussion Paper in Federal Studies, University of Leicester (1995).
particular the various actors involved in the decision-making processes within a system of co-operative federalism. All this requires mainly the use of secondary material which will be used for primarily descriptive purposes with the intention to show how different scenarios lead to different policy outcomes, as decision-makers and general circumstances vary - even if the underlying institutional structures may be very similar.

The final investigation represents the culmination of the work presented in this thesis. It is here that the various avenues, taken and followed throughout the study, come together. Away from how and why the three instruments looked at have come about and function within their own political and constitutional framework, the questions asked here concern the effects that financial equalisation, structural policies and the Cohesion Fund have. By using an inter-disciplinary approach to test the three schemes, this is also the stage at which no established literature exists, and new academic territory will be entered. The thesis will finally come to the conclusion that - given the contradictory and often conflicting parameters within which federal unions of state operate - an instrument like the Cohesion Fund must be regarded as the best-suited approach towards reducing regional disparities within the EU.

0.4 Structure and Contents of the Thesis

This dissertation is divided into eight main chapters. Chapter One prepares the general foundation upon which this work will rest by bringing together European integration and the concept of federalism. It will be argued that the Union possesses all the main features of a federal entity, but that in the absence of full statehood it cannot be considered a federation. A brief look into the difference between federalism and federation shall bring clarity to these, often confused, terms. After the link between European integration and federalism is established, the Union will - in the second half of Chapter One - be compared to other federal systems. The comparison shows that the one federal structure the Union resembles most is that of the FRG.

Chapter Two examines the similarities between Germany and the Union by comparing the ways in which the two entities have evolved as federal systems, and the problems they have faced in their respective federalisation processes. The chapter is divided into three sections, starting with a look at the similarities and differences between the unification processes in 19th century Germany and post-1945 western Europe. The second section will deal with the problems between the Länder and the higher authorities curtailing their sovereignty in a federally structured post-World War II western Germany, and aims to
compare those to the conflicts between the Member States and the institutions of the ECs. The remaining section will look for parallels between the process of German re-unification and the likely effects of incorporating the countries of central and eastern Europe into the EU.

Chapter Three will turn the focus of the dissertation to the constitutional objectives linked to the reduction of regional disparities in Germany and the EU. The strengthening of economic and social cohesion throughout the EC, solidarity among its Member States, and the maintaining of equivalent, if not uniform, living conditions throughout the FRG will be analysed in turn. The chapter will be rounded off by a comparison of these three concepts. Chapter Four, then, shifts the attention from abstract constitutional targets towards the policies and mechanisms adopted to reach them. Divided into three sections, this chapter starts with an introduction and subsequent analysis of what financial equalisation means. Section two then covers structural policy which, in many ways, is an antipode of financial equalisation. And finally the EU’s comparatively new Cohesion Fund will be looked at and analysed.

At this point the general foundations for a discussion into how certain policy instruments function, and which constitutional objectives they serve, should be well established. However, as has been highlighted before, federalism is not just a description of a static division of powers between the central/federal and the member state level of government, but represents a dynamic and ever-changing process of finding a balance between its two central objectives: to pursue equality while simultaneously maintaining diversity. Chapter Five examines, at great length, the development of financial equalisation in the FRG. It is divided into six sections, starting with an analysis of the problems the newly created Länder in the western occupied zones had in finding consensus over the issue of revenue sharing. The next section describes the significance to the equalisation process of the 1949 Basic Law. Section three then looks at the difficult adjustment processes to the relationship between federal government and Länder that took place between the establishment of the FRG and the reform of the ‘financial constitution’ in 1969. This so-called ‘Grand Financial Reform’ is the subject of section four. The fifth topic looked at in this chapter is the time after the 1969 reforms which was initially marked by relative calm, but eventually saw the re-emergence of old, and deeper divisions between the Länder. In the early 1980s these animosities even culminated in several lawsuits before the West German Constitutional Court. Only the utterly unexpected and subsequently rapid developments in East Germany redirected the attention of decision-makers in the FRG away from what soon appeared to be petty arguments compared with the problems

57 Chapter X of the GG.
shaping up with the advent of re-unification. Section six will cover these developments, and what they mean for equalisation policies in the ‘new Germany’.

Although the history of the European Communities is almost as long as that of the FRG, policies aimed at reducing regional disparities have only quite recently become prominent in what is now the EU. Chapter Six contains the main developments. It begins with an account of the slow emergence of structural policies over the first three decades of the existence of West European economic integration. Section two describes the comparatively fast evolution of the Structural Funds during the 1980s. The third section of this chapter, then, covers the Cohesion Fund - the instrument created to help speed up the EMU process for some, and support the catching up process for others. Similarly to the pattern of the previous chapter, Chapter Six closes with an examination of the current state of affairs, as far as the reduction of regional disparities is concerned, and looks ahead to what might, in this respect, lie in store for the EU.

Chapter Seven marks the culmination of the process of comparing financial equalisation, structural policy and the Cohesion Fund. The emphasis here is on the effects these three distinct approaches have on a number of selected issues, all of which are highly relevant to finding an answer to the question this study has set for itself. Section one looks at the relatively narrow issue of whether or not respective financial flows, caused by the redistributive nature inherent in all three of the schemes looked at, go into either consumption, or investment. This means they are tested for their efficiency to achieve a reduction in regional disparities. Section two then widens the focus of the investigation to the question of whether efficiency should be the only consideration, or whether not other aspects, most importantly the issue of democracy, should not be of at least equal importance. What this progression almost inevitably leads to is the core conflict within federal unions of states, the simultaneous pursuit of uniformity and diversity, or equality and pluralism, which are the parameters for the comparisons in section three. Only after the three policy alternatives have been scrutinised according to these three important sets of criteria is the scene set for a more general contrasting of the constitutional objectives of cohesion and financial equalisation.

The penultimate chapter already brings together the main points and realisations necessary to come to a conclusion. However, the final part of the thesis, Chapter Eight, exclusively concentrates on the European Union, and tests the study’s findings with regard to the EC’s attempts to reduce its internal regional disparities. Section one investigates the scope for financial equalisation to achieve cohesion, leading to the conclusion that it is an ill-equipped instrument to this end. Section two then contrasts the concept of
strengthening cohesion with that of reducing regional disparities, exposing the large gap which - at least potentially - exists between satisfying the former and fulfilling the latter. The study ends with finding the Cohesion Fund the most appropriate instrument, under current circumstances, to work towards a narrowing in the EU’s regional disparities. A cautious look ahead at medium-term prospects for the Union will serve to confirm that conclusion.
1. Basic Issues

A central assumption underlying the discussion in the Introduction is that Germany and the EU share the characteristics of federalism. But such an assumption is by no means uncontested. Two issues for further investigation arise. The first is to establish the link between West European integration and federalism, and the second has to do with choosing Germany, rather than any other federal system, to compare the Union with. However, before arguing the above cases, the jargon involved requires some clarification.

1.1 Federalism and Federation

The terms federalism and federation are often thought of as synonymous. This perception stems from the rather restrictive views some authors on federal government have taken in the past. Such views are, however, misleading and need to be rectified. The difference between the two terms lies in the fact that federalism is a theoretical concept, a doctrine even, whereas federation describes the institutionalisation of federalism in a sovereign country. In other words, federalism as a wider theory includes the narrower concept of federation. This is confirmed in King's notion that "although there may be federalism without federation, there can be no federation without some matching variety of federalism". By referring to varieties of federalism, King does nothing other than reveal that this theory can take many forms in practice. This means that federalism is nowadays thought of more as a general, and thus quite flexible, theoretical approach to government. This has not always been the case.

The classic text on federalism is K.C. Wheare's *Federal Government*, first published in 1946. This pioneering book represents what must now be referred to as a rather narrow description of federalism. According to Wheare, "the modern idea of what federal

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1 For instance: K.C. Wheare, *Federal Government*.

2 According to Preston King, quoting Alexandre Marc, in: *Federalism and Federation* 74.

3 Although it will complicate matters, it needs to be mentioned that the terms federalism and federation are frequently also used in slightly different ways by many theorists. This does not represent a contradiction to what has been said so far though. Michael Burgess and Preston King, for instance, refer to 'federation' as if it too was a theoretical concept. They do, however, not change the underlying idea that 'federation' means 'federally structured sovereign state'. To add to further confusion it has to be noted also that the central institutional level in a federal entity too is usually called 'the federation'. For more detailed reading, see: Preston King, *Federalism and Federation*; Michael Burgess, ed., *Federalism and Federation in Western Europe*; William H. Riker, *Federalism*.

4 King 76.
government is has been determined by the United States of America". In this respect federalism describes "an association of states so organized that powers are divided between a general government which in certain matters ... is independent of the government of the associated states, and, on the other hand, state governments which in certain matters are, in their turn independent of the general government". Consequently, "general and regional governments both operate directly upon the people; each citizen is subject to two governments". Wheare admits that it is not always easy to say what matters are within the sphere of either general government or regional governments, but this does not seem the crucial point. Important to him is that "the field of government is divided between a general authority and regional authorities which are not subordinate one to another, but co-ordinate with each other". In other words, the different levels of government work separately from one another, and none is superior to the other. This is where Wheare's definition of federalism becomes too narrow. He describes, essentially, what is called 'dual federalism' - the co-existence of two layers of government which, as a rule, work independently from one another.

Wheare's notion of federalism leaves no room for co-operation between the levels of government in a federal system. And yet, many federations, not least the FRG, have co-operation between the governmental levels as one of the core features of their political system. A wider definition of federalism thus needs to apply not only to dual federalism, but should also at least not exclude co-operation between the levels of government in a federal system:

Federalism is a way of organizing a state so that there is a division of powers between general and regional governments each independent within a sphere. The territory of a federal state is divided into units (for example, states, cantons, provinces, republics) which often coincide with distinctive geographic, cultural or historic divisions of the country. Many of the institutions of government are duplicated at the national and local levels with both levels of government exercising effective control over the same territory and population. Thus the citizens of a federal state belong simultaneously to two political communities: for those functions which are constitutionally assigned to the local level of government the relevant community is the citizen's particular state, canton, province or republic; for functions assigned to the national government, the entire nation is the relevant community.9

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5 Wheare 1.
6 Wheare 2.
7 Wheare 2.
8 Wheare 2.
According to William H. Riker, the distinguishing criterion between the different forms of federations is the degree of centralisation, or peripheralisation respectively. He bases his ideas on the fact that "the essential institutions of federalism are, of course, a government of the federation and a set of governments of the member units, in which both kinds of governments rule over the same territory and people and each kind has the authority to make some decisions independently of the other"\(^{10}\). This, says Riker, means that there is a whole range of possibilities for the distribution of powers to either governmental level which lie between the following minimum and maximum:

\textit{minimum}: the ruler(s) of the federation can make decisions in only one narrowly restricted category of action without obtaining the approval of the rulers of the constituent units. (The minimum is \textit{one} category of action, not \textit{zero}, because if the ruler(s) of the federation rule nothing, neither a federation nor even a government can be said to exist.)

\textit{maximum}: the ruler(s) of the federation can make decisions without consulting the rulers of the member governments in all but one narrowly restricted category of action. (The maximum number of categories is \textit{all but one}, not simply \textit{all}, because, if the rulers of the federation rule everything, the government is an empire in the sense that the rulers of the constituent governments have \textit{no} political self-control.)\(^{11}\)

It has to be noted that Riker does not rule out co-operation between the governmental levels either. Important to him is the existence of at least one area of sovereign authority for either level of government. The next question is whether Riker's theory only applies to federations, or if it extends to other federal entities too. Reiterating what has been said so far, federations have full sovereign international statehood status. Consequently, all other federal entities must be lacking this quality. Murray Forsyth calls all federal systems 'unions of states', distinguishing between 'federal states' (federations) and 'federal unions' (federal entities without own statehood). In this respect, the latter represent a transformation from interstate to intrastate relations, while the former bridge the gap between these unions and the unitary state. Forsyth's key notion is that the creation of a federal union turns at least some of what used to be external affairs into internal matters for this new federal entity.\(^{12}\)

What Riker and Forsyth have in common, is their approach to line up federal entities according to their degree of centralisation\(^{13}\). Forsyth looks at different forms of federal

\(^{10}\) Riker 5.
\(^{11}\) Riker 5-6.
\(^{12}\) Murray Forsyth, \textit{Unions of States}.
\(^{13}\) An exact degree of centralization (or decentralization) is difficult to establish. Following from Riker’s deliberations, it seems to be the amount of ‘functions’ allocated to either level of government which
systems as if they were assembled along a scale which had decentralised federal unions at one, and centralised federations at the other end. This helps to show that federalism is a rather wide and arguably flexible concept. It also, however, only gives a snapshot view of the federal entities studied this way. Hence it fails to spell out that federalism is not a static concept, but stands for a dynamic process of integration (or disintegration). Any chosen federal entity would substantiate this claim, but those federal systems still in the early stages of integration or disintegration are the most exciting proof of the dynamic nature of federalism.14

1.2 Federalism and West European Integration

In order to find out whether the European Union is a federal entity, it appears to be best to look for the most basic requirement of federalism, the existence of two distinct layers of government. To this end it seems helpful to turn to the structures and institutions of West European integration first.

It can be argued that as early as 1952 - with the establishment of the European Coal and Steel Community (ECSC) - a 'European' governmental level was created. Set up to completely integrate the coal and steel industries of its six founding members, the ECSC consisted of the following institutions: a High Authority as the main legislative and executive; a Common Assembly as a supervisory body; a Special Council of Ministers with supervisory, advisory, and co-decision powers; and a Court of Justice to “ensure that in the interpretation and application of [the] Treaty ... the law is observed”15. Although the Community’s responsibilities were (and still are) limited to a relatively small policy area they nevertheless represent “a category of action” which does not require “the approval of

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14 The history of how Switzerland developed over the centuries is one such example of how federalism covers the whole process of federal integration. Equally, the rather recent moves to decentralize Belgium along federal structures serves to show that federalism does not necessarily have to represent a trend towards centralization. Furthermore, as considerations in Canada reveal, the application of federalism there is now - at least academically - being extended to non-territorial issues, such as the participation of societal groups in the decision-making structure. For more details on Switzerland, see for instance: Jürg Steiner, ed., Das politische System der Schweiz (München: Piper, 1971); or Murray Forsyth, Unions of States. For further information on Belgian federalism, see: André Alen and Rusen Ergec, La Belgique fédérale après la quatrième réforme de l’Etat de 1993, internal paper, Belgian Embassy, London; André Alen, Belgium; or Bruno Bamps, De Belgische Staatshervorming in het Spanningsveld tussen Regionalisme en Federalisme, diss., KU Leuven, 1990. More details of ‘assymetrical’ federalism in Canada can be found in: Michael Burgess and Alain-G. Gagnon, eds., Comparative Federalism and Federation.

15 Art. 31 ECSC Treaty.
the rulers of the constituent units". A question mark was raised over this, in 1959, when a ‘manifest crisis’ highlighted the continued importance of the Member States. However, despite this, the ECSC does fall into Riker’s definition of federalism. To be more precise, it represents his minimum description of federal government. The creation of this first European community, however, only marked the beginning of a process of further integration which substantiates the earlier notion that federalism is more than a mere static concept. In the words of Pinder, “the ECSC, with its federal powers over coal and steel and substantial elements of federal institutions, can be seen as an important first step towards federation ...”.

From its meagre beginnings with the ECSC in the early 1950s, European integration increasingly gained momentum. The institutional framework changed with the establishment of the European Economic Community and the European Atomic Energy Community (Euratom) in 1958. Two Commissions were established to draft ‘European’ legislation and mainly act as the Communities’ executives. The Councils of Ministers became the principal legislator at Community level. The Assembly and the Court of Justice were shared by all three Communities. In 1965 the ‘Merger Treaty’ was signed in Paris. This led to the amalgamation of the three Communities to become the European Communities. The two Commissions and the High Authority formed the EC-Commission. Out of numerous subsequent acts and treaties altering the Treaties of Rome and the Treaty of Paris, which are the legal foundations of the ECs, two shall be mentioned here for the particular impact they had on EU integration. The SEA of 1986 legally transformed the EC into a Single Market as of the beginning of 1993, and the TEU created the European Union of which the European Communities represent one of three ‘pillars’. However, while this first pillar represents a highly integrated supranational system, the other two components, a Common Foreign and Security Policy and Cooperation in Justice and Home Affairs, were explicitly designed to be largely intergovernmental in nature.

Along with the increasing number of policy areas transferred to the Union level of government over the years, the powers of the Union’s institutions grew too. In a separate development, the distribution of decision-making authority gradually shifted as well. Consequently, compared to the early days of West European integration, the Union’s

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16 Riker 5-6.
18 John Pinder, “The New European Federalism” 49.
19 The Commission of the European Communities, or EC-Commission for short, re-named itself European Commission after the ratification of the TEU. (In a similar development, the Council of Ministers is now frequently referred to as Council of the European Union.)
present institutional structures resemble more closely those found in fully fledged federations\textsuperscript{20}. The Council still is the principal legislative power; but the European Parliament (EP) now has not only supervisory and advisory powers, but in some cases also co-operation and even some co-decision authority; the Commission has the right to initiate law and also acts as the main executive; the Court of Justice (CoJ) is the final arbiter of EU law; and the Court of Auditors (CoA) supervises the Union’s finances. The difference between the EU’s institutions and those in established federations lies with which institution dominates decision-making at federal level. In most federations this power is ultimately given to parliament\textsuperscript{21}, but the EU is dominated by the Council, and thus indirectly by the Member States.

The question thus occurs whether the Union really does fall into Riker’s definition of federalism in which he refers to the “independence one kind of the pair of governments has from the other kind.”\textsuperscript{22} In respect to secondary legislation, i.e. decisions taken on the legal basis the Treaties provide, there can be little doubt that the Union’s governmental framework fulfils Riker’s condition to govern over at least one policy area without having to consult the Member States. The Union has in fact obtained a substantial number of policy fields in which it has exclusive authority. Coal and steel policies have already been mentioned in connection with the ECSC, but over the decades the EC in particular has been taking over more and more areas of responsibility from the Member States, the most prominent (some would say infamous) of which must be the Common Agricultural Policy (CAP). Other policy areas include competition, structural and regional policies, trade, consumer protection, industrial policies, research and technological development, and environmental protection. The principal issue here is that Council decisions on these policies are taken by qualified majority voting. This means, of course, that decisions do not require the consent of all Member States in order to become legally binding in the Union as a whole.

It may be more difficult to establish the Union’s independence over primary legislation, i.e. the right to amend and extend its own constitutional framework\textsuperscript{23}, but all this does not

\textsuperscript{20} This statement is somewhat misleading and thus requires further explanation. The whole ‘institutional framework’ serves mainly the EC pillar of the Union, while for the other two pillars of CFSP and JHA (bar a few exceptions) it is just the Council which is responsible. As already touched upon in the Introduction, a division between what could be referred to as the supranational pillar and the intergovernmental pillars of the Union ultimately manifests itself in the fact that the latter two also fall outside the responsibilities of the Court of Justice. This notwithstanding, the TEU in Title I, Article C, states that “the Union shall be served by a single institutional framework ....”. The impact this divide has on the analysis of federalism in the European Union cannot, however, be ignored.

\textsuperscript{21} In Switzerland the use of plebiscitary elements is widespread too.

\textsuperscript{22} Riker 5.

\textsuperscript{23} The crucial point here is that such decisions require unanimous agreement within the Council. This in itself makes it difficult enough to determine which governmental level ultimately decides on the Union’s
dispute the fact that the Union has its own independent powers to legislate. In respect to secondary (ECs) law, decisions are taken by the Council, and not the Member States. Only when national ratification is required - i.e. when powers are transferred from national parliaments to the institutions of the EU, and that is when primary law is being decided upon - are the Member States in command. Consequently, the EU does fall into Riker's definition of federalism. Indeed, with its substantial powers over a number of policy fields, it has definitely departed from being an example of his minimum representation of federalism. Although Riker himself only refers to federations, it has already been said that his theory can, and for that matter should, be extended to other ‘unions of states’. According to Forsyth's and Pinder’s distinctions between federal states (i.e. federations) and other federal unions the EU still is only at, what could be referred to as, the lower end of the ‘federalism scale’ - but firmly on it.

The existence of (at least) two distinct layers of government, either of which has at least one area of exclusive authority, is arguably the main proof that the EU is a federal union. There are, however, two other aspects which shall be briefly mentioned to underline this notion further. The first issue has to do with the permanence of (West) European integration; the second is about the EU’s fiscal position. Doubts could easily be raised about the permanency of the Union - after all the ECSC Treaty is set to expire in 2001. However, unlike international organisations of which participation, as a rule, is temporary to the extent that it could be withdrawn at any time, membership of the EC (and Euratom) is open-ended. The Treaties do not contain any rules for membership withdrawal. In this respect the EU must be seen as being of as permanent a nature as any other federal system.

As far as the issue of the Union’s finances is concerned, it appears useful to return briefly to Pinder’s ideas about federalism, federal unions and federal states. He defines a federal union as requiring fully federal institutions, and disposing of “the essential federal economic powers”\(^4\). The EU, as has been argued above, does provide a federal institutional framework. It is more questionable what Pinder means by ‘federal economic powers’. In a narrow interpretation, he could point at the Union’s ability to decide over economic policies. More likely, however, is that Pinder refers also to the power to raise constitutional law. This notwithstanding, it can still be argued that the Council is a Union institution, and as such it is the Union level of government which determines not only secondary, but also primary, law. This notion could be supported by the realisation that only major transfers of sovereignty away from the Member States, and into the sphere of competence of the Union, require ratification nationally. However, it is exactly this point which casts a shadow over the extent to which the Council, and as such the Union, can act independently from the Member States. After all, national ratification requirements give the Member States the ultimate control over their transfer of sovereignty to the Union’s institutions.

\(^{24}\) Pinder, “The New European Federalism” 46.
taxes. "The experience of the American confederation that preceded the United States of America has entered into federalist lore: without its own power to tax, it depended on contributions from member states which were not forthcoming, so the confederation was rendered ineffective." Indeed, the notion that a country's room for political manoeuvre depends to a large extent upon how well equipped it is financially, is - of course - also true for the EU. This is a point stressed by Ulrich Hade, who writes about the ECs' 'financial constitution'. In his opinion, it is not only the Communities' competences, but also their financial resources which decide over their ability to transform plans into policies. Hade uses the term financial constitution despite his conviction that the ECs do not possess statehood quality. He does, however, find that the Communities' financial system is getting increasingly similar to that of a federation.26

Up until 1970, the ECs were mainly financed by allocations from the Member States. Only a small proportion of their revenue came from levies collected under the rules of the ECSC Treaty. This changed with the Council Decision on Own Resources of April 1970. With this amendment to the Treaties, the Communities' mixed system, consisting of some own levies, but mainly Member State budgetary contributions, was abandoned. Instead, the Member States agreed to adopt the principle of 'own resources' for the ECs, in effect giving up sovereignty over a small fraction of their own revenues. The Communities' own resources grew steadily, and today consist of: agricultural levies; revenues from tariffs imposed on imports from non-member states; up to 1% of national revenue from value-added tax (VAT); and, since 1988, a maximum levy on the national gross domestic product (GDP), currently 1.27%. The ultimate right to sanction changes in the rules governing the ECs' own resources is still reserved for the Member States, for such a move means an amendment to the Treaties, which in turn requires national ratification.

This could cast serious doubt over just how independent the Union level of government is from the Member States. However, as Riker's deliberations about the subject show, federalism is not necessarily about the extent to which the two governmental levels can act independently from one another, but the mere fact that there exist two levels of

25 Pinder, "The New European Federalism" 56.
27 Strasser 28.
28 The VAT quota is calculated on the basis of a commonly agreed denominator. This denominator, however, may not exceed 55% of a Member State's GNP, thus reducing poorer countries' contribution to the Union budget, and effectively representing a redistributioonal element within the EU financial system. For details, see: Hade 401.
30 Ulrich Hade 401.
government, each with at least one area of independent responsibility. With this in mind, it is possible to split authority over the Communities' finances into two, in a similar fashion as has been done earlier by distinguishing between primary and secondary legislation. In view of financial authority, the Member States may still decide over how much money the EU can spend, but how it is spent is determined by the Union's institutions. In this respect, the Union does have a federal budget.  

Most definitions of federalism are wide enough to extend beyond the example of the United States of America (US), and thus include a variety of entities which all have the common feature of at least two distinct layers of government, each with at least one area of authority in which it can act independently from the other(s). Two main categories of federal entities, or unions of states, can be identified: federal unions, and federal states. The latter are marked by the quality of own statehood, and are usually referred to as federations. The former lack the quality of statehood, but otherwise have all the hallmarks of a federal entity. That the EU represents a federal union is shown not only by its permanent nature, but also by its institutions' decision-making authority over many policy areas, including the budget. As a federal union, the EU can be compared to other unions of states. Such an exercise not only substantiates the Union's own federalism, but should also reveal where among federal entities it can be located.

1.3 The Union and Other Federal Systems

"Comparisons among federations are useful," writes Ronald L. Watts,

but not because their institutions are easily exportable to different situations. ... comparative analyses are useful because they give insights into or draw attention to the significance of certain features in a particular political system. The ways in which similar institutions operate differently, in which different institutions operate in similar ways, and in which unique institutions or traditions affect the political processes which predominate, can help ... to understand a particular federal system more clearly.  

The task here is, of course, to locate the European Union within the context of existing federal entities. In the article from which this quote stems, Watts uses a five-step approach to compare the FRG to other federations, mainly the US, Canada, Switzerland and Australia. The "five sets of comparative questions" are: "(1) the process of

32 Ronald L. Watts, "West German Federalism: Comparative Perspectives," German Federalism Today, ed. Charlie Jeffery and Peter Savigear 23.
federalization; (2) the social basis of federalism; (3) the institutional structure of the federations; (4) their political cultures, i.e. ideas of federalism; and (5) the functional dynamics arising from the interaction of the first four aspects.”

Because it distinguishes itself from other writings on federalism by comparing quite a broad range of functional aspects of unions of states, Watts’ article has been chosen, first, to form the basis upon which to compare the Union to some of the established federations and, second, roughly to follow its pattern with the ultimate aim to find the best possible example for the EU to draw useful lessons from. In doing so many federations, though most prominently Germany, Switzerland, the US, Canada and Australia, will - at one point or another - be looked at.

The first of Watts’ comparisons concerns the process of federalisation. As has been noted before in this thesis, federalisation can take the form of integrating formerly separate political units, or be achieved by disintegrating a formerly unified state. This is exactly the point with which Watts starts his analysis of the subject. In his view, “a simplistic contrast might be made between those federations like the United States, Switzerland and Australia which at their formation were created by aggregating distinct political units, and Canada in 1867 and the Federal Republic of Germany in 1949 which emerged from previously unitary political systems.” Watts does, however, acknowledge that the situation in the latter two examples was “somewhat more complex.” In Canada, for instance, the creation of a British North American federation in 1867 had elements of both devolution and aggregation. Tensions between the French majority in Quebec and the English majority in Ontario led to the break up of the unitary Province of Canada, which itself had only be created in 1840. However, the process of federalisation also brought with it the incorporation to the new federation of Nova Scotia and New Brunswick, and more provinces joined the new Canada in due course. Those who joined the former members of the unitary Province of Canada into a federal arrangement, did so mainly for economic and defence reasons.

In Germany federalisation has been complex too. Watts, though recognising the German federal unification process of the 19th century, points out that the creation of the FRG represents a devolutionary step. Despite the fact that the West German state was

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33 Watts 23.
34 This stands in stark contrast to other comparative works on federalism such as, for instance, Burgess’ more philosophical contrasting of federalism and federation, Forsyth’s likening of historical examples of federal and confederal unions, or Biehl’s rather specific exploration of the German system of Finanzausgleich to suggest a future fiscal regime for the EU.
35 Watts 24.
constitutionally formed by its members, the then twelve Länder of the three western occupation zones, he regards the artificial nature of these units as proof of the break up of a unitary state.\(^{37}\) This is in sharp contrast to the aggregation of ‘natural’ units of ethnic, linguistic, or religious distinctiveness such as the Swiss cantons and the Canadian province of Quebec. Watts does, however, admit that even in Canada, as in the US, there are a number of “constituent units which may have appeared artificial to begin with. Nevertheless, over the course of time those units have developed their own sense of community. ... One can see the same processes occurring within the Federal Republic of Germany.”\(^{38}\)

Although a distinction between federalisation by aggregation and federalisation by devolution is logical and conclusive, it appears useful for the present study to narrow down the criteria by which to distinguish the federalisation process of different established unions of states. After all, the purpose is to find a federation that gives sufficient clues for the study of the European Union. In his elaborations over Canadian federalisation Watts already mentions the main reasons why devolution or aggregation would occur. The former has to do with the recognition of cultural, e.g. linguistic or religious, divisions affecting the functioning of a formerly unitary state. This is why the Province of Canada was federalised in the first place. A more recent example of federalisation by devolution is the case of Belgium. Ethnic rivalry between Flemings and Walloons led to the creation of the three political regions of Flanders, Wallonia, and Metropolitan Brussels. Linguistic divisions between Dutch, French, and German-speaking Belgians resulted in the set up of three respective cultural communities, not identical with the regions, but co-existing next to them. This particular set-up is referred to as ‘bipolar’ federalism.\(^{39}\)

The European Union is, of course, the product of an opposite development to devolution, the process of integration. Hence, no more needs to be said about federalisation by devolution here. Switching over to the subject of federalisation by aggregation, or in the case of the EU integration rather, mainly two motives behind such processes can be identified: defence and security, and economics and welfare.\(^{40}\) A rough differentiation between those federations which started to aggregate on the grounds of security and...
defence, and others which first integrated economically, can be made accordingly.

Forsyth’s book *Unions of States*, to a large extent, covers exactly this subject, and identifies the early Swiss confederation (1291-1798) and the United Provinces of the Netherlands (1579-1795) as perhaps the purest examples of federal unions created to protect themselves against external threats. Similarly, the Confederation of the United States of America (1781-9) and the German Bund (1815-66) were both also created primarily for reasons to do with security and defence, but also “to give added stability to existing governmental structures, [and] ... to uphold particular principles of government.”

Possibly the best example for federalisation on the grounds of economic considerations must be the German Zollverein, a customs union established by 18 German states as per 1st January 1834. Very early on in the lifetime of the Deutscher Bund (German Confederation), it had become clear that welfare and prosperity were closely connected with economics, and trade in particular. While the nation states surrounding the Confederation applied mercantilist policies, i.e. preventing foreign goods from swamping their own markets, the German states as a rule traded freely internationally. However, internal trade among the members of the Bund was hampered not only by tariffs and thus border controls, but also by the existence of differing coinage, measures and weights. The Württemberg economist Friedrich List, an “imaginative, progressive and freedom-loving writer”, propagated the idea of a unitary economic area within the borders of the German Bund. His intentions, however, were not limited to economic policies. Right from the start, List believed that economic integration would be followed by political unification too. In Prussia, similar thoughts had been circulated. “The importance of the customs union between Prussia and southern Germany, wrote the Prussian Minister of Finance [Friedrich von Motz], lay in the fact that ‘unification of these states in a customs and trading union leads to the establishment of a unified political system.”

The European Union started its process of federalisation by economic integration too. It needs to be stressed at this point though that economic integration is - of course - not an end in itself but did, and still does, happen within a political context. In the case of

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41 Forsyth, *Unions of States* 17-8.
44 Forsyth, *Unions of States* 42.
47 BRD, Bundestag 59.
48 Golo Mann 116.
German integration last century the background was the experience of the Napoleonic era. West European integration after the Second World War was initially triggered off to prevent Germany from ever dominating Europe again, and later intensified in the light of the East-West confrontation and the perceived threat coming from the Soviet Union. In this respect, economic integration too is in effect indirectly governed by security and defence considerations.49

The ECSC, despite its main aim of preventing another war between Germany and France, was nevertheless based on aggregation along economic lines.50 This notion is confirmed by the introductory remarks to the Treaty of Paris, which states that the signatories were, among other things, “resolved to substitute for age-old rivalries the merging of their essential interest; to create, by establishing an economic community, the basis for a broader and deeper community among peoples long divided by bloody conflicts, and to lay the foundations for institutions which will give direction to a destiny henceforward shared”.51 The long-term objective of political unification, just as indirectly aimed at with the Zollverein, rings through here as well. Such political ambitions became more evident in the Treaty of Rome, establishing the then EEC. Not only was this new community to “strengthen the unity of their [the Member States’] economies”, but the plenipotentiaries who signed the Treaty also declared to be “determined to lay the foundations of an ever closer union among the peoples of Europe”52.

To summarise the above findings, the process of federalisation can take two main forms, devolution or aggregation. Of interest to this study is only the latter, a closer look at which reveals that a choice exists between different ways to pursue this goal. In history, chiefly two main strands can be identified, aggregation for reasons to do with defence and security, and economic integration. In a way they both have to do with bringing welfare to the people of the realm in question. However, federalisation on the grounds of defence and security considerations is, what could be called, a negative (or indirect) means to bring welfare. In contrast to this, economic integration is a positive step towards welfare for the people, because it directly, and actively, pursues economic growth and prosperity. Though it should not be forgotten to mention that federalisation generally seeks to find,

49 More details about this can be found in Chapter Two which deals exclusively with the issues surrounding the unification processes in Germany and the EU.
50 In a reversal of Forsyth’s point about the links between defence considerations and the welfare effects of federal integration, it could well be argued that the creation of the ECSC had as much to do with security as it had with economics. This notwithstanding, the ‘chosen path’ was economic integration.
52 Rudden and Wyatt, eds.  17.
or maintain, political stability and, at least internal, peace. The European Union has its foundations in economic integration, and the only other major example of aggregation by this route is the German Zollverein.

The second of Watts’ sets of comparative questions deals with the importance of the social basis of federalism. The question here is whether the entity looked at has the social basis for a federal structure, or whether a federal structure has simply been imposed on a basically non-federal society. However, as the EU is not a full federal union itself, and since this thesis mainly aims to look at the issue of regional disparities anyway, only three rather general aspects will be considered: the degree of territorial ethnic or religious pluralism or homogeneity, the degree of economic regionalism or integration, and the extent of economic disparities among the constituent units.

As far as the territorial distribution of linguistic or religious groups and their concentration in a federation’s constituent units are concerned, Switzerland, Canada and Belgium all have explicit language and/or confessional cleavages. In these unions of states federalism represents the political expression and recognition of such ethnic divides. In contrast to that the US, Australia, Austria and the FRG do not differ much in their ethnic composition. The EU falls somewhere in between these two groups. It is clearly divided into a number of distinct nations, themselves separated along ethnic, linguistic and sometimes religious lines. In this respect, the Union should belong into the first group of federal unions. However, while Belgium and Canada are arranged mainly along language divides, and Switzerland according to language cleavages and - originally - religious lines, the EU is far more heterogeneous altogether. At present it combines fifteen nations and eleven official, plus at least another eleven regionally spoken, languages. Religious

5 Other examples of federalisation, not mentioned so far are Austria and Australia. They somewhat fall outside the pattern described above. Austria became a federation after the break-up of the Habsburg empire and a power-vacuum in the remaining German Austria. However, real devolution it was not, as the German parts of Austria simply found themselves without a central authority. An appropriate way to describe the developments in Austria would perhaps be to call it ‘federalisation by default’. Australia, in contrast, did federalise by aggregation, but not for defence or security, neither simply along the lines of economic integration. General welfare considerations, and the realisation that a more united continent would be beneficial for the people living on it must be regarded the main motivation for federalisation. It is worth mentioning also that Australia was created out of provinces between which “there were no basic cultural, racial, religious or linguistic differences” (Joan Rydon, “The Australian Tradition of Federalism and Federation,” Comparative Federalism and Federation, ed. Michael Burgess and Alain-G. Gagnon 227). For more details on federalisation in Austria, see: Felix Ermacora, “Vorstellungen und Wirklichkeit im österreichischen Föderalismus 1848-1970,” Föderalismus in Österreich, ed. Ernst C. Hellbling, Theo Mayer-Maly and René Marcic (Salzburg: Pustet, 1970) 32-52. An account of reasons behind federalisation in Australia can be found in: Rydon 227-30.

4 The official languages are: Danish, Dutch, English, Finnish, French, German, Greek, Italian, Portuguese, Spanish and Swedish. Some of the other languages spoken within the Union include: Alsatian, Basque, Breton, Catalan, Corsican, Frisian, Gaelic, Galician, Lëtzeburgesch, Slovene, and
cleavages may have played a role in the creation of certain Member States (e.g. Belgium), but apart from the continuous conflict in Northern Ireland, they have dramatically lost their significance. The EU of today is clearly divided according to national identity, rather than language or religion.

In terms of economic regionalization or integration, i.e. the degree to which economic performance varies within, the old FRG used to be "clearly at one end of the spectrum among federations", due to its high degree of economic integration which served as a unifying factor. Watts puts Canada at the other end, with Switzerland, Australia and the US somewhere in between, although - in descending order - closer to the FRG. The EU is as yet still economically fragmented, but the provisions of the Treaties, especially after the amendments and additions made by the TEU, point into a clear direction. If fully realised one day, EMU in particular would turn the EU into a closely integrated economy.

Linked to the issue of economic integration is the degree of regional disparities which is, of course, the main subject of this thesis. "Some variation in wealth among regional units is inevitable in any federation. But significant variation may provoke intense regional resentments and undermine the sense of shared national citizenship based on a common standard of services within the federation." If, however, the welfare gap between the regions is extensive, it first "accentuates the problem of political resentment at variations in the standard of services available to citizens in different constituent units; [and] second, it makes the resolution by methods of fiscal equalization more difficult because of the much larger intergovernmental transfers of resources required to correct the situation."

The FRG used to be marked by less extreme disparities than existed in most contemporary federations.

Moreover, like Australia, Canada and Switzerland, but unlike the United States, West Germany has attempted to deal formally with the problem by a system of equalization transfers to the less wealthy constituent units. The Federal Republic of Germany is unique, however, in including among those constitutionally stipulated equalization transfers a significant element of direct horizontal transfers from the wealthier to the poorer Länder. The other federations employing formal equalization arrangements

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56 Watts 26.

57 Watts 26. This notion indirectly supports what has already been briefly discussed in the Introduction, namely the reciprocity between economic and social cohesion after and economic convergence before economic integration.
have relied solely on transfers from their national governments to top up the resources of their poorer states or provinces.\textsuperscript{58}

The EU attempts to ‘strengthen economic and social cohesion’ among its Member States, but does so largely by structural aid, i.e. payments only allocated for clearly identified projects, rather than via free financial subsidies to the poorer Member States. The Cohesion Fund, however, somewhat waters down these principles. It combines elements of structural aid and aid given directly to the constituent units, as the initial criteria for allocations are not individual projects, but firstly the wealth (or lack of it rather) of the Member State in question.

The establishment of the Cohesion Fund thus brought EU regional policy a step closer to the regime in place in the FRG. Technically the Union’s regional policies may differ from horizontal equalisation, the broad strategies behind them, however, are \textit{de facto} decided upon by the Member States, as their representatives still hold the balance of power at Union level. Finally, even though regional disparities within the Union are much graver than they used to be in the old FRG, since German unification in 1990 this is no longer the case. The ‘five new Länder’ of the East only had an average per-capita GDP of around the level found in Greece or Portugal. As a matter of fact, disparities within West Germany already looked like a miniature reflection - if of course on a smaller scale - of the pattern found within the Union.

One of the main reasons, however, why Germany, rather than any other federation, must be a good example for the EU to look at for clues in respect to regional policy is the very shock that the accession to the FRG of five relatively poor Länder gave to the social and economic balance of the new Germany. A similar experience awaits the Union. At a per capita GDP level of 30% of the EU average\textsuperscript{59} the ten applicants from central and eastern Europe (CEECs)\textsuperscript{60} are substantially poorer than the current Member States.\textsuperscript{61} This notwithstanding both the existing and the prospective new members had far more time to prepare for enlargement than had been the case when the Länder of the former German Democratic Republic (GDR) joined the FRG. In 1995, the Union made membership

\textsuperscript{58} Watts 26-7.
\textsuperscript{59} Expressed in purchasing power parities.
\textsuperscript{60} Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia.
\textsuperscript{61} The ten CEECs “represent 29% of the population and 33% of the area of the EU ... [but] it is estimated that their combined GDP represents less than 4% of the GDP of the EU.” However, levels of wealth vary enormously among the candidates. Slovenia, for instance, already has a level of GDP per head of 50% of the EU average, the same relative value that Portugal had when it joined. In comparison, the Czech Republic’s GDP per head is only 42% of the EU average, whilst respective figures for Romania and Lithuania lie below 20%. See: EU, Commission, London Office, “The Enlargement of the European Union,” Background Report B/3/97: 5.
negotiations dependent on the applicants fulfilling certain minimum conditions62. Just over two years later five CEECs, the Czech Republic, Estonia, Hungary, Poland and Slovenia, have been invited by the Commission to start talks for them to join the EU.63 Together with Cyprus they could be full members as early as the year 200364. Despite the time lag, and the attempts to bring the prospective new members closer to the Union in terms of legal/constitutional and economic/commercial structures, it seems more than likely that eastern enlargement will provide the Union with problems not unlike those seen in Germany since 1990.

To thus briefly conclude the present examination, a comparison of the social basis for federalism reveals that the FRG is, again, the one federation which the EU most closely resembles. Even though, due to its still rather fragmented nature, the EU has its own distinct territorial divisions, both the economic structures and the regional disparities in Germany can be regarded as a microcosm from which the Union should be able to draw useful conclusions.

The third test, based on Watts’ five comparative questions, concerns itself with the institutional structure of federal unions. The basic institutional characteristics of modern federations have already been looked at earlier in this thesis. Six main features can be identified, shared not only by the US, Canada, Switzerland, Australia and the FRG, but also the EU - despite the fact that the latter is a much looser federal union: firstly, the existence of at least two orders of government, acting directly on the people; secondly, a constitutional allocation of jurisdiction and resources to the two levels of government; thirdly, provisions for shared rule; fourthly, some degree of representation at central level of regional (and often also minority) views; fifthly, the requirement that amendments to the constitution require the consent not only of one layer of government, but also of a certain proportion of the governments or the electorates of the constituent units; and sixthly an umpire, be it a Supreme Court, a Constitutional Court, or the electorate by way of a referendum as in Switzerland.

While all contemporary federations share these basic institutional features, they nevertheless vary from case to case. Two characteristics of the German federal system, however, stand out in particular. One is the way in which the Basic Law has allocated substantial legislative powers to the Bund, yet given most executive authority to the

63 A sixth country, already given the go-ahead to start membership negotiation once the 1996 IGC was over, is Cyprus. See: “Politics This Week,” The Economist 11 July 1997: 6.
Länder. The other is the institutional participation of the Länder governments in federal decision-making via the Bundesrat (Federal Council). These two peculiarities are by no means exclusive to the FRG. As will be established in the following, the EU’s institutional structure resembles more that of Germany than those of any of the other major federations.

Turning to the distribution of powers across the layers of government first, a broad distinction can be made between ‘Anglo-Saxon’ and ‘European’ branches of federation, between dual and co-operative federalism. The former, represented by the US, Canada, and Australia, is generally marked by the assignment of legislative and executive responsibility for a particular area to the same level of government. “Thus, in these federations, in constitutional terms the central governments have both legislative and executive responsibility for the areas of jurisdiction assigned by the constitution to them, and the states and provinces have both legislative and executive responsibility for the areas of jurisdiction assigned by the constitution to them.” In contrast to this, practice in European federations is remarkably different. In Germany and Switzerland, the respective constitutions concentrate much of the legislative authority in their central governments, but allocate administrative authority for many of those same areas to the Länder or cantons.

This arrangement makes possible the combination of a high degree of legislative centralization with extensive administrative decentralization. The autonomy of the constituent units in their administrative activities is protected through the constitutional stipulation of their executive authority in these areas. A corollary of such an arrangement where legislative and executive authority over specific fields is divided between governments is the increased importance of ensuring both intergovernmental cooperation and consultation of the view of the administering governments when national legislation is being formulated.

A general distinction can also be made between those federations in which the separation of powers between executive and legislature has prevailed within each order of government, such as the US and Switzerland, and others in which a parliamentary executive responsible to the legislature has been the arrangement within national and within state governments, like the FRG, Canada and Australia. When it comes to

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65 A very general introduction to which can be found in: BRD, Bundeszentrale für politische Bildung, ed., “Der Föderalismus in der Bundesrepublik Deutschland.” Informationen zur politischen Bildung 204 (Neudruck 1992).

66 Watts 29. There are, as must be expected, minor exceptions to this rule. However, since they are of no real interest to this thesis, they are not being considered here.

67 Even though the Swiss cantons still have comprehensive legislative powers in certain areas, such as on the administration of justice.

68 Watts 29.

69 For more detailed information on this particular point, see: Watts 29-30.
constitutional institutions, and the distribution of powers to them, the EU has to be grouped together with the one federation of the ‘European’ blend looked at here which also has a parliamentary system, the FRG.

As has been explained elsewhere in this thesis, the Union’s constitutional framework consists of the three Treaties, together with the acts and treaties amending and supplementing them. This constitutional framework also lays down the institutional structure of the Union, formed by the Council of the EU, the EP and the European Commission, together with the CoJ (and the CoA). These institutions definitely resemble most closely those in place in a parliamentary federation. The particular feature of the German federal system is the Bundesrat, the chamber in which the Länder governments are directly represented to defend their own interests in the national parliament. The Council of the EU bears a resounding resemblance to the Bundesrat. It too consists of representatives from the Member States whose primary concern is the interest of their home country.

But the similarities do not end there. The creators of the Basic Law decided to opt for what is called abgeschwächte Bundesratslösung (toned-down federal council solution). This means that a compromise between two principles was adopted. The one extreme would have given each Land an equal number of votes in the upper house of the federal parliament, regardless of the size of population represented. The opposite option would have been the ‘pure Bundesrat solution’ under which the number of votes each Land had at its disposal would directly reflect its size within the federation. The compromise tries to combine elements of the two extremes. There is a scaling of votes, roughly following the size of the constituent parts of the FRG, and yet leaving the smaller Länder with a relatively stronger hand in federal affairs. Within the FRG, the exact allocation of votes for the Länder in the Bundesrat is written down in Article 51 of the Basic Law and varies from three for the smallest, to six votes each for the largest members of the federation. A similar voting pattern has been adopted for the Council of the EU whenever secondary legislation is decided upon, which - as a rule - requires a qualified majority in the Council. Here the votes range from two for Luxembourg to ten each for the four largest Member States, Germany, France, Italy and the UK. Primary law, which means altering and/or extending the Treaties and as such amounts to ‘constitutional change’, still requires unanimity in the Council. In this respect the balance of power is firmly with the Council at

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70 Formerly, and often still, referred to as Council of Ministers.
71 For more on this, see: BRD, Bundeszentrale für politische Bildung, ed., “Der Föderalismus in der Bundesrepublik Deutschland” 21.
Union level, while in Germany Bundestag and Bundesrat are generally seen as equals\textsuperscript{72}. This notwithstanding, it is the institutional structure of the FRG, rather than any other federation, that the EU system resembles most.

The fourth comparison between the EU and some of the existing federations deals with the political culture, values and ideas of federalism. Federalism itself has to do with the extent of, and relationship between, power and accountability in a given political unit. As far as the achievement of accountability is concerned, Watts roughly distinguishes between two quite different approaches. The ‘pessimistic approach’ distrusts the use of power and seeks to control it by sharing and diffusing power. This, so Watts, was the rationale behind the adoption of federalism, and the separation of powers between executives and legislators, in both Switzerland and the US. The ‘optimistic approach’ meanwhile concentrates legislative and executive authority within one single institution, responsible directly to the electorate. By definition, the latter approach can only be found in a unitary state, like Britain.

As far as parliamentary federations are concerned Canada and Australia link elements of the two concepts of accountability just introduced: authority is divided between the two layers of government, but within each government power is concentrated in a combined executive and legislature directly accountable to the electorate. The German federal system represents even more of a mix of the two principles of accountability. “While the principle of parliamentary executives has been incorporated, the inclusion of a number of checks and balances, particularly through the role of the Bundesrat, has made the operation of the national institutions in some respects more akin to the checks and balances and sharing of power that occur in the United States and Switzerland.”\textsuperscript{73}

The question arises where, within this scheme, the European Union would be located. Clearly, the ‘optimistic approach’ does not apply, as the EU is not a unitary system, but a federal union. Among federal entities, the similarity between the Council of the EU and the German Bundesrat would once again place the Union in one category with the FRG. However, due to the different powers the two institutions have within their respective political system, some further explanations are needed. The term ‘democratic deficit’ mainly refers to a lack of democratic control over the decisions taken by the Council of the EU over secondary legislation as this does not require national ratification\textsuperscript{74}. In

\textsuperscript{72} With the exception of those pieces of national legislation the Bundestag can decide upon without participation by the Bundesrat.

\textsuperscript{73} Watts 33.

\textsuperscript{74} The EU’s ‘democratic deficit’ is identified by the EP as “the gap between the powers transferred to the Union level and the control of the elected Parliament over them”: EU, Parliament, Directorate General
Germany the Bundesrat is checked and balanced by the Bundestag (Federal Diet), the first chamber (and vice versa). Despite growing powers, the EP only has partial control over the legislative authority of the Council which leaves the Union with, what could be termed, an ‘accountability gap’. All this, however, is mainly due to the particular nature and relative youth of the EU federal system, and does not alter the fact that it resembles, in its structures and processes, the FRG more than any other federal entity.

An aspect inseparable from the concept of federalism is the notion of community. ‘Unity in diversity’ is an often quoted description of the relationship between the federation and its constituent units, but also describes the relationship among the units themselves. Closely related to the idea of community is the issue of solidarity. In Germany this manifests itself constitutionally by the general principle of Bundestreue (federal loyalty), and in the more concrete form of fiscal federalism. Bundestreue describes a positive attitude each of the actors in the federal system is expected to have towards internal cooperation, as opposed to competition within the system. According to the principle of subsidiarity, this works either way. The centre has to consider the interests of the constituent units, and the members of the union have to support the centre.

As far as fiscal federalism is concerned, each federation is faced with the task of establishing just how uniform standards of living should be throughout its realm. The main distinction between the various arrangements of financial solidarity lies with the degree of earmarking attached to respective allocations. Where there are conditional grants given to the federal units, such as is the case in the US, the autonomy of these sub-units is seriously undermined. At the other end of the scale are Canada and the FRG, where transfers of fiscal resources “are made with only rudimentary, or no conditions as to their expenditure imposed upon the recipient governments.” The drawback here is that the money could be spent on projects not aimed at alleviating the problems for which the payments were received in the first place.

The case of the EU is altogether different, and cannot directly be compared to any of the established federations. This, again, has to do with the fact that the Union is only at the beginning of a process of integration (and federalisation). However, looking into its

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*5 The concept of federal loyalty is not explicitly mentioned in the Basic Law, but was confirmed as a constitutional principle by a ruling of the Federal Constitutional Court. For this, and more about Bundestreue, see: BRD, Bundeszentrale für politische Bildung, ed., “Der Föderalismus in der Bundesrepublik Deutschland” 16. See also: BRD ed., Bundestag Bundesrat Landesparlamente: Parlamentarismus und Föderalismus im Unterricht und in der politischen Bildung (Rheinbreitbach: Neue Darmstädter Verlags-Anstalt, 1991) 26.

*6 Watts 34.
constitutional provisions, not only can the demand for stronger social and economic cohesion be found there, but also a call for solidarity between the Member States and their peoples. As far as the Union’s legal order is concerned, the concept of solidarity could be interpreted as being part of a principle of ‘Gemeinschaftstreue’ (communal loyalty), similar to the German concept of Bundestreue, which confirms that the EU firmly belongs into the group of unions of states in which the various levels of government co-operate, rather than compete, with one another. In terms of fiscal federalism, solidarity amounts to a commitment by all levels of government to reduce regional (and social) disparities. Within the still rather fragmented Union it is the concept of stronger economic and social cohesion which aims to achieve this, whilst in the highly integrated FRG solidarity is being achieved by financial equalisation and the guiding principle of maintaining at least equivalent living conditions throughout the country. In other words, both the EU and the FRG are unions of states which aim to achieve a reduction in regional disparities, and thus work towards more equality as opposed to welfare diversity within their respective entities.

Watts’ fifth and last comparative question covers the political processes and dynamics within federations - and this mainly refers to the character of, and role played by, the political parties. Three clear distinctions can be made here. In the US and Switzerland the national parties have worked as coalitions of state or cantonal parties. This means relatively loose party discipline at national level, but considerable opportunity for the representation of regional views. In Canada and Australia a kind of dual system of national and provincial/state parties has developed due to the rather autonomous relationship between the national and regional wings of the same party. In those systems there is much less room for the expression of regional views.

A genuinely unitary party system exists in the FRG. That does not, however, mean that regional interests are sidelined. Quite the contrary is true, which has to do with the particular role of the Bundesrat. The fact that the Länder take part in federal decision-making through this institution requires the political parties to take as much of an interest in Länder affairs as in national matters. Furthermore, the relative independence given to

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77 Article A TEU; and also: Art. 2 ECT.
80 This notion is shared by Heinhard Steiger 62.
81 In the US, the main reason for political parties to collaborate on a national scale are Presidential elections.
the Länder by the Basic Law\(^8_2\) means that even Bundestag elections are, technically, being
held in the sixteen Länder, and not the FRG as one entity.\(^8_3\) The political parties in
Germany are structured and organised accordingly. All main parties, most of which have
quite a history of decentralisation\(^8_4\), are subdivided into Land branches
\((\text{Landesverbände})\).\(^8_5\) In Land elections, these branches often act quite independently from
their federal counterparts. The clearest example of this is the Free Democratic Party
which, while in a governing coalition with one main party at federal level, co-operates
also with the main federal opposition party at Land level. In a similar fashion do the two
main rivals in the Bundestag form grand coalitions in some Länder, if the outcome of an
election leaves them with little or no room for co-operation with smaller parties.\(^8_6\)

The party-political structure of the EU is, naturally, different from that of an established
federation. Again, this has to do with the relative youth of this federal union. Elections to
the EP are conducted on a national level, with differing rules concerning the electoral
system, the size of constituencies (due to the national quotas for parliamentary seats), and
even the day of polling. Voters choose between candidates from national parties who
represent them in the European assembly. However, “MEPs [Members of the European
Parliament] have an independent mandate and cannot be bound by national parties, which
is a source of friction between them and one reason why party cohesion can be weak.”\(^8_7\)

\(^8_2\) Art. 30 GG: “Except as otherwise provided or permitted by this Basic Law the exercise of
governmental powers and the discharge of governmental functions shall be incumbent on the Länder.”

\(^8_3\) This seemingly minor point has a significant importance to the composition of the Bundestag, since it
is likely to increase the number of so-called Überhangmandate (spill-over seats) which occur when more
candidates are elected directly, via the ‘first vote’, than the party they represent gained though the
‘second vote’. If the first chamber reflected the overall national vote, the scope for Überhangmandate
would be lower than it is now that such calculations are being made for the voting patterns within each of
the sixteen Länder.

\(^8_4\) The Social Democratic Party is the only main party with a centralist past. This has to do with the
ideology behind socialism. As has been mentioned earlier, social equality is closely connected to central
decision-making.

\(^8_5\) The traditional reflection of the federal structure of the party political landscape in the FRG has been
the fact that there are two Christian Democratic parties: the Christian Social Union in Bavaria, and the
Christian Democratic Union in the remaining Länder. A more recent example for the general ‘bottom-up’
structure of German party politics is the Green party \((\text{Die Grünen})\). Only established in the late 1970s,
‘the Greens’ are probably the most decentralised political party in Germany today. Apart from those
parties competing in elections nationwide there are a number of regional and minority parties. The most
prominent of these must be the Party of Democratic Socialism (PDS), the re-named successor to the
Socialist Unity Party of the former East Germany, and now a strong force in the eastern Länder. However,
even the PDS contests general elections, and in the 1994 Bundestag election the party won four direct
mandates (via the majority principle of the first vote) which meant the suspension of the usual 5% threshold clause for the entire PDS vote.

\(^8_6\) For more details about the federal-Länder structure of the political parties in Germany, see: Roland
Germany}, ed. Stephen Padgett (Aldershot: Dartmouth, 1993); or: Oscar W. Gabriel, “Federalism and

\(^8_7\) Juliet Lodge, “EC Policymaking: Institutional Dynamics,” \textit{The European Community and the
Instead, these ‘euro-MPs’ either belong to one of the EP’s party groups, such as the Group of European Socialists, the European People’s Party, and the Liberal Democratic and Reformist Group, or remain independent MEPs. This means that the present party-political system of the EU looks very much analogous to that of the US or Switzerland. Yet, similarities with the situation in Germany can be identified too. These concern the degree to which members of political parties not only pursue individual interests for the entirety of the federal union in EP and Bundestag respectively, but also how they correspond to decisions made in the other chambers, the Council or Bundesrat.

In Germany, for those laws which require the consent of the Bundesrat, the main opposition party in the Bundestag can use a majority in the second chamber for its political purposes - and usually succeeds in doing so as long as no particular Länder interest is being compromised. At EU level the Council is the dominant decision-maker and, where provided for, the EP the ‘junior partner’. But, ‘cross-level opposition behaviour’ can be detected here too. In the Spring of 1995 the British members of the EP’s Socialist Group abstained on a motion - to which they in principle agreed - for fear of weakening the position of the Labour Party at Westminster. This indicates that, even though MEPs are officially independent of their national parties, they can and apparently do act with (at least some) national party-political considerations in mind. It also shows that as much as Germany does not have a truly unitary party system, the EU’s party-political landscape is more complex as often assumed, too.

The processes of intergovernmental relations are, of course, an important aspect of the dynamics within federations. As has been seen earlier, the pattern of intergovernmental interaction in the FRG matches quite closely those in place in Canada and Australia where the executives on both levels of government dominate these processes. According to Watts

the tendency to ‘executive federalism’ is further reinforced in the Federal Republic of Germany by the particular form of distribution of powers, under which for many areas of Bund legislative authority the Länder have been constitutionally assigned executive authority, and by the institution of the Bundesrat which provides for formal participation of the Länder executives in a substantial area of national policy-making.90

88 The latter “forego parliamentary privileges reserved for the party groups and which were designed to encourage MEPs to form themselves into ideological alliances. The EP’s Rules of Procedure also favour multinational over uni-national groups by specifying minimum size criteria for recognition as a party group.” Lodge 25.
90 Watts 35-6.
Indeed, Germany is widely seen as the prototype of ‘co-operative’, as opposed to ‘competitive’, federalism. In view of the way intergovernmental relations have developed within the EU so far, there can be little doubt as to which category it belongs to: the similarity between Bundesrat and Council are striking - and with the Member States executing most of the Union’s decisions, this division of responsibilities exists too.91

Throughout this section, Watts’ ideas about comparative perspectives on federalism have been used as the basis from which to proceed to find a federation best suited to pose as an example for the EU. The aim is, of course, to single out a counterpart from which to draw useful conclusions for mainly two areas; first the general decision-making processes, and the relationship between and among respective governments; and second the more specific fiscal/financial provisions to address the issue of regional disparities. There is one main difficulty in comparing the Union with the much more integrated established federations, and that is the pace of change. While all federations are by nature more flexible than unitary states, federal unions which are only at the beginning of the federalisation process, such as the EU, see more and faster change than the established federations. The process of federalisation poses problems rarely shared by contemporary federations. It is for this reason, that comparisons also need to be made with earlier federations, and/or the federalisation process of existing federal unions.

When looking at various early federations, it soon became clear that the German Zollverein was the closest match history could provide for the Union. Some federations, most prominently Canada and Belgium, were established by devolution, a process contrary to developments in western Europe after World War II. Those examples which emerged from a process of aggregation, such as Switzerland, the United Provinces of the Netherlands, the US, and even the German Bund, had been founded for reasons of defence and security. Only the Zollverein, like the ECs, was based on economic integration, with a long-term goal of more political unity. Germany actually remains the most favoured contender throughout this quest for a suitable example for the Union to draw lessons from. As far as institutions, mechanisms, facts and situations are concerned, the FRG nearly always turns out to be the one federation from which to look at the EU would benefit most.

The old West Germany in particular would give the Union an insight into how the economy of the most integrated among federations worked. The FRG’s unique system of

91 Watts, in his article on comparative perspectives of West German federalism, also discusses the pros and cons of cooperative and competitive federalism (p. 36). As this is not of immediate interest to the present inquiry into finding a good example for the EU to draw further conclusions from, it will not be pursued any further here.
financial equalisation represents the ultimate expression of fiscal federalism and solidarity among the constituent units. Even the international contexts which contemporary Germany and the present Union find themselves in are closer than those of any other federation, due to the unique challenge to both unions of states posed by the joining of new members, all substantially poorer than the federal average. Also Germany’s institutional structure is similar - more than that of any other federation - to the institutional framework of the EU. Not only are both systems marked by a high degree of co-operative federalism, because of the division between legislative powers located at the centre, and most executive authority given to the member governments. The striking similarity between Bundesrat and Council serves to even further substantiate this close analogy.

When it comes to less factual and more ideological considerations, such as political culture, values and ideas of federalism, and political processes and dynamics within federal unions, it appears useful to remember that the EU is still an emerging federal entity. Despite several similarities the Union may currently have with contemporary federations, it should not be forgotten what this new design is likely to be heading for. Thus it appears best to return to the federalising process of the Zollverein. This German customs union must be the closest example to the EU of a number of previously sovereign states trying to integrate economically. In that capacity it reflects better the more ideological arguments behind support for and criticism of federalisation than any of the established federations does.
2. PARALLELS BETWEEN GERMAN AND EUROPEAN UNIFICATION

This chapter aims to demonstrate that there are more than just structural similarities between federal Germany and the EU. In order to highlight the parallels between the dynamic processes of German and European unification three distinct, and in themselves separate, developments shall be looked at. At first the path towards closer union in western Europe after World War II will be compared to the process of German unification last century. The rationale behind this is that in both cases the goal of political unification was pursued by means of economic integration. The second comparison will centre around the internal difficulties the centralising forces of integration posed for the members of the ECs and the newly created West German Länder after World War II. Finally, the experience of German re-unification will be used as the basis for an anticipation of the likely effects the widening of EU membership to the countries of central and eastern Europe may have.

2.1 Paths towards Unification

The parallels between (West) European integration in the 1950s and German unification last century begin with the fact that both happened against the background of devastating wars and the desires felt afterwards to avert a repetition of such conflicts. The main reason behind closer links among the German states after Napoleon’s defeat was to build a union of states which would be stronger against any future foreign aggression than the rather fragmented Holy Roman Empire of the German Nation had been. Similarly, efforts to create a European confederation after World War II rested upon the belief that cooperation had to replace conflicts in a world that had become more complex. At the time of the Congress of Vienna (1815), global affairs were dominated by the European great powers. By 1945, however, the US had firmly established itself as a world power, and with the dawning of the Cold War the increasing bipolarisation of the international political situation gradually diminished the relative position of the European countries in

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1 Despite many apparent differences, there are a number of - often striking - similarities between the processes of German unification last century and West European integration after World War II. The scope of this paper does, however, not allow for a detailed overall comparison of the two cases and thus has to limit itself to the issues relevant to this thesis. For a more comprehensive study of the similarities and differences between German unification and European integration, see: Hans W. Mackenstein, *Parallels between German and European Unification: Establishing a Basis for Comparisons*, Discussion Paper in European Politics, University of Leicester (1996).
the world. Just as in Germany over a century earlier Europe had to integrate and speak with one voice in order to maintain any substantial influence in global affairs.

In 1815, the Congress of Vienna marked the return to the old system of powerful rulers dominating European affairs after years of French domination. The four victorious countries, Austria, Britain, Russia and Prussia, co-operated with France in order to restore the old power balance on the continent. Prussia was given Westphalia and the Rhine Province which, in effect, divided the country into two separate parts, but also meant its firm establishment as a predominantly German state. However, compared to France - kept intact as one of the main powers of the time - Prussia remained rather badly compensated. Nevertheless, Britain and particularly Austria had achieved their objectives of maintaining the European order of five principal powers.

The Congress also addressed the ‘German question’. This meant that two rather opposing positions had to be reconciled. Prussia propagated the establishment of a strong German federal state, naturally dominated by its larger component parts. Meanwhile Austria’s principal interest in Germany - as in Europe - was to defend the old systems of government, and the nationalistic idea also went against a multi-national entity such as the Hapsburg empire. The outcome was the German Federal Act, a minimal framework of vague rules which proved to be interpreted by everyone according to their individual ideas over exactly what the Confederation should be. Whilst Prussia saw in it the beginning of a process of gradual federalisation, the Federal Act was seen as the furthest the southern governments were willing to go along such a path.

One main expectation from German federalisation had been a hope for economic integration. However, plans to give the Confederation authority over tariffs and trade had failed because of Bavarian opposition. In 1818 Prussia unilaterally began to push for a reform of the customs system. The new regime transformed Prussia’s economy from a prohibitive mercantilist system to a free-trade arrangement of the liberal school: exports were freed from all duties, and tariffs on imports lowered to a mere 10%. Only trade from other German states passing through Prussia was subjected to high transit duties. The latter step in particular aroused anger from Friedrich List and his German Union of Merchants. They were in favour of free trade within a German customs union but also high common external tariffs to protect its industries from foreign competition. Prussia’s prime goal, however, was the economic integration of its divided territories, and to this end it sought to force those small states and enclaves which it surrounded to join its customs regime. Only over time did the objective of Prussian trade policy shift. Friedrich
von Motz, since 1825 Prussian finance minister, had come to realise that economic integration would lead to political integration too:

> wenn es staatswissenschaftliche Wahrheit ist, daß Zölle nur die Folge politischer Trennung verschiedener Staaten sind, so muß es auch Wahrheit sein, daß Einigung dieser Staaten zu einem Zoll- und Handelsverband zugleich auch Einigung zu ein und demselben politischen System mit sich führt (Motz, 1829).²

A mixture of economic considerations and political ambitions thus led Prussia to intensify its customs policies during the 1820s. A new trade conflict forced Anhalt to join the Prussian customs union in 1828. In the same year Prussia came to an agreement with Hesse-Darmstadt. The treaty establishing a customs union between the two states contained generous conditions for the junior partner, clearly aimed at attracting other would-be members. What it did though was to make the non-Prussian states feel threatened which subsequently led to the setting up of the middle-German customs union (Mitteldeutscher Zollverein). Its existence in turn led to negotiations between the Prussian-led alliance and the newly created Bavaria-Württemberg customs system, and a customs treaty between the Prussian and the southern German system was subsequently agreed in 1829. The middle-German union collapsed and in 1831 Electoral Hesse joined the Prussian system which ended the economic isolation of Prussia’s western provinces. In March 1833 the Prussian-Hessian and Bavaria-Württemberg systems finally merged to form the Deutscher Zollverein (German Customs Union). Before the tariffs were abandoned on New Year’s Day 1834, Saxony and the Thuringian states had also joined the Union, and so did Baden, Nassau and Frankfurt in 1835/6. Until 1842, the year the first Zollverein treaty expired, 28 out of 39 federal states were part of this customs arrangement.

The Zollverein was, just like the Confederation, a federal design. Its principal institution was a congress of deputies. Every member was entitled to a veto and had the right to leave the union should it wish so. Despite these egalitarian-looking rules there was little doubt over Prussia’s leading role. The fact that in northern Germany Hanover, Brunswick and Oldenburg formed their own ‘tax union’ (Steuerverein) indicates that the apparent popularity of the Zollverein must have had its roots in considerations other than pure enthusiasm for the idea of free trade. Many of the German states apparently supported List’s nationalistic policy of internal free trade but protection from foreign competition.

² "If political science proves true that tariffs are only the result of the political division of different states, it must be true also that unifying these states to a customs and trade association at the same time leads to unification of these states to one and the same political system". In: Thomas Nipperdey, Deutsche Geschichte 1800-1866: Bürgerwelt und starker Staat (München: Beck, 1983) 359.
Yet the Prussian-dominated Zollverein applied relatively low external barriers. It was clearly a system designed to suit the largely agrarian Prussian economy. The industrialists and middle-class *Burger* were followers of List’s ideas. The reason why membership of the Zollverein was large despite such hefty opposition has to do with its internal fiscal arrangements and the opportunism of some German states they appealed to. Prussia made so many financial concessions to its fellow members that the customs union was, for its initiator, a loss-making enterprise - at least to start with. This exposes not only the political ambitions behind Prussia’s trade policies, but also that many of the German states had in effect sold their sovereignty for an improvement in their fiscal position.³

All this notwithstanding, the new customs union developed according to integration theory. That means the removal of barriers to trade within, in conjunction with a common external tariff, led to *trade diversion*, i.e. increased internal exchange of goods at the expense of trade with partners outside the union. By the time the first Zollverein treaty expired (1842), the Union’s success, mainly expressed through its high revenues, meant that the renewal of the treaties was now being actively sought by its members, a development which gave Prussia room to readjust its internal position. However, the more important effect of the Zollverein only came to be fully realised after the renewal of the Union’s mandate. *Trade creation* represents a more permanent change of comparative advantages between trading partners: the readjustment of their terms of trade. While trade diversion is a mere static development trade creation is of a more dynamic nature as it results from the positive effects of a larger market within which comparative advantages can be fully explored and larger economies of scale be realised. Large-scale structural developments, often privately funded, such as the building of roads and railways, and the development of steam navigation began. These increased demand for industrial goods eventually transforming the Zollverein from a largely agricultural into an industrial economy. There can be little doubt: the Zollverein achieved economically where the Confederation failed politically - the gradual integration of the German states.⁴

The broad commonality behind German unification last century and European integration after 1945 lies with a similar perception of the respective political situation the countries concerned saw themselves in. In both cases the original rationale behind integration lay with considerations of security and defence. Last century the German states had learned the hard lesson of where the fragmented state of the Holy Roman Empire had taken them

³ As will be seen later, the giving up of political control and/or sovereignty in exchange for more financial allocations is an intricate part of the bargaining process in any union of states, and for this reason a recurring theme in this dissertation.


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and realised the need for some degree of institutionalised co-operation in order to be stronger against a future common foe. This resulted in the establishment of the German Confederation, dominated by its two largest members Austria and Prussia. World War II had also laid bare the fact that the countries of Europe found it increasingly difficult to defend themselves without outside help. Again the pooling of resources appeared the only way forward, and the involvement of both main internal powers, here Britain and France, was seen as crucial to its success.

The situation in western Europe after World War II was, of course, more complicated than that of Germany after 1815. The natural fear of the old enemy was gradually replaced by the perceived danger coming from the Soviet Union’s expansionist policies. This development had different effects in Britain than it had in France, and by the end of 1948 it became clear that the two had drifted apart from their hitherto similar approach towards a new West European order. Britain revealed that, whilst it strongly supported moves towards integration in continental Europe, it saw itself not as part of any future European union. Instead it sought intergovernmental co-operation with its continental partners to counteract the increasingly apparent threat posed by the Soviet Union. France still very much feared a German resurgence and thus remained an ardent supporter of some form of supranational West European arrangement to defend itself against the old foe.

With only the aim of doing something against a possible new threat from Germany in common, but very diverse ideas about how to reach this goal, the outcome was - naturally - an agreement at the lowest common level: the 1949 Treaty of Westminster which set up the Council of Europe, “consisting of a ministerial committee meeting in private and a consultative body meeting in public”. Although hailed as a breakthrough on the path towards a united Europe the Council did not impinge on national sovereignty. The Council’s mandate also fell short of the original aims behind the desire for European integration. Its scope was broad but general, mainly to discuss matters of economic, social, scientific, legal and administrative affairs, together with the maintenance and further realisation of human rights and fundamental freedoms. Defence, the original reason for proposals to unite Europe, was excluded.

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5 The British leadership still very much regarded the country as a global force, and its relations with the Commonwealth together with the special Anglo-American relationship were given priority over European affairs.


7 See: Urwin 35.
When it became clear that a concerted policy for Germany as a whole was less and less likely France performed a remarkable U-turn in its policy towards its former enemy. The new approach was one of integrating the FRG into a supranational design of such magnitude that any future conflict between the two former adversaries would become utterly impossible. However, by the end of the 1940s France found itself in a situation similar to the one Prussia was in after 1815. Both countries were rather dissatisfied with the intergovernmental arrangements of which they had become part. They had both wanted more integration and looked for new ways of getting it. The solution - in both cases - was economic integration. Like Prussia in 1818, France led the initiative in 1950. Its foreign minister Robert Schuman proposed to pool the coal and steel industries of at least France and West Germany, but also any other country willing to join. The plan foresaw a supranational authority to administer the gradual elimination of tariffs on, and the future free trade area in, the goods falling under its mandate.

These proposals had, of course, as much to do with politics as they did with economics. The FRG had become a (virtually) autonomous state that had seen rapid economic growth since the 1948 currency reform. Only by way of integration could France maintain some influence over those parts of the West German economy in the past so closely connected with warfare. For the FRG the incentive to take part was also predominately political. Being invited to join the very countries Hitler's armies had been fighting only half a decade earlier represented its chance for international rehabilitation well before it could realistically have expected it.

The economic gains the French proposal would bring about followed straight integration theory, i.e. undistorted access to resources, larger economies of scale, etc. - but they were just the pretext of, and thus secondary to, the political aims. In this respect Schuman and the man behind his plans, Jean Monnet, both followed in the footsteps of people like von Motz and List: economic integration would inevitably lead to further political integration. In other words, the political aims of the Schuman plan went beyond the mere negative reasons for joining, e.g. the (narrow) national benefits to France and West Germany just mentioned. Schuman's invitation was taken up by the FRG, Italy, Belgium, the Netherlands and Luxembourg. By signing the Treaty of Paris these sovereign states set up the European Coal and Steel Community which came into operation in July 1952. This Community was ambitious in its mandate as its ultimate objective was the creation of a common market in coal, coke, iron ore, steel and scrap, some of the most basic materials in an industrialised society. Furthermore, the ECSC was the first European international

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8 For an appreciation of List's contribution to the cause of political unification by economic integration, see: Emmanuel N. Roussakis, Friedrich List, the Zollverein, and the Uniting of Europe (Bruges: College of Europe, 1968).
organisation with a level of substantial supranational decision-making. Four institutions were set up to perform this task: an independent High Authority as the main supranational executive and legislative body; a Council of Ministers as the co-legislator in many decisions to represent the interest of the Member States; a common Assembly to give some democratic input into the decision-making process, but in effect only an advisory body; and a Court of Justice to settle conflicts between the Member States, between the ECSC institutions, and between Member States and institutions.

While the ECSC was being negotiated a military conflict in Korea intensified the Cold War. Over the question whether or not to allow the FRG to arm and join the North Atlantic Treaty Organisation (NATO)\(^9\), France proposed the establishment of a European Defence Community (EDC) into which a new West German army would be fully integrated. However, the plan eventually failed because France itself proved to be most reluctant to surrender sovereignty over such a sensitive area as defence. The collapse of the EDC thus highlighted where the limits of European integration lay. This notwithstanding the ECSC worked well enough to show clear benefits and the proponents of a united Europe, above all Jean Monnet, were keen to sustain the momentum for integration. Despite its failure, the fact that the governments involved had come so close to ratifying the EDC Treaty reflected their continuing commitment for further co-operation and possibly integration.

In June 1955 an initiative by the Benelux countries resulted in a proposal to create two new communities: one strictly sectoral and confined to integration in the field of atomic energy, and the other more generally geared towards wider economic integration with the ultimate aim of forming a common market. These ideas were met with scepticism in the prospective member states. In France there was widespread support for integrating the atomic energy sectors, but strong opposition to the establishment of a common market. The other five countries were doubtful about France’s motives for the atomic energy community, but positively wanted the common market. In France opponents of wider economic integration saw the FRG as the main beneficiary from such a step and called for concessions to the principle of free trade, mainly to protect the agricultural sector which at the time still employed about one in five people in France.

Agreement was finally reached because French membership was seen as an essential counterweight to West German domination, because the compromise over agriculture also benefited farmers elsewhere, and because the leaders of the FRG were prepared to

\(^9\) NATO had been set up in 1949 as a defence pact against Soviet aggression in Europe and was the result of Britain’s efforts to tie the US permanently to western Europe.
pay almost any price in order to keep France on board as Franco-German reconciliation was the core element in Adenauer’s quest for international rehabilitation of his country. Eventually the two treaties with which the six ECSC members established Euratom and the EEC were signed, and came into force on 1 January 1958. Their institutional structure very much resembled that of the ECSC with mainly two exceptions. Firstly, instead of the High Authority, two respective Commissions, considerably weaker in their mandate than their older counterpart, were set up. Secondly the two new Communities shared the Assembly and the Court of Justice with the ECSC.

Over time the EEC emerged as the most important of the three Communities due to the fact that, unlike their counterparts, its mandate was less clearly defined and as such allowed for more room for political bargaining. Furthermore, its aims were far more ambitious, and its scope broader than was the case with the other two Communities. The task of the EEC was “by establishing a Common Market and progressively approximating the economic policies of Member States, to promote throughout the Community a harmonious development of economic activities, a continuous and balanced expansion, an increased stability, an accelerated raising of the standard of living and closer relations between its Member States.”\textsuperscript{10} Beyond all this, however, the overall aim was “to establish the foundations of an ever closer union among the European peoples,”\textsuperscript{11} - clearly a much more ambitious goal.\textsuperscript{12}

One similarity in comparing the developments in western Europe in the 1950s with those in Germany over a century earlier is that in both cases there were separate, yet parallel, efforts towards both political and economic integration.\textsuperscript{13} Both times the results were rather weak intergovernmental arrangements to co-operate politically but comparatively strong commitments for economic integration. In either case the weaker political union contained both major powers involved, i.e. Austria and Prussia in Germany, and Britain and France in western Europe. They were, however, only loose associations because one of the main powers had not been willing to give up any sovereignty. Almost the contrary can be said about the respective second largest power involved in the processes looked at. Prussia and France had both directly been dominated by the enemy. Naturally they sought to find a way forward which would allow them to re-build their economies and strengthen

\textsuperscript{10} Art. 2 EEC Treaty [EECT].
\textsuperscript{11} Preamble to the EEC Treaty.
\textsuperscript{12} For more details on all this, see: Desmond Dinan, \textit{Ever Closer Union? An Introduction to the European Community} (Basingstoke: Macmillan, 1994) 25-34; Nugent 38-45; and/or Urwin 43-7.
\textsuperscript{13} It appears necessary at this point to briefly make clear where the difference between economic and political integration lies, since economic integration naturally also leads to substantial political activity at the (often newly created) centre. The term 'political integration' describes the sharing of sovereignty in the most sensitive fields of foreign and security policies - policies closely connected to the issue of statehood.
their political position. As has been seen, they both chose to form a federal union which also would have included the other main power in question. When this failed both Prussia and France resigned themselves to go ahead with their smaller partners along a path of economic integration.

Despite all the similarities there were also extreme differences between the establishment of the Zollverein and the creation of the EEC. In Germany there was widespread public support for economic integration but hesitation, if not opposition, from the ruling elites fearful of losing their influence. Almost the reverse was the case in western Europe where the ECs' Member States were prepared to give up some sovereignty but the masses remained largely unaware of the benefits from economic integration. Only business and commerce strongly supported full economic unification both times. Although both Prussia and France sought economic integration for political reasons, their motives differed greatly. Prussia was large enough to benefit from internal reforms to its economic system, but was geographically divided into two main parts and a number of smaller exclaves. The existence of various exclaves also played a role in Prussia's aim to form a customs union with its immediate neighbours. France's political objective was to contain the rapidly growing economy, and thus political weight, of the FRG.

The difference between the road to the Zollverein and the path towards European economic integration thus lies with the membership of the respective schemes and the relative influences within. Prussia alone was larger than all other members put together. It not only had according political weight but the resources to dominate economic integration. Consequently the Zollverein was only the end result of a series of treaties and pacts with which Prussia gradually 'gathered' membership of the German customs union. In western Europe France dominated the Communities for around the first decade after the Treaties of Rome, an era which only ended when President de Gaulle left the political stage. In the FRG Adenauer's resignation as federal Chancellor had brought to power politicians who were less inclined to follow the French leadership and more confident to pursue their own agendas. Eventually this more assertive stance led to a more equal relationship between the two leading Member States and, over time, the 'Franco-German axis' emerged.

Just like the Zollverein, the ECs did (and still do) experience a parallel development of gradual integration and rising membership. The level of economic integration the Zollverein represented, a customs union, was reached by the ECs in 1968 - but the Communities' objectives were more far-reaching than that. The goal was to set up a common market and ultimately a political union. A combination of external and internal
factors, however, slowed down progress towards these targets. International economic and monetary crises during the 1970s de-railed any early plans for the realisation of a common market, and internally it was mostly the ‘euro-sceptic’ stance of subsequent UK governments which prevented any major steps ahead. Only when the French and the Germans began to pull into the same direction did European integration slowly re-emerge. After a long-standing dispute over the UK’s contributions to the ECs’ budget was solved in 1984, the way was finally open to once again tackle the two objectives of a common market and political union. The first target was - by and large - achieved with the creation of the SEM in January 1993, but the second goal seems still some way off - despite the establishment eleven months later of the European Union. The title European Union is misleading though. The core political elements, CFSP and JHA, are - by and large - only intergovernmental arrangements which, compared to the ECs’ supranational character, almost contradict the notion of union.

The example of 19th century Germany shows that ultimate political unification appears to be almost impossible to be achieved by voluntary means. In other words it either requires the use, or at least the threat, of force. In Germany it was the sheer domination of Prussia which eventually led to the creation of the German Reich in 1871 and Bismarck, its architect, had certainly not always strictly adhered to the rules of national and international law. The EU does not have the same discrepancy in the composition of its membership that 19th century Germany had and, even more importantly, all its Members are democratic states which means that they should treat each other with mutual respect. This notwithstanding, some Member States are more influential than others which has resulted in some to suggest that Germany, now that it is reunited and the largest single country in Europe outside Russia, should use its might to unite Europe into a federal and democratic union.\textsuperscript{14} Any fear of the FRG becoming a ‘second Prussia’ should, however, be unfounded. Unlike the Bismarckian power, contemporary Germany represents not a country that its fellow members in the EU should fear, but a federal democracy from which the Union itself can learn a lesson or two.

2.2 The Centralising Trends of Integration

One of the most difficult aspects of integration is that it requires those who take part to give up a degree of their sovereignty. Once started, however, a process of integration can easily turn into a perpetual circle of spill-over effects which in turn require more

\textsuperscript{14} Brian Reading, \textit{The Fourth Reich} (London: Weidenfeld and Nicolson, 1995).
centralised decision-making and thus further loss of sovereignty for the members of a federal union. The aim of this section is to show that such centralising tendencies exist in both the FRG and the ECs, and why.\footnote{A shift had to be made from the process of German unification last century to the establishment and subsequent development of the FRG, because only the latter represents a truly democratic and balanced example of a federation at work.} In the language used by ECs institutions ('eurospeak') the phenomenon just described is commonly referred to as ‘deepening’. From the days of President de Gaulle stems a widely held believe that there is a mutually exclusive relationship between deepening and what is called ‘widening’, the acceptance of new member states. Since then France has repeatedly argued that widening would lead to a slowing down of deepening. It will, however, be shown that this is not necessarily the case, and if anything the new parameters created by an increase in membership could even accelerate the process of integration.

The post-war situation in Germany can be seen as a unique combination of federalisation by devolution and federalisation by integration. The unconditional surrender of the German armed forces on 8th May 1945 marked not only the end of the Second World War, but also the end of the centralised system of government imposed onto Germany by the Nazi regime. Although the Germans were immediately relieved of all governmental functions, it was realised by the Allies that this could only be a temporary state of affairs. The plan was to decentralise what had remained of Germany, and to establish true democratic structures which would allow to hand back power to the people and would function from below rather than above.

One of the prime objectives of the new rulers was to break up Prussia which, together with the division of Germany into four zones of occupation, made a return to the pre-1933 federal structure impossible. By 1947 sixteen Länder had been set up in the four zones\footnote{Bremen, Bavaria, Hesse and Württemberg-Baden belonging to the American Zone; Hamburg, Lower Saxony, North Rhine-Westphalia and Schleswig-Holstein in the British Zone; Baden, Rhineland-Palatinate and Württemberg-Hohenzollern in the French Zone; and Brandenburg, Mecklenburg, Saxony, Saxony-Anhalt, and Thuringia in the Soviet Zone of Occupation.}, but since the four powers could not agree on a concerted policy for the whole of Germany, the Länder in their respective zones began to develop differently from one another.\footnote{For more details on this point see: BRD, Bundeszentrale für politische Bildung, ed., “Die Entstehung der Bundesrepublik Deutschland” 7.} The British and US administrations were the first to realise that Germany no longer posed a political threat, but rather that its potential should be used positively in the new confrontation between East and West, the Cold War. On 1st January 1947 the British and American zones were merged to form the ‘United Economic Area’. Then, in the Spring of 1948, the three western Allies decided to integrate their occupied territories firmly into western Europe and to entrust a Parliamentary Council with the task to write
the constitution for a new West German state. The Currency Reform of June 1948, which affected not only the three western zones but also the three western sectors of Berlin, only pre-empted the political division of Germany into two distinct entities.

The relationship between the western Länder and the military governments of the occupying forces was - naturally - a hierarchical one. Although the Allies wanted to establish democracy from below, the distribution of powers was of course decided upon from above. This meant that the Länder could only operate within a given range of policy areas. It also, however, meant that they were free to co-operate in these fields and coordinate their policies. As it turned out, agreement on even the most pressing problems of the day, e.g. economic assistance and fiscal redistribution, proved difficult, often impossible. This can be explained by the rather exceptional situation of the time. The respective positions of the Länder and the military governors within western Germany were static, but also only temporary. The mainly centripetal effects of federal integration only occurred with the creation of the FRG in 1949. Since then, questions concerning the fiscal relationship between Bund and Länder have become the principal reason for constitutional change which, until 1990, have always led to more centralisation, i.e. a steady shift of responsibilities from the Länder governments to the federal institutions.

This trend has its roots in the particular blend of federalism the Basic Law contains. While most decisions are taken by the federal institutions, they are carried out mainly by the Länder. This, however, means that it is of utmost importance whether, or not, the Länder are financially capable to fulfil this constitutional objective. Yet, the Länder do not have themselves the power to raise revenues and are thus dependent on federal legislation to decide which sources of income, and/or how much of it, shall be theirs. A mechanism of financial equalisation, with which the Länder are constitutionally obliged to balance out their incomes, ensures them similar per capita revenues. What the system ignores though is that underlying structural imbalances persist amongst the Länder, and that poorer areas have - as a rule - higher statutory expenditure.

In the FRG this phenomenon regularly led the poorer Länder to call upon the federation to step in and take over responsibility. Had they managed to act together, the Länder could of course have used their influence on federal decision-making in the Bundesrat to achieve higher revenues for themselves. However, as will be seen in more detail in

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18 The development in the Soviet zone of occupation took a different path which, however, is not relevant to the present discussion and shall thus not be part of it.
19 The difficulties the Länder had in sharing their finances will be discussed in more detail in Chapter Five.
20 Art. 107 GG.
Chapter Five, this never really happened because some Länder always put their own interest before the good of the Länder community as a whole. In this respect, the pre-FRG tradition of rather un-solidaristic behaviour among the Länder continued for forty more years. Only the collapse of the Berlin Wall, and the subsequent re-unification of Germany to one entity, provided the enlarged federal system with a challenge which made previous conflicts between the federal and the Länder level, and among the Länder themselves, look comparatively minor.

In contrast to the FRG, which was based on parts of a formerly centralised state, and as such began its lifetime as an already rather centralised federation, European integration had to start from scratch. This means that the circumstances under which the ECs began to integrate are almost completely different from those in place in western Germany, with the sole exception that both entities had a federal structure. The contrast in their respective degrees of centralisation was reflected in the fact that in Germany the Bund had the bulk of legislative authority while the institutions of the ECs started with a very limited mandate for European law. Another major indication that the FRG already was an integrated federation and the ECs only at the beginning of a process of federalisation lies with who was represented in the decision-making institutions at the centre.

In western Germany, a bicameral parliament of Bundestag, representing the German people, and Bundesrat, defending the interest of the Länder, conjointly decided upon most national legislation. In contrast to this, binding decisions at ECs level were by and large only made by the Council, which meant that the Member States had reserved the right to control the development of the Communities for themselves. The difficulties the German Länder had with agreeing on common positions became an experience soon shared by their European counterparts. Unlike the former, the latter had no higher authority, such as the military governors, or later the Basic Law, which provided them with a reason to having to speak 'with one voice'. The absence of a second chamber at ECs level made it difficult for the Member States to distinguish between their roles as national and European actors. This, together with the fact that integration had only just started, represents the main difference between the centralising trends in the FRG and the ECs. While in the former the Basic Law, and a distinct national level of government, left only limited room for constitutional re-allocations of power across the vertical levels of government, in the ECs different impetuses provided the stimuli for integration: external pressures and internal spill-over effects.

Even though the ECs had not, like the German Länder, had outside forces directly gearing them towards integration, there were - as has been seen earlier in this chapter - indirect
external pressures for the Member States to co-operate closely. Once the three communities had been set up, the centralising forces began to work. Apart from implementing the provisions of the Founding Treaties, both internal and external demands pushed for more integration, not only in terms of economic policies, but also politically. The first reform became necessary in the mid 1960s over budgetary questions to do with the CAP, and immediately led to the 'empty chair crisis' of 1965. Only when French President de Gaulle left office in 1969 did some kind of normality return to the process of European integration. The application of Denmark, Ireland, Norway and the UK to join the Communities, formerly opposed by de Gaulle, was now being considered, but the French feared that larger membership could slow down the process of integration and called for a summit of the Member States' leaders to make substantial progress towards deepening in advance of the first round of enlargement.

At a meeting at The Hague in 1969 it was decided that the four applicants should be allowed to join; that the Communities' budget should consist of own resources rather than direct contributions from the Member States; that the EP should gain a say in the budgetary process; and that plans to set up a full EMU by the year 1980 should be studied. All these decisions were subsequently adopted by the ECs. The budgetary changes were made in 1970. Denmark, Ireland and the UK joined the ECs in 1973, while a referendum in Norway rejected ECs membership. The commissioned study into EMU was produced but never realised. This was, however, not due to internal difficulties, but had to do with external pressures.

At the beginning of the 1970s the Bretton Woods agreement of fixed exchange rates had collapsed and caused havoc on the international currency markets. Rather than a smooth transition towards ever narrower exchange rates the Member States of the ECs had to resort to emergency management as currency prices around the globe were cut loose from the US Dollar and began to float freely. Attempts to link their monies in what became known as 'the snake' proved difficult and only partly successful. To make things worse the 1973 oil crisis affected individual members of the ECs in different ways, thus destroying whatever little hopes there may still have been to achieve EMU. In the same instance, however, the economic crisis which resulted from these external shocks called for concerted action by the Member States. A Franco-German initiative led to the establishment, in 1979, of the European Monetary System (EMS) to bring back some stability and predictability to the currency markets, and therewith to internal trade. Although a positive step forward in terms of economic and monetary integration, the establishment of the EMS was a mere reaction to external developments. The new monetary regime also remained outside the formal ECs structure, and even though
membership was restricted to the members of the Communities not all of them participated in the system's main component, the Exchange Rate Mechanism (ERM).

On the political front the realisation that most progress towards European integration could be achieved if the leaders of the Member States directly debated the sticky problems had led to the formal setting up of the European Council in 1974. The decision at this first meeting also to hold direct elections to the EP and to establish a European Regional Development Fund (ERDF) were additional signs, after the budgetary reforms, that the ECs was integrating politically too.

A more positive attitude by the Member States to transfer even more sovereignty to the Communities only arose after the economic difficulties of the 1970s had been overcome, and a budgetary conflict with the UK settled. By the mid 1980s a global economic recovery allowed national politicians to look beyond their domestic markets, only to discover that the ECs had fallen behind the US and Japan on almost all counts. The main reason for this, it was argued, was that the US and Japan both have one large domestic market in which the factors of production are easily available across, in which economies of scale can be realised, and in which consumers have undistorted access to all goods and services. In contrast to this, the ECs consisted of a patchwork of individual markets among which the exchange of production factors was limited if not restricted, and a plethora of non-tariff barriers prevented the realisation of economies of scale and the free access of services and even goods, despite the existence of a customs union. This situation had to be overcome by creating a common market for the ECs - which is what, by and large, happened. With the SEA, ratified in 1987, the Communities were to be transformed into a Single European Market by the end of 1992.

By 1987 the accession to the Communities of Greece (1981) and Spain and Portugal (1986) had shifted the balance of the ECs. Geographically, the ECs now not only covered western Europe, but also most of its southern areas. In terms of wealth, the three new Member States were substantially poorer than most of their counterparts. This had to do with the general structural backwardness of these countries. The latter posed a particular problem for the realisation of the SEM. The mainly agrarian economies of the poorest members made it harder for them to compete in a unified market. At the same time lower social standards such as maximum working hours, minimum wages, health and safety regulations, etc. gave the southern Member States a potential comparative advantage over their more regulated richer northern counterparts.
More likely, however, was the threat of mass migration from the South to the North. In order to address these issues the Communities’ budgetary base was altered in 1988, and the ECs were given more money and a wider scope for spending. CAP expenditure was reduced while the regional and social funds were doubled. As far as workers’ rights were concerned the European Council, meeting at Strasbourg in December 1989, adopted the Social Charter, a catalogue of minimum social standards for the ECs. A second spill-over effect of the common market programme was an increasing realisation by some that a single market would be incomplete without a single currency. A renewed study into how to achieve EMU resulted in the decision to set up an IGC on this subject at the end of 1990.

Meanwhile, the historical changes in central and eastern Europe had already begun to shake up the ECs’ external position. More immediately, however, the rapid demise of the GDR made the prospect of German re-unification more likely by the day. Doubts arose in some Member States over whether a united Germany would (or even could) remain part of the western alliances, or whether it would (have to) pursue a policy of neutrality between the still existing ‘blocs’. In order to show that the FRG’s commitment to European integration had and would not change, Chancellor Kohl proposed a substantial step forward towards politically integrating the Communities, with the aim to lock Germany firmly into the western Community. With this in mind the European Council agreed, in June 1990, to hold a parallel IGC on political union. Both IGCs opened in December 1990 and a year later, at a summit meeting in Maastricht, the European Council agreed on the Treaty on European Union. As the title suggests, the aim of this substantial review of the Founding Treaties was to transform the Communities into a European union, indicating a shift towards closer political links. However, even though the TEU institutionalises more political co-operation, the approach chosen means that only little progress has been made towards further federalisation of western Europe, a key demand from Germany.

The European Union is the classic example of a political compromise. Varying degrees of willingness by the Member States to give up sovereignty over - admittedly crucial - policy areas resulted in the adoption of a three pillar structure: the ECs, a Common Foreign and Security Policy, and Co-operation in Justice and Home Affairs. Unlike the Communities, the second and third pillars are intergovernmental affairs since all decisions are taken by the Council and by unanimous agreement. The only real progress towards further

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21 After all the Basic Law, written as a temporary constitution for all Germany, used to state in its preamble: “The German People ... Have enacted ... this Basic Law for the Federal Republic of Germany. They have also acted on behalf of those Germans to whom participation was denied. The entire German people are called upon to achieve in free self-determination the unity and freedom of Germany.”
federalisation was made by extending the scope of the first pillar, the ECs. The most substantial addition was the adoption of the conditions for and a timetable towards EMU, and the introduction of the Cohesion Fund. In a further attempt to bring more democratic elements into the decision-making process of the ECs, the EP was given the right to co-decide on certain pieces of legislation after it had already been given the right to co-operate on questions concerning the Single Market in the SEA.

Right from the start the TEU ran into difficulties: the unfolding tragedy in the former Yugoslavia made an instant mockery of the CFSP; ratifying the Treaty proved difficult, particularly when a first referendum in Denmark went against it\(^2\); and the adoption of the new Cohesion Fund and another near doubling of the regional funds made it necessary to increase the Communities’ budget, subsequently agreed at the Edinburgh summit in December 1992. However, the problems surrounding the ratification of the TEU only exposed the deep divisions which had existed within the Communities for quite some time. These divisions were not as straightforward as often portrayed. Four main positions can be identified. Firstly the ‘positive’ stance, clearly taken up by Germany, the Netherlands, Belgium and Luxembourg, supporting both further integration and more federalisation. Secondly, the ‘confederal’ position which supports the principle of federalism, but also the idea of decentralisation, a position Denmark seems to hold. Thirdly, the ‘functionalist’ attitude pursued by countries such as France which want deep integration but little federalism. Finally, there is the ‘negative’ position for which the UK became infamous as it did not seem to support either principle, integration or federalism.

At this stage it appears necessary to clarify the use of the terms ‘integration’, ‘centralisation’ and ‘federalisation’ in the present context. Integration refers to the transfer of authority from the national to the ECs level of government. The degree of centralisation (or decentralisation) is determined by the amount of power the Member States have compared to the ECs level. And federalisation describes the degree to which decisions at the central level are taken by majority voting, and thus reflects the degree of political integration. The level of federalisation has always lagged behind the extent to which governmental functions have been transferred to the European authorities. Even after the Luxembourg Compromise\(^3\) was given up, there still remained many areas for which the Treaties required unanimous agreement. The gradual rise in the number of Member States, however, made it increasingly difficult to find consensus. This forced the

\(^2\) In a second referendum in May 1993, the Danish people accepted the TEU after a number of concessions, similar to those directly won at Maastricht by the UK, had been granted.

\(^3\) The ‘Luxembourg Compromise’ was a deal between the then six Member States not to outvote any member in the Council on issues of ‘national importance’, even though the Treaties would allow qualified majority voting. In effect this compromise gave the Member States a veto in the Council.
Member States to gradually allow more and more majority decisions. In other words, the extension in the use of majority voting is a direct spill-over effect from widening - thus confirming that widening does not prevent further deepening. Beyond the issue of voting methods in the Council, a wider review of the Communities’ institutional structure became more pressing with each round of enlargements.

The accession negotiations with Austria, Finland, Norway and Sweden, in 1993, highlighted a number of problems, and pointed out just how urgent some of them had become: the distribution of votes for decisions requiring a qualified majority in the Council was criticised because some of the larger Member States felt that their smaller counterparts were gaining too much collective power; the Commission was threatened with having more members than portfolios; and the EP’s main problem was that three new languages would mean the recruitment of a large number of new interpreters and translators, and the printing of even more copies of their documents. Although only three of the four applicants joined the EU in 1995 after a referendum in Norway once again went against membership, another six candidate countries have already been identified by the Commission to start membership negotiations in 1998. The June 1997 European Council at Amsterdam may have failed to alter the Union’s institutional structures, but reforms are still urgently needed in order to prevent the next enlargement from paralysing decision-making in the EU. The question only is what such reforms will ultimately lead to: a true federal union, or a watered down confederation.

In this respect the Union has come to a point similar to one the FRG found itself at in the late 1980s. With the signing of the SEA, the federal government had transferred not only part of the federal level’s own decision-making authority to the ECs, but also given them power over exclusive Länder responsibilities. Shying away from blocking ratification of the SEA in the Bundesrat, the Länder nevertheless realised that European integration posed a direct threat to the federal structure of the then West German state. In the running up to the TEU they published their so-called Eckwerte-Beschluß (cornerstones resolution) in which they set out their ideas about how to leave the vertical divisions within the FRG intact. Since then the German Länder have won the right to send their own (Bundesrat) representative to such EU Council meetings in which their areas of responsibility are being discussed and decided upon.

If the trigger to a reassessment of the federal balance in Germany was the gradually increasing shift of sovereignty to the EU, the Union appears to have itself now come to a

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point at which a decision has to be made over which direction to take, caused by the mounting strain subsequent rounds of enlargement have brought on an institutional structure designed for a union of few members only. The choice, as has been mentioned above, is between taking a decisive step down the path of political integration, and give the EU institutions true federal powers, and the maintaining of the current status quo, which is a dissatisfying and confusing mélange of federal, confederal and intergovernmental arrangements.

The facts appear to speak for themselves: with more and more responsibilities already transferred to the EU level, and many others singled out to follow suit, efficient government can only be achieved by a streamlining of decision-making structures. This, however, requires the Member States to give up influence accordingly: less unanimous and more majority voting in the Council; a smaller Commission, recruited on grounds of merit, not nationality; and more democracy through a Parliament that more closely represents the people and which should have co-decision powers over all decisions taken by majority voting in the Council. The alternative to all this would be a case of ‘too many cooks spoiling the broth’. Experience with the two intergovernmental pillars has already shown that agreement is difficult to come by if twelve or fifteen Member States have to find a common solution. Moreover, Maastricht, the 1996 IGC and the Amsterdam Treaty all serve to reinforce the impression that the more Member States there are, the more disagreement there seems to be. In the absence of a significant shift towards more political integration an EU of, say, 21 members will find it even more difficult to function efficiently, thus undermining the justification - under the principles of subsidiarity - for its very existence.

2.3 Incorporating the East

Apart from the institutional pressures the acceptance of countries from central and eastern Europe will bring with it for the EU, the most challenging aspect of this undertaking is the fact that these prospective new members all substantially differ from the current Member States. Not only are they relatively recent converts to democracy and the rule of law as well as the principles of capitalism and the market, they are also structurally more backward, and financially much poorer than the existing members of the EU. The problems these differences pose for the Union of today is something the FRG has already had to deal with when the collapse of the Berlin Wall opened the way for the five Länder of the former GDR, as well as the whole of Berlin, to join it under the provisions of the Basic Law: the incorporation into a functioning federal system of significantly poorer
units compared to which the ‘old’ members were relatively similar in terms of their wealth.

The fall of the Berlin Wall caught everyone by surprise and happened at a time at which the West German Länder had arrived at the lowest point in their financial relations. Very soon after the borders between the two German states had been opened it became clear that the days of the GDR would be numbered. Rather than reforming the ex-communist state and confederate it with the FRG, full unification became the favoured option. However, instead of two sovereign states negotiating a merger, including the discussion of a constitution suiting both parts, the GDR was to be divided into its original five constituent Länder which then joined the FRG under the existing provisions of the Basic Law. This means that, in effect, unification amounted to an enlargement of the (West) German federation and not the creation of a new Germany as the five new Länder accepted, what in euro-jargon would probably be called, the acquis fédéral.

As equal partners in the governmental structures of the enlarged FRG the new Länder were also to be immediately incorporated into the financial equalisation mechanism with which the Länder balance out their average per-capita revenues. The problem though was that the ‘new’ Länder had very little tax-raising potential themselves\(^2\(^5\), and as a consequence would have multiplied the volume of inter Länder transfers. With no direct mandate to raise taxes themselves, however, the sources of income for the Länder could not change, which meant that the Länder community as a whole faced the prospect of having to share what the western Länder had already found difficult to redistribute amongst themselves during the 1980s. In other words, after equalisation none of the Länder would have been left with enough resources to finance the fulfilment of their constitutional tasks. What amounted to a serious threat to the federal balance within Germany was, however, temporarily averted in a deal struck between the federal government and the West German Länder in the running up to the unification process: the financial constitution was suspended from applying to the territories of the former GDR until the end of 1994 and, for the meantime, a German Unity Fund (Fonds Deutsche Einheit) was set up to replace the payments to the East which otherwise would have had to have come out of the equalisation mechanism.\(^2\(^6\)

\(^2\(^5\)\) Economic, monetary and social union with the FRG meant the abrupt end of the GDR’s trade links with its former Comecon partners, because the latter could not afford to pay in hard currency. At the same time, eastern German products did not live up to western standards, and even domestic markets virtually disappeared under competitive pressures from the West. The economies of the new Länder thus almost completely collapsed. 

\(^2\(^6\)\) A more detailed account of the developments can be found in Section 5.6.
The advantage of the Unity Fund for the western Länder was that over half of the money - the bulk of which was borrowed on the market - was contributed by the Bund. Nevertheless, for the future, a more long-term solution was needed. To this end the federal government and the Minister Presidents of the Länder got together to discuss the financial problems of the eastern Länder in the so-called Solidarity Pact negotiations which came to an earlier-than-expected conclusion in March 1993 with an agreement that took many by surprise. Instead of reforming the system of horizontal equalisation, the mechanism was merely extended to largely keep the per-capita financial positions of the old Länder intact by way of increasing their overall fiscal base. The remarkable aspect of this solution was that a long trend in the history of the FRG had been reversed: the Länder had - for the first time - gained back some of what the Bund had previously taken from them. In line with what has been said in the previous section about a reassessment of the federal balance in Germany, the latter development only serves to confirm the more assertive position the Länder appear to have adopted vis-à-vis the Bund over the past decade or so.

This notwithstanding, since 1 January 1995, the entirety of the FRG is, once again, subject to the rules of the Basic Law, and with it the provisions on financial equalisation agreed upon at the Solidarity Pact negotiations in 1993. Even though the horizontal system as such runs relatively smoothly, and the constitutional demand for at least equivalent living conditions throughout the federation is met by way also of the application of uniform social legislation, the deep structural and fiscal divisions between the western Länder on the one hand and their eastern counterparts on the other cannot be overlooked. Nor can they, as will be seen later on in this thesis, be expected to easily be reduced.

Compared to the highly integrated FRG, with its constitutional demand for equivalent, if not uniform, living conditions and its single set of social legislation, the EU is a much looser union of states. Its internal financial relations are, consequently, very different from those in place in Germany. The most obvious distinction is that the Member States determine the Union’s financial sources, and not the other way around as is the case in Germany. This notwithstanding, the EU budget does, despite its relatively small size, possess large redistributive elements which create problems similar to those experienced with financial equalisation in Germany. In accordance with its degree of federalisation the Union has no full-blown financial constitution, and certainly no equalisation mechanism. Yet, the accelerating increase in the provisions for regional policies have begun to highlight the differences in the relative wealth of the Union’s Member States and the consequences this has on their budgetary positions.
Similar to being in an equalisation scheme, the Member States see themselves either as net contributors to the EU budget, or as net recipients from it. In this respect the variations between richer and poorer Member States very much resemble the picture in the former West Germany where the poorest Länder depended on money allocated to them via the equalisation mechanism in order to fulfil their constitutional duties. Even though the Union’s Member States have the power to raise their own taxes - for the poorest of them the additional income from the Community’s funds already have a noticeable impact on their budgets. As was the case in western Germany, those countries which currently receive allocations from the Union’s regional funds would potentially be hardest hit by an eastward expansion of the EU. If the Czech Republic, Estonia, Hungary, Poland and Slovenia, together with Cyprus, were to join under the present rules of the acquis communautaire Greece, Portugal, Ireland and Spain would face a similar challenge to their relative financial position within the Union as did Bremen, Lower Saxony, Rhineland-Palatinate, Saarland and Schleswig-Holstein when faced with incorporating the five new Länder and Berlin into the existing horizontal equalisation scheme in Germany.

In a way the challenges facing the EU are not as drastic as were the problems with which the FRG was confronted in 1990. In Germany economic, monetary and social union (EMSU), which came about three months before political unification took place, resulted in two parallel problems for the new Länder. First the introduction of the West German currency, the D-Mark, immediately brought to an end traditional trade links between eastern Germany and its former Comecon partners who suddenly could no longer afford to buy what had over night become ‘western’ goods. Second, the application of social legislation to the territory of the former GDR - if not the mere notion of once again belonging to one country - led to swift calls for wage and benefit differentials between East and West to be narrowed, and caused the trade unions to call for equal pay levels throughout the country. Both developments made the eastern Länder uncompetitive and led to the economic devastation of the German East.

Compared to all this, the situation faced by the EU and the applicant countries located in central and eastern Europe is far more relaxed, yet similarly difficult. One advantage for both sides involved is the mere time that has elapsed since the countries of the old communist bloc turned into democracies with market-led economies. Unlike eastern Germany, which chose to take the apparently easy option, the countries of central and eastern Europe had to adapt to the new reality of having to operate in a (reasonably) open global economy almost entirely on their own merits. This meant that they had to readjust and find out where their own comparative advantages lay. In some countries, such as the
Czech Republic or Hungary, this went relatively well, whereas others, like Bulgaria and Romania, found this process more difficult to sustain. To use a metaphor, it could be said that all of the old command economies required some serious ‘slimming down’ and ‘shaping up’ in order to be able to compete in a world economy that requires a good level of fitness. However, whilst some candidates managed their diet plans with various levels of success, others could not resist the temptation of tampering with their slimming down programmes. Once lean and slender, the more successful CEECs went on to start building up their fitness levels. The metaphor can actually be used also to expose the fallacy of the supposedly easy option chosen by eastern Germany. For what happened there was more like putting someone directly onto a life support machine instead of allowing for a chance to readjust at a more natural pace. The problem with this was, of course, that the candidate was nearly starved to death - and this means that any level of real fitness can now be regained only after a long, slow and rather painful building up programme.

The second positive difference between EU eastern enlargement and German re-unification is that the EU is not - by a long way - as highly integrated, and thus egalitarian, as the FRG. This means that even within the EU, there is room for Member States to exploit - at least to an extent - their comparative advantage vis-à-vis their fellow members. For the CEECs this will mostly be on the grounds of price, i.e. lower factor cost, in particular for labour, but perhaps initially also for land. But, what is a positive aspect for the CEECs presents itself as a problem for the existing EU. Whilst EMSU in Germany led to the collapse of large sectors of the eastern economy, the ‘slimming down and getting fit’ process in the CEECs has made them concentrate on those sectors of the economy in which they have a comparative advantage. The structural backwardness which decades of communist rule left the CEECs with means that those industries are located mostly in the primary and secondary sector, agriculture, heavy industries, the textile industry, shipbuilding, etc. - the very areas to which the EU’s overwhelming amount of budgetary commitments are linked.

It is exactly this point, the fiscal implications of enlargement, at which the similarities between German re-unification and EU eastern enlargement lie. The situations under which both processes took or are likely to take place may be different, but so are the respective circumstances as far as the accepting and the joining entities are concerned. In Germany the highly centralised and egalitarian nature of the FRG, together with the provisions for accepting other German Länder into the federation laid down in the Basic Law, meant that the five eastern Länder and the whole of Berlin had to be incorporated fully into the political, economic and social structures of the former West Germany. The

\[\text{\footnotesize See: Preamble and Art. 23 GG (old version)}\]
implications this had have only just been described earlier in this section. The EU, as a far less integrated semi-federal entity, works rather differently from the FRG. Here solidarity, as will be seen in more detail in Chapter Three, does not take the form of horizontal financial equalisation amongst its constituent units, but manifests itself as centrally decided upon measures designed to strengthen the Union’s economic and social cohesion. The areas identified for respective allocations are: general backwardness in terms of wealth, structural decline, and unemployment. Each of these criteria is met by the CEECs: all ten of them are (often substantially) poorer than the existing EU Member States, they are all undergoing readjustment processes away from primitive methods and outdated installations in the primary and secondary sector, towards modern competitive market economies with a sizeable tertiary sector; which, finally, sets free excess capacities, and often represents a shift away from labour-intensive to capital-intensive production, therewith creating either outright unemployment, or at the very least the need to retrain people.

In 1995, the agriculture sectors of the ten CEECs alone accounted for 7.8% of their GDP and 26.7% of employment, compared with 2.5% and 5.7% respectively in the EU. These figures already give a clear indication as to the impact eastern enlargement is likely to have on the budget of an extended Union. Two main effects can be identified. First, the substantially larger agriculture sector in at least some of the applicant countries, most noticeably Poland (26.9% of employment), means that under static rules, CAP expenditure must be expected to soar. Second, with fixed amounts available for regional spending, a shift within the relative positions of the Member States appears inevitable, meaning that current recipients will not only lose out, but may even be turned into net-contributors to the EU budget.

As past experience within the ECs shows, both the effects eastern enlargement is likely to have on the Union’s budget will be bitterly fought over by those most affected. Farmers and their lobbies will try and resist any changes to the fiscal provisions of the CAP, and

28 In terms of GDP per head, as a percentage of the EU’s average (EU=100; in 1995), the five ‘front runners’ only muster the following figures: Slovenia 42%, the Czech Republic 20%, Hungary 19%, Poland 14% and Estonia 11%. This compares with figures of 63% for Greece and 73% for Portugal, currently the EU’s poorest Member States. The combined GDP of the ten CEECs in 1995 represented less than 4% of the GDP of the EU. Sources: “Eastward Ho, They Said Warily,” The Economist 19 July 1997: 35; the author’s own calculations based on figures from: EU, Eurostat, Eurostat Yearbook ‘96 (Luxembourg: EUR-OP, 1996) 210; and: EU, Commission, London Office, “The Enlargement of the European Union” 5.


the current ‘cohesion countries’ (with the possible exception of Ireland$^{32}$) will be fiercely opposing any weakening of their position within the redistributive process. So far, as will be seen in more detail in Chapter Six, enlargement has always resulted in certain regional policy concessions, and more recently Spain has emerged as the principal defender of the recipient status for the current cohesion countries. With the power to veto enlargement, Spain, Portugal and Greece have an effective bargaining tool at hand. The outcome of enlargement may thus well be that regional spending, be it through the Structural Funds or the Cohesion Fund, will have to be increased to the extent that the three or four poorest current Member States will not loose out too much from much poorer new members joining the Union. In effect this will be very much what happened in Germany after re-unification, when the horizontal equalisation scheme was merely topped-up to cope with far wider revenue disparities between the Länder than before. However, the lesson from Germany must be that simply expanding redistribution to allow the old rules to continue will do nothing to tackle regional disparities per se. What is needed is a change of the rules themselves to positively be able to reduce regional disparities, and thereby show real solidarity.

$^{32}$ Ireland’s GDP per person is expected to have grown to above 90% of the EU average per capita GDP, which represents the qualifying threshold for Cohesion Fund money, by the end of the current period in 1999. See: “Green Is Good,” The Economist 17 May 1997: 25-8.
3. CONCEPTS OF EQUALISATION

In a federal system the financial relationship between the centre and the constituent units, as well as among the members of the union themselves, are of crucial importance as far as the quality (and the funding) of federalism are concerned. Too much fiscal dependency of either level of government from the other would seriously bring into question whether a federal system could at all be said to exist. This is true of a fully integrated federation like the FRG where the Länder are quite restricted in their fiscal room for manoeuvre, and it applies also to a rather young federal entity such as the EU where the centre has relatively limited budgetary powers. All this points back to the wider issues in the study of federalism: the unity versus diversity debate. It has been seen earlier that diversity is about pluralism, which in turn is supposed to be maintained via the constitutional concept of subsidiarity. Unity, meanwhile, has to do with equality, and so the search is on for a counterweight to subsidiarity. As with the latter, notions of the former can be found in the constitutional provisions of a federal union. The mere concepts of ‘union’ or ‘community’ indicate some degree of togetherness and thus assistance which might be described by the term ‘solidarity’. This chapter will commence with a look into the meaning of the concept of solidarity in order to prepare the ground for the subsequent analyses of the more concrete constitutional aims of ‘strengthening economic and social cohesion’ in the EU, and ‘the maintenance of uniformity of living conditions’ for Germany. The chapter will culminate in a comparison of the two objectives themselves as well as the general framework within which they are used. How these objectives are eventually attempted to be met will not be investigated here, but shall be the subject of Chapter Four.

3.1 Solidarity

The principle of solidarity is of a rather vague nature which allows it to be applied to various situations and actors. Solidarity as a general idea originates from Christian theory but developed its own history as ‘a socio-philosophical term that describes the ontological and ethical relationship of the members within a community to that community’. Although already used by the champions of the French Revolution, solidarity became increasingly identified with the emerging labour movement during the 19th century which

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itself had its roots in the fundamental social changes brought about by the industrial revolution. Solidarity must not, however, be confused with the communist doctrine of (enforced) equality. The slogan adopted by the German Genossenschaftsbewegung (cooperative movement), “Einer für Alle, Alle für Einen”, sums up what solidarity is supposed to circumscribe: a communal spirit amongst individuals, or groups of individuals, that finds its expression in mutual support and assistance. Such a spirit, sociologists argue, is needed to keep the order within a given group for otherwise the members of the group would be guided by opportunism and deterred from acting in an unsocial manner only if threatened by punishment.

... solidarity ... is a function of normative internalization. To the degree that members identify with a group’s norms ... they can be expected to engage in the appropriate behaviors without sanctioning. Internalization makes individuals fit for social life, or socializes them, by removing the conflict between the individual’s interest and that of the group.

This confirms that solidarity within a political system needs to be based on a set of general rules and norms. A country’s constitution - or in the case of the European Union a Treaty framework with constitutional character - usually contains such a set of basic rules and norms. Rather than secondary legislation, which directly states where a given action becomes unlawful and will consequently be punished, constitutional objectives act more as a general guideline from which to conduct secondary legislation if and when the need arises. Basic objectives of constitutional law are notions such as liberty, democracy, respect for human rights, the rule of law - and solidarity.

The question in the present context is who and what exactly solidarity refers to if found in a constitutional text. Based on Article 5, EC Treaty, one commentator on EC law seems to follow the above approach, yet limits it to the relationship between the Community and the Member States:

The principle of solidarity is both positive and negative since it provides that member states must: (1) take all appropriate measures to ensure fulfilment of the obligation arising out of the treaty or resulting from action taken by the institutions of the Community and to facilitate the achievements of the Community tasks, and (2) abstain from any measure which could jeopardize the attainment of the objectives of the treaty.

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4 “One for all, all for one.”
While not disputing the validity of the above statement, some of what has been said about solidarity so far suggests that the concept applies not only to the relationship between two levels of government, but all actors within a given community. It should also have a much narrower meaning than, for example, just reminding the Member States to remain loyal to the European venture. In a more concrete application, solidarity is about recognising the differences between certain actors and - where deemed necessary - attempting to reduce them by calling upon the strong to help the weak. Apart from advice and information the main way in which solidarity is thus expressed in any given polity is that of financial assistance and redistribution. Exactly what form such redistributive arrangements take then depends, to a large extent, on the degree to which decision-making is centralised in the entity in question. To take the extreme forms of centralisation and decentralisation it appears useful to look outside either end of the ‘federalism scale’. In a unitary state solidarity would most definitely be associated with social policies and the welfare state, and hence the relationship between the (central) government and the individual. A closer look, however, reveals that the state only acts as an intermediary - for the welfare system, in effect, represents indirect, since institutionalised, solidarity between those who are net contributors to the scheme and those who are net recipients from it. In contrast to this an intergovernmental treaty organisation focuses on the relationship between sovereign states, and solidarity is expressed by aid payments from the richer to the poorer signatories to such organisations.

Returning to the two cases studied in this thesis, the FRG and the European Union very much represent polities still at opposite ends of, but already on, the federalism scale. The presence of a federal system means of course that the clear-cut distinction between pure unitarianism and absolute intergovernmentalism has disappeared and been replaced by some combination of the two, depending upon the degree to which decisions are taken at the centre or remain with the constituent units. In accordance with what has been said about who and what solidarity refers to in unitary states and intergovernmental organisations respectively, the degree of centralisation has a direct effect on where within a federal entity the emphasis of solidarity lies.

The Basic Law states that Germany is a democratic and social federal state. This clearly puts an emphasis on social policies and, again, the relationship between ‘the state’ and the individual. However, as a federation ‘the state’ in Germany consists of several players and as a rule refers to the Land in which a citizen lives. The dilemma the Länder face though is that they are by no means homogeneous as far as their per capita wealth is concerned.

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8 Art. 20 (1) GG.
9 "Except as otherwise provided or permitted by this Basic Law the exercise of governmental powers and the discharge of governmental functions shall be incumbent on the Länder." Art. 30 GG.
yet spending for social policies and tax levels are both decided upon at federal level. This leaves the Länder in a position in which the main parameters of their spending are pre-set, and puts a particular burden on the poorer among them which are most likely to face the twin problem of low tax raising ability and high social spending. In order to maintain what the Basic Law refers to as 'uniformity of living conditions throughout the federal territory', the Bund is not only required to give the Länder community as a whole sufficient financial means to fulfil their constitutional duties, but the Länder themselves are also obliged to show solidarity with each other by balancing out their per capita income through the horizontal financial equalisation scheme. This reconfirms that in a federal entity solidarity applies to all actors involved.

Whilst Germany is a rather centralised federation, expressed in the present context by a sophisticated welfare system, the European Union epitomises the opposite - a union of states only at the beginning of a process of federalisation. This is reflected by the fact that the central level of government has no direct authority over financial assistance to individuals (as is the case in the FRG), but quite some in respect to redistributive payments to regions and Member States. Unlike the Basic Law in Germany, the Founding Treaties actually contain the term 'solidarity'. Initially only found in the preambles to various treaties and acts, where its legal effect is at the least questionable, solidarity was finally inserted into the EC Treaty through the amendments made by the TEU. Article 2 of the EC Treaty now states as one of the Community's tasks to promote "economic and social cohesion and solidarity among Member States". As a general principle solidarity may be a vague concept, but in conjunction with the constitutional goal of more economic and social cohesion its application is quite clear: a sharing of the financial burden to reduce the welfare gap between the richer and the poorer Member States.

The differences in the degree of integration between the EU and Germany explains why in a looser union of states, such as the EU, the constitutional provisions should explicitly mention solidarity whilst the constitution of the much more integrated FRG does not even contain the term. The fact that the Union has only a piecemeal constitution, as it is still in the early stages of a process of federalisation, requires the promotion of solidarity as a constitutional objective. The Basic Law, in contrast, contains concrete rules on redistribution which actually represent solidarity. In Germany this extends to both the state and the individual, and applies among the Länder - thus reflecting the social and the

10 Art. 106 (3) 2. GG.
11 As part of the principle of Bundestreue.
12 Art. 107 GG.
federal character of the Republic. Even though it is at present impossible to say just how far down the line towards full integration the EU may be heading, it seems at least certain which route the Union will have to take in order to keep Germany on board. According to the Basic Law the EU will have to respect not only federal but also social principles to enable Germany to remain a member of the Union.  

This dissertation does not look at solidarity per se but at those constitutional provisions which aim at reducing regional disparities and thus reflect the solidaristic relationship among the members of a federal union as well as that between them and the union itself. In this respect social policies and the welfare system fall outside the direct focus of this thesis. They nevertheless have to be seen as a reflection of structural imbalances, rather than an attempt to solve them, and as such remain an important background factor of the overall discussion. The study will eventually move on to focus on the redistributive efforts between centre and constituent units, and among the members themselves in the federal entities examined. Before that, however, the constitutional provisions such policies are derived from shall be introduced, explained, and then compared with one another.

3.2 Economic and Social Cohesion

The constitutional objective aimed at reducing regional disparities in the EU is the ‘strengthening of the EC’s economic and social cohesion’. Title V, ‘Economic and Social Cohesion’, consisting of Articles 130a to 130e, was inserted into the then EEC Treaty after the ratification of the SEA in July 1987. ‘Cohesion’ is defined as “the act or condition of sticking together”. This means that strengthening the Community’s economic and social cohesion has to be seen as a process of narrowing the disparities that exist in the economic performances and social conditions across the Member States. While one commentator believes that Article 130a should be regarded “more as a political letter of intent than as a source of guidance for the resolution of existing disputes”, others see cohesion in the context of the wider Single Market project which created three imperatives for reform. First, the Single European Act created a political imperative through its clear establishment of the principle of solidarity

14 “With a view to establishing a united Europe the Federal Republic of Germany shall participate in the development of the European Union, which is committed to democratic, rule-of-law, social and federal principles ...”. Art. 23 (1) GG.
15 Art. 130a ECT.
between Member States. A true internal market necessitated economic and social cohesion. Secondly, the need to reduce regional disparities created an economic imperative. Thirdly, the Act specifically created a legal imperative through its requirement in Article 130d of a comprehensive review of the structure and operational rules of the then existing Structural Funds.18

This realisation not only highlights the reciprocal relationship between integration on the one hand and economic and social cohesion on the other, it also serves to show that economic and social cohesion provides for a vital link between economic and political integration. While economic integration has the tendency to exacerbate the divergences within the ECs, and stronger cohesion would represent a more level playing field, the latter also requires political will for mutual assistance, i.e. the commitment to solidarity. Exactly how far this commitment goes depends, largely, on the degree of unity within the entity in question, and consequently reflects just how politically integrated it is.

The original EEC Treaty only indirectly referred to regional policy by making it one of the Community’s tasks to promote throughout the EEC ‘a harmonious development of economic activities’19. In addition to this the Treaty contained provisions to set up a European Social Fund (ESF)20 and a European Investment Bank (EIB)21, both early initiatives to help and reduce social and regional disparities within and between the Member States. Important in terms of cohesion were also the Treaty’s rules on competition22 which make national subsidies liable to Community control, the early structural interventions; and loans that could be given to Member States with balance of payments difficulties23. However, those elements of the EEC Treaty had little importance in respect to the Community’s cohesion until the early 1970s.24 Even though the Commission had tried on several occasions during the 1960s to get the exclusive competence for regional policy transferred to the Community level, the economically rather homogeneous structures of the six founding members, with the exception of Italy, meant that questions of regional policies or cohesion were only given minor consideration. Another problem at the time was President de Gaulle’s refusal to transfer any more competences to the ECs. Only his departure from office paved the way for the 1969 meeting of the Member States’ leaders at The Hague at which they not only decided

20 Art. 3 (i) Art. 123-128 EECT.
21 Art. 3 (j) Art. 129-130 EECT.
22 Art. 92-94 EECT.
23 Art. 108 EECT.
to widen the Community in terms of membership, but also to deepen its scope for action by embracing in principle the aim of establishing an economic and monetary union. The Werner Report was commissioned and, at their 1972 Paris summit, the ECs’ leaders decided to link the goal of EMU with that of a common regional policy. The Communities’ institutions were called upon to set up a European Regional Development Fund which, despite the collapse of the Werner Plan in 1973, was eventually established on 1st January 1975.25

This date is generally regarded as the beginning of EC regional policy, even though the new fund’s effect on cohesion was initially only minor.26 Most of its payments went back to the Member States according to a quota system - and only the disproportionate allocations given to Italy and Ireland, under the provisions of the New Community Instrument27, had any consequence on the Community’s cohesion. This notwithstanding, the share of the least prosperous members, Italy, Greece, Ireland and the UK, rose between 1974 and 1982 from 40 to 70 per cent of the three structural funds (ERDF, ESF, and the European Agricultural Guidance and Guarantee Fund EAGGF).28 During the 1980s the close link between regional and cohesion activities on the one hand and decisions concerning further integration on the other continued. In tandem with the second southern enlargement the Integrated Mediterranean Programmes (IMPs) were introduced as a means of addressing the reservations over Iberian membership coming from the EC’s existing Mediterranean members France, Italy, and Greece. The latter even threatened to veto Spanish and Portuguese membership over fears that this would reduce its share of regional payments from Brussels, and the country could only be persuaded to give up its opposition to the enlargement by the prospect of a continuation of money flows from the IMPs.29

The transformation of the concept of cohesion from an implicit constitutional principle to an explicit constitutional objective, which the Communities henceforth were obliged to

25 The UK had made membership of the Communities depended on the establishment of an equalisation fund. See: Schäfers and Fetzer 72.
26 It has to be noted at this point that the ECSC Treaty had already contained strong elements of regional policy, mainly in the form of industrial policy initiatives aimed at industrial restructuring.
27 This was the compromise deal with which Italy and Ireland were persuaded to agree to the establishment of the EMS. It consisted of an agreed amount of up to ECU 5 bn in loans from the EIB for structural measures over a period of five years, and at an interest rate of three percent points below the going rate. See: Rolf Caesar, “Das Europäische Währungssystem - Kein geeignetes Instrument eines innergemeinschaftlichen Finanzausgleichs,” Das Europäische Währungssystem: Bilanz und Perspektiven eines Experiments, ed. Hans-Eckart Scharrer and Wolfgang Wessels (Bonn: Europa Union Verlag, 1983) 333.
28 Schäfers and Fetzer 72.
actively pursue, only came with the ratification of the SEA on 1st July 1987. The insertion of the then Chapter V, Economic and Social Cohesion, into the EC Treaty must thus be seen as the most significant step towards a genuine cohesion policy for the ECs.\textsuperscript{30} However, the development in this field did not stop there. The European Council, meeting at Maastricht in December 1991, not only amended the EC Treaty to the extent that the strengthening of economic and social cohesion became one of the Community’s explicitly named activities\textsuperscript{31}, a new Cohesion Fund was also established by the end of 1993 “to provide a financial contribution to projects in the fields of environment and trans-European networks in the area of transport infrastructure.”\textsuperscript{32} In the ‘Protocol on Economic and Social Cohesion’, annexed to the Treaty, the High Contracting Parties \textit{inter alia} agree that the Cohesion Fund would supply Community financial contributions to projects in the above mentioned fields “in Member States with a per capita GNP (Gross National Product) of less than 90% of the Community average which have a programme leading to the fulfilment of the conditions of economic convergence as set out in Article 104c [EC Treaty].”

This, however, makes the new instrument a rather inappropriately named one, since the Cohesion Fund does not so much aim to reduce the Community’s regional disparities \textit{per se}, but first and foremost attempts to support the poorer Member States in their pursuit of meeting the convergence criteria in order to qualify for membership of EMU. But “[c]ohesion ranges wider than regional convergence alone. It implies: policies which reinforce rights, equalize development opportunities, and assure a balance in the distribution of the costs and gains from economic and monetary union”\textsuperscript{33}. This means that cohesion is not only about narrowing the gaps between the economic indicators relevant to the convergence criteria, but that it stands for positively creating a level playing field across social and regional divides.

It would, of course, be useful to explain in more detail what exactly leads to more cohesion, but as the scope of this thesis is limited the focus has to remain on the issue most important to the present analysis: the question of how far cohesion is supposed to go in terms of reducing regional disparities.\textsuperscript{34} Unlike the German Basic Law, the Treaties do not contain objectives such as ‘financial equalisation’ or ‘uniformity of living conditions’. This is no real surprise since such constitutional goals express, rather than

\begin{itemize}
\item\textsuperscript{30} Schäfers and Fetzer 73.
\item\textsuperscript{31} Art. 3 (j) ECT.
\item\textsuperscript{32} Art. 130d ECT.
\item\textsuperscript{33} Stuart Holland, \textit{The European Imperative: Economic and Social Cohesion in the 1990s} (Nottingham: Spokesman, 1994) 3.
\item\textsuperscript{34} Stuart Holland’s book \textit{The European Imperative} represents an impressively comprehensive account of what cohesion entails.
\end{itemize}
demand, solidarity within a given polity. Contrary to its impressive name the European Union is politically still far from unified which is highlighted by the EC Treaty’s call for the promotion of solidarity among the Member States. This acknowledges and accepts the existence of regional disparities. The demand to strengthen the Community’s economic and social cohesion may aim at gradually reducing these divisions, and as such it clearly points into one direction. What cohesion does not stand for - at least not directly - is a final destination. In this respect cohesion is an open and rather vague goal. This impression is only confirmed by the current version of Article 130a EC Treaty:

In order to promote its overall harmonious development, the Community shall develop and pursue its actions leading to the strengthening of its economic and social cohesion.

In particular, the Community shall aim at reducing disparities between the levels of development of the various regions and the backwardness of the least-favoured regions, including rural areas.

The first part of the article arouses even further suspicion over the importance of cohesion by calling into question whether the strengthening of economic and social cohesion really is a constitutional objective in its own right, or whether it is simply supposed to be a means to a different end (i.e. promoting the EC’s overall harmonious development). Such doubts are only reinforced by the first sentence of the Protocol on Economic and Social Cohesion which recalls that the strengthening of economic and social cohesion is one of the EU’s instruments to promote economic and social progress. All this notwithstanding such a relatively negative view can quickly be rejected for the situation is much more complex than the above suggests. It would be more appropriate to say that the two goals ‘strengthening economic and social cohesion’ and ‘promoting economic and social progress’ enjoy a mutually complementing, rather than a hierarchical, relationship. This is reflected in the Protocol on Economic and Social Cohesion where the High Contracting Parties reaffirm “that the promotion of economic and social cohesion is vital to the full development and enduring success of the Community”. The Commission, in a communication paper to the Council, agrees:

How could the main objective of the European venture - Political Union - be achieved without the backing of a prosperous and dynamic economy? Unless this condition is fulfilled, it would be futile to promise success in the reinforcement of economic and social cohesion within the Community.
... the march towards greater cohesion presupposes a dynamic economy so that any adjustments can be made in the best possible condition, and disparities in development possibilities and living standards can be eliminated.35

While this serves to show that cohesion and prosperity are merely two sides of the same coin, the degree to which either can be achieved ultimately depends on the degree of solidarity the Member States are willing to show for one another. Cohesion could, of course, be pursued also by the Member States themselves if they were prepared, or even obliged, to assist each other to such an effect. The Treaty, however, clearly gives the task to strengthen cohesion to the Community and calls on the Member States to “conduct their economic policies and ... coordinate them in such a way as, in addition, to attain the objectives set out in Article 130a.”36 This consequently means that the level of cohesion, and thus prosperity, will ultimately depend upon the Community’s financial strength.37

3.3 Uniformity of Living Conditions

The German Basic Law does not contain any direct rules aimed at reducing regional disparities. The only time it explicitly mentions regional imbalances is in Article 104a which deals with the apportionment of expenditure between federation and Länder. Its Section 4 gives the Federation the right to grant the Länder financial assistance for particularly important investments which are necessary - among other things - “to equalize differences of economic capacities within the federal territory”. However, even this reference reads more like a provision aimed at temporary phenomena because the main impression the Basic Law gives is that living conditions throughout Germany are - more or less - the same. Articles 72 (2) and 106 (3) of the Grundgesetz (GG) both used to refer to the uniformity of living conditions which had to be maintained (not attained!) across the FRG. Yet living conditions in Germany are not, have never been, and realistically never will be, completely the same - which they would have to be to be uniform. Consequently a lively debate emerged over whether or not it would be more appropriate to call for equivalent living conditions throughout the Republic instead.38 In 1990 German unification, and particularly economic, monetary and social union which preceded political

36 Art. 130b ECT.
37 Not surprisingly the Commission in its communication paper to the Council From the Single Act to Maastricht and Beyond, p. 3, argues that an ambitious task such as the strengthening of the Community’s economic and social cohesion “will require adequate resources.”
38 The difference between the two terms lies in the fact that uniformity (Einheitlichkeit) requires everything to be the same, whereas equivalence (Gleichwertigkeit) refers to all being of equal value.
union by just over three months, made it blatantly obvious that living conditions in Germany were far from being uniform. In October 1994 Article 72 was thus amended and the criterion of ‘maintenance of uniformity of living conditions’ was replaced by a requirement to ‘establish equivalent living conditions’. However, to complicate matters, Article 106 remained unchanged.

The difficulty with the above mentioned references to the country’s living conditions is that they do not represent constitutional objectives per se, but have to be seen as guiding principles in decisions concerning the division of power between Bund and Länder. The question thus must be whether, and if so to what extent, these references affect regional disparities in Germany. Article 72 GG deals with the Federation’s concurrent legislation, and Article 106 with the apportionment of tax revenue. In either case the principle of maintaining the country’s uniformity of living conditions used to be one of the main justifications for the Bund to take over from the Länder either the right to legislate or a further share of overall revenues. The first section of Article 72 used to rule that “[i]n matters of concurrent legislation the Länder have the right to legislate as long as and to the extent that the Federation does not exercise its legislative powers”. The special characteristic of concurrent legislation is, of course, that both Bund and Länder may pass laws in the fields laid down in Article 74 GG. In effect, however, the latter only could do so as long as the former had not already made use of its right to legislate. This caused some constitutional experts to dub the provisions of Article 72 ‘priority legislation’, in lieu of concurrent legislation.39

Section 2 of Article 72 lists the three preconditions for federal legislation which, before the 1994 amendments, gave the Federation the right to legislate where: (a) a matter could not be effectively regulated by the legislation of individual Länder, or (b) regulation by a Land might have prejudiced the interests of other Länder or the FRG as a whole, or (c) the maintenance of legal and economic unity, especially the maintenance of uniformity of living conditions beyond the territory of any one Land had necessitated such regulation. The fulfilment of one of the above conditions sufficed for the federal legislator to make use of their right to take over from the Länder as decision-maker in any given field of concurrent legislation. The decision over whether or not one of the preconditions for federal legislation were fulfilled was, however, left to the Bund’s own discretion. This, but particularly the reference to the ‘maintenance of uniformity of living conditions beyond the territory of any one Land’, was interpreted by some as one of the crucial ‘competency co-ordinating points’40 of social federalism.

40 ‘Kompetenzielle Schaltstellen’ according to Scholz. See: Schmidt-Bleibtreu and Klein 815.
Following this approach, the 'uniformity principle' had to be seen in conjunction with the principle of Germany as a social state, and the more fundamental notion that all people are equal before the law\textsuperscript{41}. Put together these three constitutional principles then formed the precept of social equality in a federal state. The discretion of the federal legislator in deciding when to make use of their concurrent right to legislate was not enforceable by law as it truly was a matter of judgement. The Constitutional Court could examine \textit{ex post} whether an abuse of this right had taken place, but would have had to bear in mind the political decisions aimed at bringing about more equality in social and economic conditions. Despite this 'the maintenance of legal and economic unity' and 'the maintenance of uniformity of living conditions' are still legal, rather than political, concepts. They are referred to as vague legal concepts and as such leave the legislator broad room for interpretation. As a consequence, all of the fields listed in Article 74 GG used to be potential candidates for centralised legislation, which not only ignored the federal principle but also gradually undermined it.\textsuperscript{42}

The apparently open mandate for the federal legislator to take away areas of decision-making from the Länder caused considerable concern to most of them. The prospect of unification brought with it the threat of even further transfers of decision-making authority to the federal level, based on the requirement to keep living standards uniform, yet also a unique chance to undertake large-scale constitutional reforms in which the issue of erosion of power from the Länder to the federal level could be addressed too. In their cornerstones resolution of 5th July 1990 the Minister Presidents of the western Länder thus demanded a strengthening of their states' power to legislate.\textsuperscript{43} They argued that in the FRG the vertical division of power, one of the hallmarks of federalism, had come to be seriously threatened. Even though the Basic Law had originally not intended the Bund to play a weightier role than the Länder the balance had, nevertheless, shifted that way to the detriment of the Länder. The respective increase in the importance of the Bundesrat through which the (governments of the) Länder gained more influence at the federal level did not, however, adequately compensate them for the loss of their (parliaments') own individual right to legislate. The Minister Presidents put the blame squarely on the provisions of Article 72 (2) GG as the principal reason for the shift of power away from the Länder and into the realm of the Bund. They also named Article 75 GG which contains rules on federal 'framework provisions'\textsuperscript{44}, the Joint-Tasks of Bund and Länder\textsuperscript{45},

\textsuperscript{41} Art. 3 (1) GG.
\textsuperscript{42} For more detailed reading see: Schmidt-Bleibtreu and Klein 815-6.
\textsuperscript{43} The Minister Presidents of the newly created eastern Länder endorsed the 'cornerstones' in December 1990.
\textsuperscript{44} 'Rahmenvorschriften' by the Federation the Länder have to follow when legislating on matters to which this article refers.

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and the financial aid the federation is allowed to give according to Article 104a (4) GG as 
other areas in which the Länder had become severely limited in their room for individual 
manoeuvre.46

Article 5 of the Unification Treaty between the FRG and the GDR, which called for the 
legislating bodies of unified Germany to consider within two years those questions 
concerning the amendment of the Basic Law that had arisen from German unification, 
explicitly referred to the considerations regarding the relationship between Bund and 
Länder the Minister Presidents had laid down in the above mentioned resolution. 
Consequently the Joint Constitutional Committee (Gemeinsame Verfassungskommission) 
of Bundestag and Bundesrat, the body preparing the alterations of and additions to the 
Basic Law, also reviewed Article 72 for which it recommended the following text47:

(1) In matters of concurrent legislation the Länder have the right to legislate, as long 
and as far as the Federation has not by law made use of its competence to legislate.

(2) The Federation has in these matters the right to legislate, if and as far as the 
realization of equivalent living conditions or the maintenance of legal unity in the 
interest of the whole country requires federal legislation.

(3) By federal law it can be determined that a federal rule, for which the necessity 
according to Section 2 no longer exists, can be replaced by Land legislation.48

The only change made to this before it became the new Article 72 in October 1994 was 
that in Section 2 it now reads “... or the maintenance of legal or economic unity ...”. This 
notwithstanding the new text approaches concurrent legislation in, what could be called, a 
more subsidiaristic manner. Section 1 now brings more clarity to the two aspects of when 
and to what extent the Federation has made use of its concurrent right to legislate. In the 
past the mere initiation of the legislative process had been widely seen as the moment at 
which the Federation had taken over. It was also generally accepted that as soon as the 
Bund had legislated on one aspect of a certain matter, the whole matter had come under 
federal legislative authority. The new rule clearly states that the Länder have the right to 
pass law until the Federation has made use of its concurrent right to legislate by law.49
The subsidiaristic nature of the reformed Article 72 is underlined by the provisions of the

45 As laid down in Section VIIIa, Art. 91a and 91b, GG.
46 For an account of the position taken by the Minister Presidents, see: BRD, Gemeinsame 
Verfassungskommission, Bericht der Gemeinsamen Verfassungskommission (Bonn: Deutscher 
47 The report of the Joint Constitutional Committee was finally agreed on 28 Oct. 1993. See: BRD, 
Gemeinsame Verfassungskommission 5.
48 BRD, Gemeinsame Verfassungskommission 60.
49 Dieter Hesselberger, Das Grundgesetz, 9th rev. ed. (Bonn: Bundeszentrale für politische Bildung, 
1995) 252-3.
newly inserted Section 3. It goes beyond limiting the shift of legislative authority from the Länder to the Federation as depicted in Sections 1 and 2 and now allows the Federation also to give back to the Länder the right to decide over matters for which the conditions set out in Section 2 no longer apply.50

Of most importance to this thesis, however, is Section 2 containing the conditions under which the Bund can claim its concurrent right to legislate. In tune with the overall impression given by the amended Article 72, Section 2 also has a strong subsidiaristic ring to it. Of particular interest here is the replacement of the necessity for federal legislation to maintain the uniformity of living conditions by the Federation’s right to legislate only if the establishment of equivalent living conditions requires it. The aim of the Joint Constitutional Committee was to “concentrate, sharpen and make more precise” the conditions under which the concurrent right to legislate could be exercised by the federal level, and to make the ‘necessity clause’ more easily justiciable before the Bundesverfassungsgericht (Federal Constitutional Court).51 Some, however, believe that the amendments to Section 2 have transformed the ‘necessity clause’ into a ‘requirement clause’. In this respect the reform of Article 72 will have a double effect, concerning both the distribution of legislative power between the vertical levels of government, and the degree to which living standards throughout the country may now be allowed to diverge. Rudiger Sannwald confirms this by predicting that the Federation will no longer be able to claim its right to intervene on the grounds of the uniformity principle since equivalent living conditions can also be achieved by the Länder themselves.52

This highlights the weight carried by legal concepts such as ‘maintaining uniform living conditions’ and ‘establishing equivalent living conditions’. Even though these criteria set the parameters for decisions affecting the concurrent right to legislate, there also seems to exist a reciprocal relationship between the two aspects of Article 72 (2) GG. In other words the question must be whether the provisions referring to the country’s living conditions merely serve to justify federal concurrent legislation or whether they represent a positive aim themselves.53 Such an assessment can only be made with the complete

50 It has to be noted that it is still the Federation that decides over whether to hand back authority to the Länder, and not the Länder themselves. For more details about this point see: BRD, Gemeinsame Verfassungskommission 66-7.
51 BRD, Gemeinsame Verfassungskommission 66.
52 Rudiger Sannwald, “Die Reform der Gesetzgebungskompetenzen,” Die Öffentliche Verwaltung [DÖV], 15 (1994): 632-4. Some of Sannwald’s comments have to be taken with caution since they are based on the recommendations of the Common Constitutional Committee which only refer to the country’s legal unity. Many of his conclusions are either based on or at least influenced by the absence of any reference to the Republic’s economic unity. The final version of Section 2, however, does refer to both the Republic’s economic and legal unity.
53 Horst Zimmermann, “Föderalismus und ‘Einheitlichkeit der Lebensverhältnisse’: Das Verhältnis regionaler Ausgleichsziele zu den Zielen des föderativen Staatsaufbaus,” Beiträge zu ökonomischen
picture in place, and that requires a look at the other explicit mentioning of uniformity of living conditions in the Basic Law first.

Article 106 GG, which remained unchanged after unification, deals with what is referred to as *vertikaler Finanzausgleich*\(^{54}\), the distribution of revenues from taxation. Section 3 refers to the respective shares for Federation and Länder of the overall revenue from turnover tax. This is determined by federal legislation which has to be based on a number of principles. One of these is that "the coverage requirements\(^{55}\) of the Federation and of the Länder shall be co-ordinated in such a way that a fair balance is struck, ... and uniformity of living conditions in the federal territory is maintained."\(^{56}\) According to Horst Zimmermann the reference to uniformity of living conditions weighs heavier in Article 106 than it does in Article 72 because it represents the positive demand to support uniformity. Due to the explicit aim for a fair balance, 'maintaining' has to mean more than 'not getting worse'. Rather than 'keeping the status quo', 'maintaining uniformity' ought to be understood as something along the lines of 'reducing no longer justifiable differences between regional living and development conditions'. What it should not mean is that such differences would be completely levelled out. Despite all this, as Zimmermann also points out, the above only applies to the distribution of tax revenues, and thus only has very limited relevance to the general aims of the Republic's federal structure. A wider application should not be derived from it, certainly not the notion that the uniformity principle may represent a constitutional objective in its own right.\(^{57}\)

Maunz and Dürig find the reference to uniformity difficult to understand in the context of Article 106. In their opinion the issue of maintenance of uniformity of living conditions is a problem of horizontal imbalances while Article 106 deals with the vertical allocation of revenues between Federation and the Länder. They conclude that the uniformity principle in Article 106 can refer only to the fixing of coverage requirements for the Länder community as a whole where existing differences between individual Länder's income and spending figures have to be calculated on the basis of a fictitious standard position.\(^{58}\) Peter Lerche, who also expresses astonishment over the mentioning of uniformity in the context

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\(^{54}\) This translates as 'vertical financial equalisation' but does not describe an active equalisation mechanism. How vertical financial equalisation fits in with horizontal financial equalisation can be seen in Chapter Four.

\(^{55}\) 'Coverage requirements' refer to the need to cover the financial responsibilities caused by legislation.

\(^{56}\) Art. 106 (3) 2. GG.

\(^{57}\) Zimmermann 39-40.

\(^{58}\) Theodor Maunz and Günter Dürig, *Maunz-Dürig: Grundgesetz Kommentar* May 1994: 57; on the point of what uniformity may refer to in the context of Art. 106 (3) 2., see also: Schmidt-Bleibtreu and Klein 1204-8
of the vertical distribution of financial resources, feels let down by those provisions of the Basic Law where he had most expected a reference to the uniformity of living conditions: Article 107 which deals with horizontal financial equalisation, and as such does address regional disparities. Lerche wonders whether the absence of the uniformity principle in the one part of the Basic Law where it would have been most effective actually could be interpreted as a deliberate refusal of the general principle.59

To respond to this it is necessary to return to the provisions with the wider application, i.e. Article 72 GG. However, the common verdict on the uniformity principle here used to be that it was simply one of a few criteria to restrict the Federation in exercising its concurrent right to legislate.60 So in the apparent absence of any substantive positive provisions to support a reduction of regional disparities in living conditions it has to be concluded that any such effort must be based on the indirect effect the references to the country’s living conditions have. That - what have earlier been called - vague legal concepts, such as ‘uniformity of living conditions’ and ‘equivalent living conditions’, do have an impact can be shown by the possible changes the more subsidiaristic new Article 72 could bring about. The Federation now has to prove whether its legislation is required to achieve certain objectives, or whether individual legislation by the Länder cannot do this as well. The fact that ‘equivalence’ is a more vague concept than ‘uniformity’ makes it harder for the Federation to state its case. Sannwald sees numerous problems arising from this, but in particular the difficulty in establishing exactly what amounts to equivalent living standards. He predicts that the amendment of Article 72 is likely to result in more divergent living conditions throughout Germany.61 What has to be remembered though is that living conditions in Germany have never been uniform. In this respect the Basic Law has simply caught up with reality, and whether or not the country’s living conditions actually differ is not the point. The importance of constitutional principles such as ‘establishing equivalent living conditions’ according to Article 72, and ‘maintaining uniformity of living conditions’ as found in Article 106 GG, is that they amount to indirect constitutional aims, which not only ensure that living conditions will not be allowed to diverge, but represent a positive demand for a high degree of - what in eurospeak is referred to as - economic and social cohesion.

60 See, for instance: Zimmermann 39.
61 Sannwald 632-4.
3.4 The Concepts Compared

The main differences between ‘strengthening the EC’s economic and social cohesion’ and ‘establishing equivalent living conditions’ or ‘maintaining uniformity of living conditions’ throughout Germany originate from the contrasting degrees to which the respective entities are politically integrated. While the FRG is one of the most centralised federations in the world, the EU must be regarded as a union of states still only in the early stages of a process of federalisation which is reflected by the relatively limited amount of central decision-making. How much the degree of political integration varies between Germany and the EU becomes apparent when looked at their respective constitutional provisions. While the Basic Law represents a comprehensive framework of general rules for a clearly integrated political entity, the Union’s Founding Treaties only contain concrete rules on matters to which respective Contracting Parties could agree, and rather vague provisions on those issues they had to compromise on. Neither of the two statutory laws, however, defends a status quo. Due to the dynamic nature of federalism, there is room for manoeuvre in both the Basic Law and the Founding Treaties. The direction the latter point into at present is pretty clear: they generally aim for more cohesion within the EU. In contrast to this, the Basic Law appears to have received a slightly more subsidiaristic element of late - but then the FRG and the European Union stand at opposite ends of the ‘federalism scale’ as far as the degree of integration is concerned.

In tune with this, the constitutional concepts aimed at reducing regional disparities in Germany and the EU apply to the respective situations. The European Union is clearly still marked by significant regional diversity in terms of economic and social conditions. In contrast to this the former West Germany used to be a relatively homogeneous entity, hence the reference in the Basic Law to maintain the (apparent) uniformity of living conditions throughout. After unification the FRG became economically and socially divided, and the new constitutional aim to establish equivalent living conditions not only recognises this, but also calls for the reduction of such divisions. The main difference between the Union’s ‘constitution’ and the Basic Law though is that the former explicitly links the objective of strengthening economic and social cohesion with the instruments to achieve it, while the latter does no such thing. There are various hints and references to Germany’s economic and social cohesion in the Basic Law, such as the notion that Germany is a ‘social state’ (Art. 20), the existence of the Joint Tasks (Chapter VIIIa), and the provisions for federal financial assistance under certain circumstances (Art. 104a (4); Art. 107 (2)). Nowhere, however, are these directly linked to the concepts of establishing equivalent, or even maintaining uniform, living conditions. How all this is likely to affect regional disparities in Germany and the EU shall be seen in the following.
4. POLICIES AND MECHANISMS

After establishing the constitutional backgrounds for ways in which regional disparities may be reduced in Germany and the EU, the focus of the analysis will now turn to the more concrete means with which this is to be achieved. In Germany, the horizontal Finanzausgleich is linked to the demand in the Basic Law to maintain at least equivalent, if not uniform, living conditions throughout the country. The European Communities have at their disposal the Structural Funds and the Cohesion Fund to achieve a strengthening of the EC’s economic and social cohesion. One aim of this chapter is to introduce and study these instruments in terms of the way in which they function and how they are supposed to meet their respective constitutional goals. The other objective is to find an early explanation to the question of how the Cohesion Fund differs from the Structural Funds, and whether this does, indeed, represent a departure away from a traditional, centrally organised, structural policy, and towards a German-style horizontal equalisation scheme.

4.1 Financial Equalisation

The term ‘financial equalisation’ will - in the present context - have a rather precise (and thus narrow) meaning which requires some explanation. It derives from the German notion of Finanzausgleich. However, Finanzausgleich means more than just the active reallocation of revenues between and among the levels of government in a political entity. Popitz defined Finanzausgleich as “the sum-total of all facts and regulations containing the financial relationships of the administrative bodies existing in a unitary state or a federal entity.” In other words financial equalisation - as understood in Germany - begins with the distribution and financing of duties across the various levels of government, also includes the allocation of tax raising powers across the different levels of government, the vertical distribution of revenues, and finally culminates in horizontal and vertical reallocation of revenues. According to Keller a distinction can be made between the distribution and financing of governmental duties, which he calls ‘passive financial equalisation’, and the remaining items of the ‘active’ Finanzausgleich. Such a distinction not only makes sense, it serves to highlight the potential problems the former can create for the latter. This is particularly true in the FRG where the Basic Law divides legislative

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and executive powers from one another and in most cases allocates them to different levels of government.

Apart from existing structural disparities between the Länder\(^3\), it is this wider allocation of legislative and executive authority which sets the preconditions for the active financial equalisation. While the bulk of legislation is passed at federal level the majority of executive powers lies with the Länder. Executive powers, however, create expenditure and can thus only be performed to a satisfactory extent if enough financial resources are available. Here, as Renzsch points out\(^4\), the German federal financial constitution contains a unique feature among federations: the Länder have no own powers to determine the levels of those taxes which are constitutionally theirs. With the vast majority of compulsory spending determined by federal legislation the scope for action - in particular the political room for manoeuvre - is thus extremely limited for the German Länder. As pointed out elsewhere this creates a situation in which the poorer Länder are faced with the double burden of low levels of income but high social spending. To counteract this (and not least to create equivalent, if not uniform, living conditions throughout the FRG) the German financial constitution provides for a highly sophisticated mechanism of redistributing revenues between the Länder aimed to create a level playing field for all of them to meet their constitutional duties. This scheme is called *horizontaler Finanzausgleich*, and it is this active horizontal redistribution mechanism which the term ‘financial equalisation’ shall refer to throughout this thesis.

Highly sophisticated the mechanism may be, but the question of interest to this study is - of course - just how much of a level playing field financial equalisation actually creates. Finding the answer requires a look at the technical details of the scheme. However, to make sense of those it is necessary to set out the wider framework in which financial equalisation takes place. Article 106 GG determines the vertical distribution of revenues. The majority of taxes is directly attributed to either Bund or the Länder community but represent only a small proportion of the overall revenue from taxation the two levels of government raise. Revenues from the two largest taxes, income tax, and VAT, and from corporation tax and the directly deducted tax on interest payments go jointly to Bund and Länder. While revenues from income tax, corporation tax, and the interest tax are shared by equal halves between them\(^5\) VAT distribution has been made more flexible to accommodate shifts in responsibilities between the two levels of government. Such shifts

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\(^3\) Such disparities arise for many reasons such as differences in population figures, geographical circumstances, divergent regional trends in economic growth, and other structural problems.


\(^5\) Local authorities may, and currently do, receive 15% of the revenue from income tax, and a 12% share of the directly deducted tax on interest payments.
naturally have repercussions on the financial requirements of the federation and its constituent units. VAT shares are thus decided upon on a periodically adjustable basis by federal legislation requiring the consent of the Bundesrat. The objective here is to equip either governmental level with the financial means necessary to fulfil its duties, to avoid too high a financial burden on the tax payer, and to maintain uniform living conditions.

The horizontal distribution of the Länder's tax revenues is laid down in Article 107 (1) GG. Revenues from the Länder's exclusive taxes as well as their share of income and corporation tax, as a rule, belong to the Land in which the taxes are raised ('local revenue principle'). Revenue from VAT is distributed according to population figures, but a federal law, requiring the consent of the Bundesrat, may (and in fact does) rule that up to a quarter of the sum total of the Länder's revenue from VAT are used for a first corrective 'pre-equalisation' (Vorausgleich). These supplementary allocations go to the Länder in which per-capita revenues from own taxes plus income and corporation tax lie below the all-Länder average. The aim is to secure minimum financial provisions for the poorer Länder and to bring them up to 92% of the average Länder per-capita revenue from taxation. Only then does the main process of horizontal financial equalisation begin.

Article 107 (2) GG determines that the federal law, referred to above, has to ensure a reasonable equalisation of the differences between the financial capacities of the Länder. This law, entitled Gesetz über den Finanzausgleich zwischen Bund und Ländern, or Finanzausgleichsgesetz (Financial Equalisation Act) for short, is required by the constitution also to "specify the conditions governing the claims of Länder entitled to equalisation payments and the liabilities of Länder required to make such payments, as well as the criteria for determining the amounts." To this end an 'equalisation indicator' and a 'financial capacity indicator' were devised. These are determined by quite complicated calculations which shall not, however, be explained in any detail here as this would be of very little value to the current discussion. Put simply, the financial capacity

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6 Art. 106 (4) GG.
7 Art. 106 (3) GG.
8 Certain procedures, such as the one that revenues from income tax on salaries are raised directly by employers' local tax offices, lead to a situation in which revenues may not be going to the Land in which employees (who are the tax payers) live, but to the Land in which they are employed. Similar problems exist with corporation tax. Local revenue is determined by where a company is officially based rather than where its business takes place, although it is the latter that causes the duty to pay taxes. Clearly such considerations can make a substantial difference between the fiscal positions of the Länder, and for that reason a federal law rules that for income tax the 'location of residence principle' (Wohnsitzprinzip) and for corporation tax the 'location of business principle' (Betriebsstättenprinzip) should apply.
9 For further details on the Vorausgleich, see: Biehl, "Die Entwicklung des Finanzausgleichs in ausgewählten Bundesstaaten" 103.
10 Due account has to be taken also of the financial capacity and requirements of the local authorities.
11 For a comprehensive introduction into the technical details of financial equalisation in the FRG, see: Biehl, "Die Entwicklung des Finanzausgleichs in ausgewählten Bundesstaaten" 101-7. Even though re-
indicator results from the sum-total of all tax revenues a Land and its local authorities are entitled to, while the equalisation indicator is based on weighted population figures. With a financial capacity indicator above its equalisation figure a Land becomes a contributor to the equalisation mechanism, if its equalisation indicator exceeds its financial capacity indicator it will be a recipient from the system. The overall target of this part of the equalisation scheme is to bring all Länder up to 95% of their average per-capita revenue. This is reached as follows: low-income Länder with a financial capacity indicator below 92% of the equalisation indicator are entitled to the full difference, those with a financial capacity indicator between 92 and 100% of the equalisation indicator receive 37.5% of the difference; high-income Länder with a financial capacity indicator of between 100 and 101% of the equalisation indicator pay 15% of the difference, those with a capacity of between 101 and 110% pay 66%, and Länder with a financial capacity of more than 110% of the equalisation indicator pay 80% of that difference.

In addition to the payments from horizontal equalisation exceptionally weak Länder can expect further financial support from the Bund, called Ergänzungszuweisungen (BEZ). These federal complemental grants are given to Länder with special needs, such as those having critical budgetary difficulties, and the ones with a comparatively low number of citizens resulting in proportionally high cost for government and administration. Between 1988 and 1993 BEZ accounted for 2% of the VAT revenue of the former West Germany each year. They are financed from the Bund’s share of VAT revenue and lift the low-income Länder up to a revenue level of 99.5% of the Länder average!

Despite all this, and the definite direction into which the mere term equalisation seems to point, financial equalisation - just as federalism, the concept of which it is part - aims to reconcile two conflicting goals. On the one hand the mechanism drastically reduces the differences between the per-capita revenues of the Länder, yet on the other hand it has to ensure also a degree of independence and diversity between them. Biehl refers in this context to the social and federal functions of financial equalisation. The mechanism’s social function (sozialstaatliche Funktion) is to bring the fiscally weaker Länder to a position that ensures, financially, a certain standard of public services for their territories. In contrast to this the federal function (bundesstaatliche Funktion) of horizontal unification, and the decisions taken in connection with the ‘solidarity pact’ negotiations which followed, substantially altered the mechanism in terms of which Land pays and which receives, the overall volume of redistribution, etc., the technical ways in which horizontal equalisation works has not changed much.


Based on Art. 107 (2) GG, and ruled on in detail in the Financial Equalisation Act.

Schleswig-Holstein, Finanzministerium, “Der Länderfinanzausgleich - Aufgabe und Funktion -,” internal paper.
equalisation is to maintain a situation in which the Länder have the responsibility to fulfil their constitutional duties themselves and remain able to determine their own spending policies without becoming financially dependent.\textsuperscript{14} In other words horizontal equalisation aims at maintaining the diversity between the Länder while balancing out the fiscal differences which result from it.

This is the crucial point: equalisation does not tackle the underlying structural causes behind the differences in their revenues. The constitutional concepts of uniform or equivalent living conditions refer only to the fiscal position of the Länder and their corresponding ability to provide a minimum standard of services. In this respect there is no threat to Germany’s federal structure coming from the horizontal mechanism. The degree to which horizontal equalisation can fulfil its federal and social functions, and thus maintain two of the most important constitutional goals\textsuperscript{15}, ultimately depends on the vertical distribution of revenues and thus basically on how much money the Länder community as a whole have at their disposal to redistribute. This is where the political sensitivity of the subject lies, both between Bund and Länder and among the Länder themselves. With a limited amount of financial resources available the rivalry between Bund and Länder for the highest possible share is almost self-explanatory. Amongst the Länder other considerations prevail. The fact that some of them have higher per-capita incomes than others creates pragmatic differences of interest over just how much independence the Länder need, want, or can afford. Those at the wealthier end of the scale have often argued for more Länder independence, be it in terms of policy determination, or even tax-raising ability. In contrast to this the poorer members of the federation are often only too willing to give up certain powers to the federation in order to relieve some of the financial burdens those tasks bring with them.

To conclude it can be said that financial equalisation leads to a nominal balancing of the per-capita revenues of the German Länder without (directly) altering the underlying structural differences which cause the discrepancies in their income positions. In this respect the diversity aspect of federalism is maintained, and its unity aspect served but not seriously addressed. For the latter to occur the financial requirements of the poorer Länder would have to be the criterion for equalisation, not their relative income position. This is where financial equalisation differs from structural policy which targets geographical areas on the grounds of specific structural deficiencies. The FRG does apply policies that are aimed at reducing the structural disparities within its territory. The Joint Tasks of Bund and Länder\textsuperscript{16}, which were introduced in 1969, have the objectives of

\textsuperscript{14} Biehl, "Die Entwicklung des Finanzausgleichs in ausgewählten Bundesstaaten" 101-2.
\textsuperscript{15} Art. 20 (1) GG determines that the FRG is a democratic and social federal state.
\textsuperscript{16} Gemeinschaftsaufgaben as laid down in Chapter VIIIa of the Basic Law, Articles 91a and 91b.
establishing and maintaining institutions for higher education, ameliorating regional
economic structures, and improving agrarian structures and coastal protection. In 1989
pressure from the poorer Länder for the Bund to ease the burdens brought upon them by
federal tax reforms resulted in a federal Structural Aid Act (*Strukturhilfegesetz*) which
contained provisions for direct federal aid for Länder with disproportionally high
unemployment, a disproportionally low per-capita GDP, and disproportionally low
employment developments. This entitled nine of the then eleven German Länder to
receive allocations for a number of structural measures aimed at improving their economic
positions. The two Länder that missed out, Hesse and Baden-Württemberg, immediately
challenged the law before the Constitutional Court. However, the swift developments
following the collapse of the Berlin Wall, in particular the accession to the FRG of the five
eastern Länder and East Berlin in October 1990, made a general review of the financial
relationship between Bund and Länder necessary. As a result the *Strukturhilfegesetz* was

Even though it would be interesting to contrast the volume of structural support for the
Länder by the Bund to the size of the non-earmarked equalisation mechanism, such an
investigation would only distract from the tasks this thesis has set itself, the comparison of
the EU’s structural policies to the financial equalisation mechanism of the FRG.

### 4.2 Structural Policies

Just like financial equalisation structural policies stand for the reallocation of finances to
balance out regional disparities. However, while the former is based on population figures
and revenues from taxation, and as such only represents a *nominal* equalisation of per-
capita revenues, the latter have as their target to address the *structural* disparities within
an entity. The other distinctive characteristic is that financial equalisation (by and large)
takes place horizontally, that is between the constituent units of a federal union, whereas
structural policies are vertical measures with which the central government supports a
country’s poorer parts. Unlike financial equalisation, structural policies are also, if not
more so, applied in unitary states. The main difference between structural policies in

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17 The third criterion not only sounds dubious, according to Renzsch it was only inserted for political
reasons to ensure Bavaria would be a recipient too. For more details, see: Wolfgang Renzsch,
*Finanzverfassung und Finanzausgleich*, 272.
18 For the exact details, see: Art. 1, “Gesetz zum Ausgleich unterschiedlicher Wirtschaftskraft in den
19 At the same time the German Unity Fund, which until 1995 replaced the financial equalisation
mechanism in the new territories, was increased. For more details, see Chapter Five.
federal unions and unitary states is that the vertical division of power in the former make the union’s member states the recipient for structural assistance, whereas in the latter the central government can directly aim at smaller sub-units in need. One example for structural policy in a federation is, of course, the German Strukturhilfegesetz mentioned above. Perhaps surprisingly, given that this thesis has gone to quite some length in explaining why the ECs are of federal quality, its structural policies resemble more those in a unitary state, as they too target sub-regional areas with clearly defined structural deficiencies.

Any redistribution mechanism naturally consists of incoming and outgoing payments and a set of rules to determine them. Due to its horizontal nature the German equalisation scheme has ‘financial capacity’ and ‘equalisation’ indicators to establish who spends and who receives. Structural policies seem more straightforward as they apply vertically. This means the central level of government decides on the overall size of its structural aid package and defines certain criteria to determine its spending. At EU level it is the EC that deals with structural policies. Apart from the European Investment Bank and other financial instruments, both of which shall not be discussed here, the Community’s main tools in achieving the strengthening of its economic and social cohesion are the Structural Funds: ERDF, ESF, EAGGF Guidance Section, and - since 1993 - the financial instrument for fisheries guidance (FIFG).

The ERDF aims at reducing the gaps in development between the EC’s regions, the ESF has the objective to improve employment prospects in the Community, the EAGGF Guidance Section assists in part-financing national agricultural aid schemes and in developing and diversifying the EC’s rural areas, and the FIFG has the task to assist in restructuring the fisheries sector. For the period 1994-1999 the Structural Funds amount

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21 See Art. 130a ECT, where “the Community shall aim at reducing disparities between the levels of development of the various regions, and the backwardness of the least-favoured regions, including rural areas.”


23 According to Art. 130b ECT.

24 In parts of the literature the Cohesion Fund is also counted among the Structural Funds. However, as will be seen in Section 4.3., the Cohesion Fund differs substantially from the way in which ERDF, ESF, EAGGF Guidance Section, and FIFG work, and as such cannot be seen - primarily - as an instrument of traditional structural policy.

to some ECU 150 billion ready to be given to specific projects pursuing at least one of the following objectives:

**Objective 1:** the economic adjustment of regions whose development is lagging behind;

**Objective 2:** the social and economic conversion of declining industrial areas;

**Objective 3:** action to combat long-term unemployment and facilitate the occupational integration of young people and people in danger of exclusion from the labour market;

**Objective 4:** the adaptation of workers to industrial change by means of measures to prevent unemployment;

**Objective 5a:** the adjustment of agricultural and fishery structure in the framework of the reform of the CAP;

**Objective 5b:** the economic diversification of vulnerable rural areas;

**Objective 6:** the economic adjustment of regions with an extremely low population density.

Of these only Objectives 1, 2, 5b and 6 have a direct regional application, as they form the basis for measures in specific eligible regions or subregions, whilst Objectives 3, 4 and 5a cover the whole of the EC. However, with nearly 70% of all Structural Funds money earmarked for regions eligible for assistance under Objective 1 alone\(^{26}\), the regional dimension of the EC's structural policies is clear.

In very general terms, assistance from the EC's Structural Funds takes the form of non-refundable grants to the Community's Member States for the financing of development programmes put forward by them and approved by the European Commission. These programmes implement either Community initiatives designed to remedy specific problems at EC level, or national and regional development strategies agreed with the Commission. The effectiveness of the Funds, however, depends upon the quality and relevance of the measures undertaken. To this end they are guided by four principles: concentration of effort, partnership, programming and additionality.

Concentration of effort finds its expression not only in the foci provided by the above mentioned Objectives, but also in reasonably clear rules concerning the eligibility for structural aid, its size, and the allocation of appropriations from the Funds. For instance, to qualify for Objective 1 status, a region's per-capita GDP, based on figures for the three years preceding the period for which the evaluation is being made, has to be less than 75% of the Community average. (Exceptions from this rule are areas in which GDP was

around 75% of the average but where there are 'special reasons' to include them under Objective 1.) On the basis of this a list of eligible areas is drawn up which, at present, includes the whole of Greece, Portugal and Ireland; large parts of Spain; southern Italy; the five eastern German Länder and East Berlin; Northern Ireland; and smaller areas in Scotland and England, Austria, the Netherlands, Belgium, and France (including its overseas territories). There is quite some flexibility as far as the rates of assistance are concerned, but as a general rule allocations from the Structural Funds can cover a maximum of 75% of the total cost and at least 50% of public expenditure in the case of measures carried out in the regions eligible for assistance under Objective 1, and a maximum of 50% of the total cost and at least 25% of public expenditure in the case of measures carried out in the other regions.

The second guiding principle for the Structural Funds is programming. It consists of four main points. The first concerns the general time frame for which respective rules are to apply, currently the period 1994-1999. Then there is a three-stage decision-making procedure leading up to the allocation of structural aid. It begins with a development plan, submitted by the Member State in question, which has to fulfil a number of requirements. The next step then is the establishment by the Commission, in collaboration with the Member State and the region concerned, of a ‘Community support framework’ (CSF) which sets out the priorities, funding and forms of assistance. Finally the operational aid measures, most commonly in the form of ‘operational programmes’, but also possible in other forms of assistance (such as global grants, large projects, or aid schemes), are submitted by the Member States in the form of an application for assistance and adopted by the Commission. For all this, a time table is agreed, and - as the fourth element of programming - the scope of the Structural Funds defined in much detail. The ERDF, for instance, covers the following areas: productive investment to permit the creation or maintenance of jobs; investment in infrastructure in the regions and areas designated under Objectives 1, 2, 5b and 6; the development of indigenous potential in the regions by measures which encourage and support local development and small and medium-sized enterprises (SMEs); in the regions designated under Objective 1, investment in the field of education and health contributing to their structural adjustment; measures contributing towards regional development in the field of research and

27 For regions located in Member States concerned by the Cohesion Fund, which itself is being discussed below, contributions from the Structural Funds may be as high as 85% of the total cost.
29 For details, see: ECs, Commission, Community Structural Funds 1994-99 22.
technological development; productive investment and investment in infrastructure aimed
at environmental protection; etc.\textsuperscript{30}

In order to prevent the EC's Structural Funds from being used merely to replace national
aid measures, the principle of additionality was introduced. This means that in establishing
and implementing the CSFs, the Commission and the Member State concerned have to
ensure that the Member State maintains, in the whole of the territory in question, its
public structural or comparable expenditure at least at the same level as in the previous
programming period.\textsuperscript{31} Finally, the fourth guiding principle for the Structural Funds is
partnership which involves "close consultations between the Commission, the Member
State concerned and the competent authorities and bodies - including ... the economic and
social partner, designated by the Member State at national, regional, local or other
level ... ."\textsuperscript{32}

Outside these four guiding principles lies the 9\% proportion of Structural Fund
commitment appropriations that are devoted to 'Community initiatives' - initiatives
"which give the Commission the opportunity to activate special funds for measures of
special interest to the Community."\textsuperscript{33} Based on principles, guidelines and rules, drawn up
by the Commission, the Member States and/or regions prepare and carry out programmes
relating to the Community initiatives and complement those measures included in the
CSFs. Five broad areas for Community initiatives have been identified: cross-border,
transnational and inter-regional co-operation and networks; rural development; assistance
to the outermost regions; employment promotion and development of human resources;
and management of industrial change.\textsuperscript{34}

\textsuperscript{30} For the complete details concerning the scope of the ERDF, see: Art. 1 "Council Regulation (EEC) No
Implementing Regulation (EEC) No 2052/88 as Regards the European Regional Development Fund," \textit{OJ}
Regulation (EEC) No 2052/88 as Regards the European Social Fund," \textit{OJ} L193 (31 July 1993); for the
scope of the EAGGF Guidance Section, see: Articles 2 and 5 "Council Regulation (EEC) No 2085/93 of 20
Regulation (EEC) No 2052/88 as Regards the European Agricultural Guidance and Guarantee Fund
(EAGGF) Guidance Section," \textit{OJ} L193 (31 July 1993); and for the scope of the FIFG, see: Art. 3 Council
Regulation (EEC) No 2080/93.

4253/88 Laying down Provisions for Implementing Regulation (EEC) No 2052/88 as Regards
Coordination of the Activities of the Different Structural Funds between Themselves and with the
Operations of the European Investment Bank and the Other Existing Financial Instruments," \textit{OJ} L193
(31 July 1993).

\textsuperscript{32} Art. 4 (1.) Council Regulation (EEC) No 2081/93.

\textsuperscript{33} ECs, Commission, \textit{Community Structural Funds 1994-99} 27.

\textsuperscript{34} For a more detailed account of the rules for the Community initiatives, see: ECs, Commission,
These are the essential technical details of the Structural Funds, and the aim of briefly introducing them has been to demonstrate where structural policies differ from financial equalisation. To reiterate, the latter represents a mere nominal balancing out of fiscal inequalities between the constituent units of a federal union, whilst the former stand for pin-pointed efforts from the central level of government to alleviate regional disparities throughout the territory in question. As Section 4.1. concluded, financial equalisation in itself does not alter the structural differences that exist between the members of a federal union. The question that has to be asked now is whether structural policies do.

In its fifth periodic report on the social and economic situation and development of the regions the European Commission paints a cautiously positive picture. It concludes that, between 1989 and 1993, the weaker regions had made some progress towards converging in real terms with the rest of the Community but that the process had generally been slow and that regions had been affected to differing extents. However, the report also points out that the experience with Objective 1 regions, the recipients of the bulk of structural aid, had been rather mixed since 1986. While some had undoubtedly made progress, others only managed to maintain their relative economic positions, and a minority of Objective 1 regions even fell back in key areas compared to the rest of the EC.35

Despite all this, it should not be forgotten that the EC is still in the middle of a dynamic integration process with the potential to worsen the structural divisions within. While the Community as a whole is to respond positively to economic and monetary integration, such an aggregate result consists of above average beneficiary regions that out-perform areas which lose out because of their geographical location, their infrastructural backwardness, and/or the fact that in future competitive devaluations may become impossible. Such a realisation brings the performance of the Structural Funds into perspective. However little they may achieve, in their absence a much more scattered picture would exist. In this respect they do achieve real results. However, just as with financial equalisation, the quality of structural policies ultimately depends on the amount of money available. If the EC really wants to strengthen its economic and social cohesion, the Structural Funds would have to be large enough to counterbalance the trend economic and monetary integration brings about.

4.3 The Cohesion Fund

One of the reasons why this thesis undertakes a comparison between the EU and the FRG is that the former is portrayed as a union of states still in the early stages of federalisation, whilst the latter represents one of the most closely integrated federations in the world. Consequently the EU finds itself in a dynamic process of economic, monetary and - to an extent - political integration with the ultimate destiny of some form of union. The FRG is one such union, and as such an example for the EU to learn lessons from. Before re-unification regional disparities used to be relatively static in Germany, only affected by actively pursued changes, such as structural measures within, or by decisions concerning external factors, for instance European integration or global trade agreements. In contrast to this, regional disparities within the EU are threatened to widen by the impact of the dynamic integration process. The creation of an EMU is set only to accelerate this problem, and an increase in the size of the Structural Funds would have been a logical response. However, the Cohesion Fund, the latest instrument with regional effect at the EC’s disposal, represents a change in approach by the Community’s decision-makers.

Without going into too much detail at this stage36 the TEU, which set up the Cohesion Fund, contains provisions to establish not just any EMU, but one that would be represented by a currency as solid as the German Deutsche Mark. Technically this only requires an independent central bank with tasks similar or equal to those of the Bundesbank. However, in terms of regional disparities, the issue of how compatible the partners forming an EMU are cannot be ignored altogether. As the experience with German economic, monetary and social union in 1990 clearly shows, an ‘early’ union - meaning one formed by members with differing economic data - would lead to an increased demand in regional aid unless the EC’s economic and social cohesion was to be compromised upon. By and large, this would have been the continuation of past policy: further integration is counteracted by more regional aid, usually in the form of an increase of the Structural Funds - in other words an ex-post dealing with the consequences of EMU.

What the decision to create a ‘strong’ European currency entails is an ex-ante reduction in structural differences between those countries forming a monetary union. The difficulty the poorer Member States face in the light of having to converge ahead of economic and monetary unification are very similar to those encountered by the poorer German Länder in the purely nominal equalisation scheme: the double burden of high expenditure and low

36 A more detailed assessment of the chronology of EU regional policy, and where within that context the Cohesion Fund is located, can be found in Section 6.4.

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revenue. The way it works, qualifying for EMU requires the Member States to reach a number of ‘convergence criteria’, among which are low levels of borrowing and “a government budgetary position without a deficit that is excessive.”\(^{37}\) However, reducing regional disparities ahead of EMU clearly requires increased spending. A catch-22 situation - and a challenge to the political will within the EU to extend the concept of ‘political union’ from notions of a common foreign and security policy to a commitment for more solidarity within.

Although the Cohesion Fund officially came into existence to „contribute to the strengthening of the economic and social cohesion of the [European] Community”\(^{38}\), its real aim has to be seen as to help the economies of the poorer Member States to converge with those of their richer counterparts. The new Fund will, of course, serve the goal of strengthening the EC’s economic and social cohesion, but this has to be looked at as only the indirect impact of a policy which - really - pursues a different goal. This thesis argues that the Cohesion Fund represents a cross-breed between financial equalisation and structural policies, and a look at the way this latest EC instrument with regional impact works quickly confirms this view.

The first, and arguably most obvious, characteristic of the Cohesion Fund is that it serves to aid the poorer Member States, and not sub-national regions or smaller areas in need. As has been mentioned before, this is more in line with regional policies in federal unions than it is with structural policies in unitary states. A close resemblance with German financial equalisation is the requirement that a Member State’s per capita GNP has to be less than 90% of the Community average\(^{39}\) in order to qualify for Cohesion Fund allocations. At present the Member States entitled to receive money under this rule are Greece, Spain, Ireland and Portugal. If no further conditions had been imposed, this would indeed very much look like an embryonic equalisation mechanism.\(^{40}\) However, as a true cross-breed, the Cohesion Fund also has a number of features usually associated with structural policies. The first of these is earmarking, here the requirement that allocations from the Fund can only be used for projects in the fields of the environment and trans-European networks. Another feature usually brought into context with structural policy is the setting of a time-table for a period of several years (currently, and in line with the Structural Funds, until 1999). Finally, just as with structural policies, the Cohesion Fund

\(^{37}\) Art. 109j (1.) ECT.
\(^{39}\) Measured in purchasing power parities.
\(^{40}\) The difference is that the ultimate aim of the Cohesion Fund is not to balance out the per-capita financial positions between the fifteen Member States which, by definition, a full equalisation scheme would require.
only contributes to projects that qualify under its rules, and the maximum rate of assistance - generally - lies between 80 and 85% of the overall expenditure for them.\footnote{Art. 2-7 Council Regulation (EC) No 1164/94.}

If this seems to indicate that the Cohesion Fund is still closer to structural policies than financial equalisation, a number of other considerations may help to change this impression. The odd feature of the Cohesion Fund is, of course, that its prime aim is not so much to strengthen economic and social cohesion, but to achieve economic convergence, because a Member State’s poverty itself does not suffice to qualify for financial contributions from the new instrument: Article 2 of the Council Regulation establishing the Cohesion Fund\footnote{In line with the Protocol on Economic and Social Cohesion, annexed to the TEU.} explicitly demands “a programme leading to the fulfilment of the conditions of economic convergence referred to in Article 104c of the Treaty [on European Union].” The shift away from the quite restrictive conditions of structural policy allocations and to the direction of financial equalisation, where no earmarking applies, is probably best reflected by the fact that the Cohesion Fund targets whole Member States rather than smaller, sub-national areas. This gives the recipients substantial room for manoeuvre since, despite the requirement that the projects have to be in the fields of environmental protection and/or transport infrastructure, they do not have to be in the countries’ poorer regions. Environmental protection and transport infrastructure are both fields in which the poorer Member States are lagging behind their partners in the EU, and it would thus require large proportions of their national budgets to finance their catching up in these fields. In this respect money from the Cohesion Fund has to be regarded more as financial injections to the poorer Member States to relieve them from the budgetary pressures brought about by the strict convergence criteria of the Maastricht Treaty, rather than allocations meant to ameliorate definite structural deficiencies.

To conclude, the Cohesion Fund combines elements from the structural policies introduced in Section 4.2, and the German system of financial equalisation discussed before that. At first glance the Fund appears to be more akin to the EU’s structural policies, but a closer look reveals that the earmarking is of rather vague a nature. Consequently the Member States, who are the recipients of Cohesion Fund allocations, have quite some discretion over exactly where to spent the money. Even though the Cohesion Fund is no financial equalisation in the sense that richer Member States give up part of their own revenues for the benefit of their poorer counterparts - after all the money comes from the Union’s coffers to which all fifteen member countries contribute - the effect the Cohesion Fund has on the budgetary position of the poorer members very
much resembles that the horizontal mechanism has on the fiscal situation of the poorer Länder in Germany: helping them to cope with higher expenditure caused by their relative poverty. In this respect financial equalisation in Germany and the European Cohesion Fund can be said to have similar objectives.

As has been discussed in Chapter Three, the equalisation mechanism in Germany does not create uniform living conditions throughout the FRG, but merely achieves a nominal equalisation of the per capita fiscal position of the Länder. In the EU the main goal of the Cohesion Fund is to support the economic convergence amongst the Union’s Member States - and helping to strengthen the EC’s economic and social cohesion can only be regarded as a secondary aim.
5. The German Experience with Equalisation Policies

In a federal union the shape, and - ultimately - the effect, of regional policies is very much determined by how and to which extent the conflicting goals of federalism are being pursued by the decision-makers involved. The question is of course how to accommodate notions of diversity, in the present context represented by a subsidiaristic interpretation of democracy and hence accepting a degree of regional disparities, with those of unity, which demand a high level of solidarity between the decision-makers involved and as such aim at eradicating grave variations in regional standards of living. So far this study has only introduced and explained the current status quo, as far as financial equalisation in Germany and regional policies in the EU are concerned. However, as has been frequently highlighted throughout this thesis, federalism is not just about the vertical division of power, it is also about a dynamic process of continuous readjustment as to where in this vertical structure decisions should be taken.

In this respect past developments behind the policies and mechanisms looked at in this thesis reveal as much, if not more, about the relationship between diversity and uni(formi)ty in Germany and the EU as the practices, aimed at reducing regional disparities, currently in place. However, in addition to all this, the behaviour patterns between Länder and Bund, as well as amongst the Länder themselves, especially with the various party-political constellations in Bundestag and Bundesrat in mind, give important further insight into the way in which federal systems work in general, and how they deal with the essential question of fiscal redistribution in particular. Not only a much more integrated federal union than the EU, the FRG has also a longer history of conflict between the goals of fiscal federalism to study and draw lessons from. For this reason the German experience shall be looked at first.

5.1 Before the Establishment of the Federal Republic of Germany

The first conflicts of fiscal federalism in post-World War II Germany emerged as early as 1946. Initially the discussion centred around the wider implications of the German Finanzausgleich, the vertical allocation of tax raising authority. By 1947 mainly two alternative positions had become clear: one that, mainly for political reasons1, promoted a

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1 In other words: the avoidance of centralism, which was also the position taken by the representatives of the Allied military governments. See: BRD, Bundesministerium der Finanzen, Referat
strongly subsidiaristic model, and one which used economic arguments for a rather unitary solution. These positions of course represent the classic dilemma of federalism just mentioned above. Due to the particular circumstances of the time, the devastation the war had left behind and the subsequent poverty and suffering of large sections of a population inflated by significant numbers of refugees from the eastern territories given to Poland and the Soviet Union, the arguments for a unitary system of taxation eventually won the day. However, the divisions between the decision-makers involved did not follow strict party political patterns. More economically and socially minded politicians and experts, mostly social democrats and the liberal Free Democrats but also Christian democrats, predominantly from the North, supported the unitary model. Promoting the idea of more powers for the Länder were the representatives from the southern Länder and the Hanse cities, amongst which nevertheless also were a number of prominent social democrats.²

During the year 1947 the initially theoretical debate turned into a real one when, due to the deteriorating economic and social situation in Germany, and the impact of the Cold War, the US and Britain performed a remarkable U-turn in their policy stances vis-à-vis their former enemies, and switched from a position of punishment to one of helping the Länder in their occupation zones to rebuild their economies. As a first step these Länder were merged to form the Unified Economic Area (Vereinigtes Wirtschaftsgebiet, more commonly known as the Bizone) - and for the second time in German history economic integration preceded political unification. Just like the Zollverein, the Bizone also had a federal structure, but this time the central level of government, which consisted of an Economic Council (Wirtschaftsrat) and a Länder Council (Landerrat), received substantial competencies in the field of public finances. However, powers to rule into the financial relationships between the Länder were not included, even though the situation within the Bizone was one of grave, and to this extent economically unjustifiable, disparities in the fiscal position between its constituent units.

These disparities had its origins in a taxation system that was based on a simple version of the local revenue principle briefly discussed in Chapter Four. What this meant was that revenues went to the Land in which the reason to tax occurred. In general the principle favoured larger cities, because this is where most people live and where most companies have their headquarters. Within the federal structure of the Bizone this led to a situation in which the larger and economically and structurally more diverse Länder managed to balance out their internal divisions, but in which also the two Hanse cities gained over-
proportionally much. Hamburg and Bremen received all revenues from customs and excise on the goods traded through their ports, regardless of where or what these goods were destined for. Another example of the unfair distribution of revenues was the motor vehicle tax. Hamburg, for instance, was home to the regional headquarters of the post and railways which meant that all their vehicles were registered there, and all taxes paid on these motor vehicles went into the coffers of the city state despite the fact that the two utilities also served large parts of the rest of northern Germany. As a consequence the two territorially larger Länder between which Hamburg is sandwiched lost out on such revenues. Schleswig-Holstein and Lower Saxony thus represented a third category of Länder: those which, due to a mixture of structural backwardness, lack of economic diversity and low population levels, had only a limited tax raising ability, and as a result were relatively poor. The influx of refugees from the territories lost to Poland and the Soviet Union, together with the financial burdens from occupation, had an additional, disproportionally serious, effect on the already strained budgets of the poorer Länder.

The question of which level of government should be entrusted with the task to balance out the already significant differences between the income positions of the bizonal Länder never really arose, because the Länder had reserved for themselves the exclusive right to decide over a horizontal financial equalisation scheme. Furthermore, the central authorities were primarily interested in securing for their own governmental level a sufficient proportion of the revenues from taxation. They were aiming to become able not only to fulfil their own duties, but maybe also to perform their own vertical equalisation scheme. The dwindling budgetary position of Schleswig-Holstein certainly would have warranted central intervention, but the Länder insisted on tackling such problems amongst themselves. This, however, turned out to be an extremely difficult task - and eventually proved impossible in the absence of a higher authority forcing the Länder into a proper scheme of financial equalisation. The higher authority only arrived, in the form of the Basic Law, with the establishment of the FRG. For the meantime the bizonal Länder just could not agree on any equalisation mechanism among themselves, let alone find a way of including the Länder of the French occupation zone when that issue arose in 1948.

The scope of this study does neither allow for, nor does it really require, a detailed account of exactly what went on between the Länder in their pursuit of finding a solution to the problem of significant differences in their financial capacities. Important to this

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3 Bremen served as the main port for the US zone of occupation.
4 Renzsch, Finanzverfassung und Finanzausgleich 27-8.
thesis are only two main points: an apparent lack of solidarity between the Länder, and a clear rift between the positions of the 'richer' and the 'poorer' Länder. A definite pattern, as far as the financial relationship among the Länder, and eventually also between them and the federal government, is concerned, already emerged then. The richer Länder, using the federal principle of diversity as their main argument, tried to hold on to as much of their revenue as possible, both in respect to the vertical distribution of revenues, and the horizontal equalisation mechanism. Their poorer counterparts meanwhile pointed to the unity aspect, and the notions of solidarity that come with it, primarily to gain as much as possible out of the horizontal equalisation scheme. Given these irreconcilable differences in their positions, it cannot surprise that no agreement was found for a working equalisation mechanism before the establishment of the FRG. However, one trend already emerged then, and that was that the stubborn and selfish position of the richer, allegedly more federally minded, Länder drove the poorer ones into seeking help from the central authorities which, as will be seen in the following, had exactly the opposite effect. As long as the federal level merely supported the poorer Länder by means of vertical aid payments, their political independence was not directly threatened. Only when the poorer Länder began to reduce the strains on their budgets by asking the central authorities to take over certain responsibilities from them did the uncompromising stance of the richer Länder begin to backfire.6

5.2 The 1949 Basic Law

In 1949 the political unification of western Germany, in the form of the establishment of the FRG, led to a vertical reallocation of powers between the Länder and the new federal level. Even though the Basic Law upheld, in principle, that the exercise of governmental powers and the discharge of governmental functions remained incumbent on the Länder, this was only the case as long as the Basic Law itself did not rule otherwise.7 It did, however, give to the federal authorities a large number of legislative powers directly8, with another list of governmental duties allowed to be taken over by the Bund via the rules of concurrent legislation.9 Compared to the situation before the establishment of the FRG the Bund had received a much larger share of legislative responsibility than the central authorities of the Bizone ever had. Indeed, the federal level now had command over the bulk of legislation, which left the Länder with only culture and education, the

6 For a comprehensive analysis of the period between the establishment of the Bizone and the creation of the FRG, see: Renzsch, Finanzverfassung und Finanzausgleich 27-53.
7 Art. 30 GG.
8 See: Art. 73 GG.
9 See: Art. 74 and 72 GG respectively.
police and public order, and their own internal and judicial affairs as fields of their own undiminished responsibility.\footnote{Dietrich Thranhardt, "Gesetzgebung," Handwörterbuch des politischen Systems der Bundesrepublik Deutschland, 1995 ed.: 200. For a more detailed account, see: Anton Böhringer and Walther W. Schmidt, "Die Landtage - ihre Arbeit im Wandel des Bundesstaatssystems -," Bundestag Bundesrat Landesparlamente (Rheinbreitbach: Neue Darmstädter Verlags-Anstalt, 1991): 135-9.} What the Länder did keep though was the bulk of administrative authority.

With the division between legislative and administrative powers, the question over which level would have to carry the financial burden of government arose. Only two main alternatives were possible. The expenditure could either be linked to the right to legislate, or to the execution of law. Logic would suggest that those who, by passing law, largely determine spending should also pay. On the other hand the principle that the ultimate power of government lies with the Länder (Art. 30 GG), and the rule that they execute federal law as their own affairs (Art. 83 GG), could be used to justify a link between the execution of law and the expenditure that goes with it. The latter, however, carried the threat that the federal government could use the unequal division of legislative and executive powers across the vertical levels of government to its political advantage. Apart from a few specific issues, the Basic Law contained no direct rules on the distribution of expenditure which, as will be seen in the following, led to so many problems between Bund and Länder that a reform to parts of the Basic Law became necessary almost as soon as the FRG got up and running.

Following the general pattern of legislative authority, the 1949 Basic Law gave to the Bund the exclusive right to legislate over customs and the financial monopolies, and the concurrent right to decide over virtually all other important taxes.\footnote{Art. 105 GG.} Even though, in accordance with the general provisions concerning concurrent legislation\footnote{Art. 72 (2) GG.}, the federal government had to justify why the Bund would extend its legislative scope to include certain taxes, this amounted to a mere formality as Article 123 (1) GG already provided for a continuation of the unitary taxation regime of the old Reich. This means, of course, that the Länder never really had a chance of using their concurrent right to legislate over taxes, and that the Bund had come to dominate decision-making in this field right from the early days of the FRG.

All this notwithstanding, as far as the vertical distribution of revenues from taxation was concerned, the Basic Law of 1949 redressed the balance to the benefit of the Länder. The Bund effectively only received revenues from those sources which could not be traced back to regional origin. These included income from customs, monopolies, and taxes on...
consumption, including turnover tax, but excluding beer tax. The Länder were entitled to all other revenues, most importantly those from income and corporation tax. However, due to the uncertainty over whether the federal level would have enough financial resources to fulfil its governmental duties, the Bund was given also the right to claim, by simple federal legislation, part of the revenue from income and corporation tax in order to pay for those expenses which it could not otherwise finance. Even though this means that the FRG started off with a 'system of separation' in which each level of government was entitled to the full revenues from the taxes allocated to them, the prospect that the federation could make use of its right to claim part of the Länder’s revenues from income and corporation tax de facto created a mixed system in which more than one level of government share their sources of income. The revenue entitlements as just described were only meant to last until 1952. For the time after that Article 107 GG (old version) foresaw a federal law which would, once and for all, apportion tax sources to Bund and Länder in accordance with their duties. This law, which was to require the consent of the Bundesrat, had to give to the Länder a legal claim to certain taxes, or at least part thereof, to prevent the Bund from any future attempts to try and fob the Länder off with mere financial allocations.

Since the vertical distribution of revenues from taxation was based on the principle of local occurrence, significant imbalances had to be expected between the income positions of the various Länder. Reasons for that were not only the differences in their economic and financial capacities, but also the differing degrees to which individual Länder had been destroyed during the war. To avoid too large differences in the supply of public services between the Länder, two equalisation schemes had been incorporated into the Basic Law, a vertical and a horizontal financial equalisation. Article 106 (3) GG contained a partial vertical equalisation in which the Bund was to give to the Länder supplementary allocations to cover their expenses in the fields of education, health, and general welfare. Art. 106 (4) GG allowed for a federal law, requiring the consent of the Bundesrat, to rule on a horizontal equalisation mechanism among the Länder, in which those with lower than average per-capita revenues received financial allocations from their counterparts with higher than average incomes.

At long last a horizontal equalisation mechanism which, in its form, was unique among federations, had been imposed on the Länder by the Basic Law. It was not, however, the

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13 Art. 106 (1) GG.
14 Art. 106 (2) GG.
15 No one knew at the time what the financial legacy of the war would be. See: Clemens Esser, *Strukturprobleme des bundesstaatlichen Finanzausgleichs in der Bundesrepublik Deutschland* (Bonn: Institut ‘Finanzen und Steuern’ e.V., 1992) 2.
only peculiar feature of German federalism. Whereas in most federations a clear separation exists between the areas for which a level of government takes complete responsibility in terms of legislation, administration and expenditure, the FRG opted for a mixed system that isolates rights and duties from governmental tasks and gives them to different levels of government. The FRG represented a new brand of federation, one in which often extreme elements of unitarism, such as the high concentration of legislative authority at federal level, and subsidiarity, like the horizontal equalisation scheme, were combined with new ideas, for instance the representation of the Länder, in the form of the Bundesrat, at federal level.\textsuperscript{16}

5.3 A First Reform

As has been hinted at above, the financial relationship between Bund and Länder was not going to be an easy one. The lack of clarity over whether to link the expenditure to the right to legislate or to the right to execute law soon exposed the Bund's dominating position. With the near exclusive right to pass legislation on taxation it had a particularly efficient argument to see through its position \textit{vis-à-vis} the Länder - despite the requirement that, for most matters, the federal government needed the approval of the Bundesrat. The latter, however, only posed a minor problem to the federal government. The rift between the richer and poorer Länder still existed, not only in their income positions, but also in respect to their ideological stance. And since the better-off Länder were in a minority, the federal finance minister regularly managed to use the fiscal weakness of the poorer Länder to win over a majority of votes in the federal council by offering various schemes of co-financing and financial assistance from the federal coffers.

The irony behind this 'policy of the golden bridle' (\textit{Politik des goldenen Zügels}), as the 'buying' of Bundesrat votes is commonly referred to, was that the federal level financed its generosity by gradually taking over parts of the revenue from income and corporation tax which in principle belonged to the Länder. In other words, the Bund began to financially support the Länder and paid for it with revenues it took away from them. To give an impression of the volume of these shifts: as early as 1951 the federal level had taken over 27% of the revenues from income and corporation tax, a figure which by 1954

\textsuperscript{16} For more detailed reading on the division of powers between Bund and Länder in the 1949 Basic Law, particularly as far as the financial constitution is concerned, see: Biehl, "Die Entwicklung des Finanzausgleichs in ausgewählten Bundesstaaten" 79-90. For a critical assessment of the 1949 financial constitution, see: Herbert Fischer-Menshausen, "Die Abgrenzung der Finanzverantwortung zwischen Bund und Ländern," \textit{DOV}, 5.22 (1952): 673-9.
had already risen to 38%.\textsuperscript{17} Almost needless to point out that this led to a gradual undermining of the powers of the Länder level as a whole. They in fact lost influence to such an extent that during the early years of the FRG the federation gained even more authority than the already generous rules of the Basic Law permitted.\textsuperscript{18}

The growing dominance, both financial and political, of the federal level was not only partly aided by the ideological differences between the richer and the poorer Länder, it was also partly responsible for them. As far as the Länder as a whole were concerned, they had entered a vicious circle from which to escape would prove to be extremely difficult. The reluctance of the richer Länder to commit themselves to the degree of horizontal equalisation the poorer Länder demanded meant that the latter often found the federation more sympathetic to their plight than their wealthier counterparts who had apparently not realised that the acceptance of more homogeneity amongst the Länder would have been the only way to safeguard the rapid erosion of their influence.\textsuperscript{19}

A strong indication as to just how delicate the issues surrounding the financial relationships within the new FRG were was the postponement twice of the deadline, set in Article 107 of the 1949 Basic Law, to find a permanent settlement for the vertical distribution of revenues. A compromise was eventually reached in the form of the Financial Constitution Act (\textit{Finanzverfassungsgesetz}) of 1955\textsuperscript{20}, which also improved the horizontal equalisation mechanism and clarified a number of uncertainties surrounding the attribution of expenditure. However, the amendments to the Basic Law really only were the result of compromises between the decision-makers involved. Instead of a ‘conclusive’ settlement of the vertical distribution of revenues, the Bund-Länder ratio for the allocation of revenues from income and corporation tax was set at 33.33 to 66.66 for the time until 1 April 1958, and readjusted to 35 to 65 for the time after then. Further readjustments were made dependent upon diverging developments in the budgetary positions of Bund and Länder which would result in deficits of such magnitude that a correction in the participation ratio between the two governmental levels became

\textsuperscript{18} Biehl, “Die Entwicklung des Finanzausgleichs in ausgewählten Bundesstaaten” 90.
\textsuperscript{19} For more detailed reading on the developments between the introduction of the Basic Law and the first constitutional reform in 1955/56, see: Biehl, “Die Entwicklung des Finanzausgleichs in ausgewählten Bundesstaaten” 90-92; and/or Renzsch, \textit{Finanzverfassung und Finanzausgleich} 75-129.
imperative. However, in order to avoid too frequent changes to the ratio, a minimum period of two years before any new readjustment could take place was imposed.  

While the outcome of the constitutional amendments have to be regarded as rather unsatisfactory as far as finding a permanent solution to the vertical distribution of revenues was concerned, they were judged to have been more successful in respect to financial equalisation. Its provisions, which had so far been dependent on federal legislation, were now part of the financial constitution, and as such had become obligatory. The horizontal mechanism, which was still based on local occurrence, had this principle improved to ‘real’ local occurrence, meaning that revenues went to those Länder in which the reason to tax occurred and not, as had been previously the case, to the ones in which they were raised. This led to more fairness in the assessment of whether a Land would be able to receive from or would have to contribute to the mechanism. The financial constitution also provided for the federation the option to give vertical supplementary allocations (BEZ) to the weaker Länder.

5.4 The Grand Financial Reform

With the difficulties concerning the financial relationships between the Länder largely resolved, the fiscal problems within the FRG began to centre around those issues which the constitutional reforms had not been able to address to a satisfactory extent: the vertical distribution of governmental responsibilities and revenues. The problems that had existed before the 1955 reform remained the same. The general mismatch between the four responsibilities - legislative power, executive power, tax-raising authority and the duty to pay - made it difficult to determine the (still shifting) financial requirements of the governmental levels. The federation’s overall domination in the field of legislation meant that the Länder received more and more executive responsibility without necessarily receiving more money to fulfil their tasks. The Bund’s exclusive right to set the level of taxation left the Länder in a situation in which the former set the agenda and the

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21 This rule was not to apply in cases in which the financial situation of the Länder was directly affected by federal legislation, either through the allocation of more tasks, or through measures leading to a reduction in the revenues of the Länder.
22 As the new Article 107 GG.
23 For more detailed reading on the 1955/56 reforms, see: Biehl, “Die Entwicklung des Finanzausgleichs in ausgewählten Bundesstaaten” 92-4; and/or Renzsch, Finanzverfassung und Finanzausgleich 130-69.
24 The differences between richer and poorer Länder naturally remained, but compared to the difficulties that existed in the vertical relationship between Bund and Länder, the horizontal problems were only minor. For a detailed assessment of the latter, between 1955 and 1969, see: Renzsch, Finanzverfassung und Finanzausgleich 180-97.
25 Due to the extensive use of its concurrent right to legislate, laid down in Art. 72 GG.
Bundesrat, as the federal representative of the Länder, could only react, but not take the initiative. Inevitably the Länder were frequently forced to ask the federation for assistance which the latter, as a rule, provided by taking over policy areas from the Länder, rather than by allowing them a larger share of the overall revenue from taxation. As a result of this, it was the Bund which increased its proportion of the sum-total of public revenues between 1955 and 1969.

An important issue not looked at so far is the influence party-political aspects had on the financial relationships between Bund and Länder and amongst the Länder themselves. As has been discussed elsewhere in this thesis, despite an often decentralised history, most political parties in the FRG are unitary, national organisations structured 'top-down', rather than 'bottom up' which would be a more organic, and for a federation more typical, subsidiaristic approach. Ever since the founding of the FRG both federal chambers had had CDU-led majorities which, given the main parties’ hierarchical structure, clearly contributed to the trend of shifting more and more authority from the Länder (parliaments) to the federal institutions. The only real exception was the subject of finances which, understandably, was more important to the Minister Presidents than even party-political pressures. This relatively cosy relationship changed when, in 1966, the governing coalition in the Bundestag between the Union parties (CDU and CSU) and the liberal F.D.P. collapsed and in due course led to the formation of the ‘Grand Coalition’ between CDU/CSU and the social democrats (SPD).

With the two main parties in co-operation, the way was open for them to tackle some long overdue constitutional changes. Indeed, during the short lifetime of the Grand Coalition the Basic Law was amended more frequently than during any other term of government. Of interest to this thesis are, of course, the changes affecting the financial constitution. They were made in what has become known as the ‘grand financial reform’ (Große Finanzreform) of 1969. Basically three reasons for this reform can be identified. First the increase in the entanglement of responsibilities between Bund and Länder, and the need to limit it while also sanctioning some of the procedures which had already become common practice. Then the trend to centralise decision-making justified by the controversial constitutional principle of ‘uniformity of living conditions throughout the

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26 See: Abromeit 63.
28 BRD, Bundestag 412.
Finally there was a general trend at the time for more planning and involvement by the state which, to be evenly spread, required either national legislation, or at least coordination between the Länder to an extent that would produce matching results.29

As its name clearly indicates, the grand financial reform was more than just a cosmetic change to the Basic Law. By sanctioning the entanglement of governmental responsibilities between Bund and Länder it created what has become known as ‘co-operative federalism’30, and as such laid the foundations of how the FRG functions to this day. The most obvious amendment to the Basic Law was the introduction of the Joint Tasks of Bund and Länder - the very embodiment of the principle of co-operative federalism.31 In the fields of ‘construction of institutes for higher education’, ‘improving regional economic structures’ and ‘agrarian structures and coastal protection’ the Bund and Länder were given joint authority for framework planning and the financing of respective projects. Decisions on the framework planning required the consent of the Bund, which had as many votes as the Länder community as a whole, and that of a majority of Länder, which had one vote each.32 Financing was determined by the federal level, and the Länder usually contributed half of the sum decided upon.33

The other significant change the grand financial reform brought about was the creation of the ‘grand tax union’ (großer Steuerverbund) between Bund and Länder. In the general spirit of co-operative federalism, both levels of government were given access to revenues from the three largest sources of governmental income: income and corporation tax, and turnover tax. This meant that four fifth of all revenues from taxation now belonged to both levels jointly, which left the Bund with 15% and the Länder with a meagre 5% of the entire revenue pool exclusively to themselves.34 Turnover tax was chosen to provide the flexibility needed should the fiscal requirements of the two levels change over time. The new constitutional rules divided the other two sources equally between Bund and Länder,

30 The expression ‘cooperative federalism’ has been used earlier in the thesis to distinguish the kind of federal union in which the governments of the constituent units are directly represented at federal level from those where the two governmental levels are strictly separate from each other, referred to as the ‘dual system’. This notwithstanding, the term cooperative federalism is, in the context of the FRG, closely linked to the noticeable increase in cooperation between Bund and Länder following the 1969 constitutional reforms. See: Uwe Andersen, “Bundesstaat/Föderalismus,” Handwörterbuch des politischen Systems der Bundesrepublik Deutschland, 1995 ed.; 82-3.
31 Art. 91a GG.
32 At the time this meant that Bund and Länder together had 22 votes, and the Bund (with eleven votes) needed the agreement of six Länder to reach the three quarter majority required.
33 For the field of coastal protection the Länder only needed to contribute 30% of the total cost. For more details on the Joint-Tasks, see: Biehl, “Die Entwicklung des Finanzausgleichs in ausgewählten Bundesstaaten” 98.
but only after the third level of government, the local authorities\(^{35}\) had been given their share which, in 1969, was 14% of the sum total of the revenues from income and corporation tax.

With turnover tax succeeding income and corporation tax as the bone of contention between the governmental levels, the criteria hitherto used to determine the division of revenues from the latter now applied to the sharing of income from the former. Article 106 (3) GG contained mainly two principles: firstly Bund and Länder had the equal right to expect that their compulsory expenditure should be financially covered, and secondly the requirements to cover their expenditure should be co-ordinated to such an extent that a fair balance was struck, the tax payer was not overburdened, and the uniformity of living conditions within the federal territory was maintained.\(^{36}\) The shares for Bund and Länder of revenue from turnover tax were initially set at 70 and 30% respectively. However, it now only required federal legislation to readjust this ratio, and no rules on any time frame for a reassessment were included in the new regulations. In this respect the ratio could, in future, be changed as often or as seldom as the two houses managed to agree on any such amendment. As will be seen in the following, this opened the way for the federal government to continue its policy of the 'golden bridle'. It should, however, also be pointed out that it gave the Länder - as a community - the potential to hold out against the federal government by refusing consent to any changes to a ratio they considered favourable to themselves.

Horizontal equalisation received with the 1969 reforms the shape it - by and large - still maintains today. Apart from small changes to the more technical details\(^{37}\), and the degree to which the richer Länder have to contribute to the mechanism\(^{38}\), the system of financial equalisation remains just as described in Chapter Four: a first 'pre-equalisation' to bring the poorest of the Länder up to 92% of the all-Länder average per-capita revenue from taxation, followed by the main mechanism in which the poorest are lifted up to 95.5% of the latter (95% before 1995).\(^{39}\) This scheme did not address the structural differences

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\(^{35}\) Towns and communes.

\(^{36}\) For more details, see: Schmidt-Bleibtreu and Klein 1201-7.

\(^{37}\) Such as the *Einwohnerwertung*, the weighting of population figures for the calculation of the equalisation indicator. See: Herbert Fischer-Menshausen, "Kommentar zu Art. 104a bis 108 GG, " *Grundgesetz-Kommentar*, 1983 ed. A detailed key for this calculation can, of course, be found in the *Gesetz über den Finanzausgleich zwischen Bund und Ländern* (Financial Equalization Act).

\(^{38}\) Before 1995, the Länder with a capacity indicator of between 100 and 102% of the equalisation indicator did not have to contribute to the horizontal mechanism, those with a capacity of between 102 and 110% had to give 70% of the difference, and the Länder with a capacity indicator of over 110% of the equalisation indicator contributed everything that exceeded this figure to the mechanism. See: Dieter Biehl, "Distribution of Revenues in the German System of 'Finanzausgleich'," *Finances publiques et regionalisation*, ed. Henry Tulkens (Louvain-la-Neuve: Cabay, 1982) 43.

\(^{39}\) See Section 4.1.
between the Länder, something the poorer of them had wanted, but was totally unacceptable to their richer counterparts. What the mechanism did achieve, however, was a reduction in the gap between the Länder's financial capacities to a range of between 95.6% and 104.7% of their average per capita revenue in 1970.** Article 107 GG, which contained the general rules of financial equalisation, also provided for a vertical element, enabling the federal level to give to the poorer Länder supplementary allocations (BEZ) to further improve their fiscal position vis-à-vis their wealthier counterparts.

What the 1969 reforms did not achieve was to eradicate the existing differences in the financial interests between Bund and Länder, and among the Länder themselves. This is hardly surprising given that the allocation of (limited) financial resources brings with it more room for political manoeuvre, and therewith more influence. This notwithstanding, the new constitutional provisions, because of their flexibility and ability to adapt, did greatly reduce the conflicts over horizontal equalisation amongst the Länder.** There were, of course, many other changes made by the reforms to the financial constitution as well as the wider Basic Law, but they are only of negligible importance to this thesis and shall for that reason not be discussed here.**

5.5 After the Reforms

Even though the grand financial reform created constitutional law which, as far as financial equalisation is concerned, has remained unchanged well into the 1990s, this does not mean that there have been no conflicts since. However, the rather flexible rules of the financial constitution allowed for the tackling of problems, certainly those occurring before 1990, by way of amending secondary legislation, i.e. the Finanzausgleichsgesetz rather than the Basic Law itself.

As the Länder enjoyed a more peaceful coexistence, after their quarrels had been largely laid to rest with the new horizontal equalisation mechanism, the attention shifted back to the vertical relationship between Bund and Länder. For the years 1970 and 1971 the latter got the former to pay DM 100 million in BEZ annually, and that figure rose to DM 550 million per year in 1972 and 1973. A re-negotiation of the vertical distribution of revenues from turnover tax in 1974 was used by the Länder to push for a different approach. They

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81 Renzsch, *Finanzverfassung und Finanzausgleich* 259-60.
82 For a full account of the changes the 1969 constitutional amendments to the Basic Law brought about, see: Biehl, "Die Entwicklung des Finanzausgleichs in ausgewählten Bundesstaaten" 97-112.
managed to get BEZ linked to the federation’s revenues from turnover tax, and secured a rate of 1.5%. This resulted in a rapid increase in the amount allocated as vertical supplements from DM 750 million in 1974 to virtually double that figure, almost DM 1.5 billion, in 1981.\(^{43}\) It would, however, be wrong to suggest that this substantial improvement in the financial position of the poorer Länder was simply due to a more harmonious atmosphere within the Länder community as such. Rather than that it was the result, once again, of a particular political constellation. While, since the Autumn of 1969, the Bundestag was dominated by a coalition of SPD and F.D.P., most votes in the Bundesrat - throughout the 1970s - came from Länder governed by CDU and CSU the majority of which counted as ‘poor’. Almost inevitably under such circumstances, any amendment to the Financial Equalisation Act had to go before the *Vermittlungsausschuss*, the conciliation committee of the two federal chambers which consists of a member each from the Länder, and a matching number of representatives from the Bundestag, roughly reflecting its party-political set up. There a majority formed by the CDU/CSU-led Länder collaborating with Lower Saxony, and the CDU/CSU opposition in the Bundestag managed to push through the rather generous deal described above.\(^{44}\)

The 1970s were a decade of huge economic crises and tremendous structural change which, naturally, not only just affected the German Länder, but affected them in different ways and to different extents. The 1973 OPEC embargo, for instance, led to an explosion in the price of oil which in turn resulted in rapid increases in revenues from oil production for Lower Saxony. At the same time a global oversupply in ships and steel reduced prices in those markets to levels at which the FRG could no longer compete. The fallout of these developments hit Bremen, Hamburg and North Rhine-Westphalia particularly hard. While Bavaria’s financial position gradually improved to bring this traditionally ‘poor’ Land up to the all-Länder average, the hitherto ‘rich’ Land of North Rhine-Westphalia declined down to around the same level. As BEZ payments were still based on 1970 statistics, a readjustment would have been more than justified. However, any such attempt was blocked by the recipient Länder which, after the 1976 elections in Lower Saxony, were all run by CDU or CSU-led governments and, with 21 votes, now commanded a majority in the Bundesrat. This majority prevented a reassessment of BEZ allocations which would have resulted in Bavaria, Lower Saxony and Rhineland-Palatinate losing parts of their

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\(^{43}\) Renzsch, *Finanzverfassung und Finanzausgleich* 261-2. For a more detailed list of how BEZ was allocated to the recipient Länder between 1970 and 1978, see: Biehl, “Die Entwicklung des Finanzausgleichs in ausgewählten Bundesstaaten” 121.

entitlements, and Bremen and North Rhine-Westphalia, both governed by the SPD, being incorporated into the circle of recipients.45

With the collapse of the governing coalition between SPD and F.D.P. in Bonn in the Autumn of 1982, and its replacement by a CDU/CSU-F.D.P. government under Helmut Kohl, the federal parliament returned to the pre-1969 situation of both houses being led by the same political force. This circumstance allowed for some amendments to the Financial Equalisation Act which, although reducing the tensions among the Länder, did not eradicate them. The peculiar feature of this particular arrangement though was that the agreement had been reached outside the procedures provided by the Basic Law. According to Renzsch, the governing Christian-liberal coalition in Bonn created a precedent by striking a deal with the Minister Presidents of the CDU and CSU-led Länder to secure a majority along party-political lines for a smooth passage of the Act in the established legislative process.46

The question, however, must be why the CDU/CSU-led Länder followed the federal government’s line even though the proposals from their SPD-governed counterparts appear to have been more advantageous to all of them, bar Lower Saxony. The answer lies with the Oil Production Levy which had - almost suddenly47 - provided the latter with a disproportional increase in its revenues. The problem was that the Levy did not count as a tax, and a such did not enter the financial equalisation mechanism. Nevertheless, with a volume of up to DM 2 billion per budgetary year48, the Oil Production Levy heavily distorted the horizontal balance between the fiscal relationships of the Länder. In 1982, for example, Lower Saxony received DM 1.1 billion from the equalisation scheme because, based on revenues from taxation alone, it was considered financially weak. However, after adding DM 1.7 billion in revenue from the Oil Production Levy, the Land turned out to be wealthier even than those of its counterparts which had to contribute to the equalisation scheme. A clearly untenable, if not unconstitutional, situation, efforts had been made even before the political changes in Bonn by the two Länder most directly affected by the conflict over the Oil Production Levy, Lower Saxony itself, and Baden-Württemberg, the largest contributor to horizontal equalisation. The plan, which became law after the change of government at federal level, was to gradually include parts of the

45 Renzsch, Finanzverfassung und Finanzausgleich 262.
48 Exler 84.
revenue from the Oil Production Levy into the financial equalisation scheme, starting with a third in 1983, and going up to a half in 1986.49

Apart from altering the horizontal equalisation mechanism, which mostly favoured the contributors to the system, Baden-Württemberg, Hamburg and Hesse, the incorporation of parts of the Oil Production Levy should also have justified a realignment of the BEZ. However, here the picture looked different. Although North Rhine-Westphalia and Bremen called for a reassessment of the federal complemental grants, their attempt was rejected by the five recipient Länder which still had 21 out of 41 votes in the Bundesrat - and which still were not interested in having their shares cut by readjusting the overall allocations from BEZ. In other words, the compromise found within the CDU/CSU circles (naturally) reflected the interests of those taking part in the extra-constitutional decision-making which characterised this particular amendment to the Financial Equalisation Act. The advantages to the two Länder which had come up with the compromise was most evident: Lower Saxony, despite losing an estimated DM 800 million in revenue from oil production, at least maintained its share of almost one third of the sum-total of BEZ; whilst Baden-Württemberg stood to save DM 300 million from the enlarged horizontal mechanism. It has to be reiterated though, that this compromise only became possible after the political changes in Bonn, which opened the way for the party-political, as opposed to inter-governmental, agreement.50

Under the impression of having been excluded from the real decisions amending the Financial Equalisation Act, the SPD-led Länder of North Rhine-Westphalia, Hesse, Hamburg and Bremen resorted to the only avenue still open to them, a law suit before the Federal Constitutional Court. The Saarland joined the four after the SPD took over power there, and so did Baden-Württemberg as the only CDU-led Land. However, while the SPD governed Länder contested the only partial incorporation of the Oil Production Levy into the horizontal equalisation, as well as the still unaltered BEZ allocations, Baden-Württemberg wanted to curb the rules which gave the city states certain advantages in the horizontal mechanism.51 In its verdict of 24 June 1986 the Bundesverfassungsgericht ruled the existing Financial Equalisation Act unlawful and imposed rather strict rules as to how to proceed henceforth. The Oil Production Levy had to be fully included in the financial equalisation scheme, and federal complemental grants had to be just that: a top-up after, rather than an alternative to, horizontal equalisation.52 In May 1987 the federal finance

49 Part of the proposal was also to increase a special allocation to the Saarland, from DM 10 million to DM 65 million in 1984, with the basic aim to ensure its support for the compromise deal.
51 For more details, see: Exler 84.
52 For an analysis, see: Otto-Erich Geske, “Konturen eines neuen Länderfinanzausgleichs,” Wirtschaftsdienst VII (1986): 399-403; Reinhard Mußgnug, “Der horizontale Finanzausgleich auf dem
The minister proposed a new equalisation bill which attempted to restrict the changes to the Court's recommendations, aimed to intensify the horizontal mechanism to the advantage of the recipient Länder (by increasing the extent to which the financial capacity of local authorities was included in the calculations), and foresaw a limitation of BEZ to the financially weak Länder. As this proposal served the interest of the federation more than that of the Länder, all of them, except for Bavaria, opposed the bill.\(^5\)

In the negotiations between Bund and Länder that followed, three typical patterns emerged. First, the Länder were united in their demand to at least avoid a cut in BEZ, but also to try for further financial support from the federation. Secondly, they agreed that it should be the federation which should do more for the financially weak amongst them, thus rejecting the federal proposal for an intra-Länder solution, an idea only brought forward as a result of pressure from the poorer Länder. In this respect, the latter found themselves in the - by now familiar - situation of being referred to their richer counterparts by the Bund, and back to the Bund by the richer Länder whenever they were looking for more money. Thirdly, the Länder managed to agree on some more technical amendments to the federal bill. These concerned changes to the special weighting for 'harbour burdens', and a revised distribution key to the BEZ.\(^5\)

Until the summer of 1987 various negotiations took place between the Bund and all of the Länder, and it looked as if the constitutional decision-making process would be used to pass a new financial equalisation law. Then, however, the federal government once again tried to circumvent this procedure in order to escape a lengthy battle in the Vermittlungsausschuss, which this time around should prove to be a rather expensive venture for the Bund. After the Saarland had elected an SPD-led government in 1985, any of the Länder run by CDU or CSU had the potential to side with their SPD governed counterparts and thus frustrate the federal government's efforts to find an extra-institutional, pre-procedural agreement within the CDU/CSU camp.\(^5\) Perhaps not surprisingly, it was CDU-led Lower Saxony, the only real loser from the 1982 Financial Equalisation Act and the ruling of the Constitutional Court that followed, which used the situation to its advantage. It made its support for a tax reform, planned by the federal government, yet opposed by the SPD - among other reasons - because of its


\(^{54}\) For more details, see: Renzsch, Finanzverfassung und Finanzausgleich 267-8.

disproportional effect on the budgetary positions of the Länder, dependent on an improved financial equalisation. In concrete terms the price the federal government had to pay to get Lower Saxony on board was an increase in BEZ payments from 1.5% to 2% of its revenue from turnover tax, an amount of DM 700 million in the first year alone! This second arrangement between the Bund and the CDU and CSU-led Länder to secure agreement before entering the official legislative process clearly suited the wishes of the latter. Any attempt by the SPD run Länder to have their concerns considered fell on deaf ears, and once again they felt the only way left for them was to return to the Constitutional Court in Karlsruhe.\(^5\)\(^6\)

While the new Financial Equalisation Act became law, it very soon emerged that the way in which agreement had been reached had made the federal government vulnerable to extortion by the CDU or CSU-led Länder. By Spring 1988, in what became known as the Albrecht-Initiative\(^5\)\(^7\), the four northern Länder together with North Rhine-Westphalia and the Saarland complained about the disproportionate burden brought upon them by social security payments to the long-term unemployed of which they had higher percentages than their southern counterparts. The proposed solution was that the federal government should contribute half of the money for such welfare payments in order to ease the burden.\(^5\)\(^8\) As this plan would have had an effect on financial equalisation, the southern Länder were not keen on the idea.\(^5\)\(^9\) However, with six Länder, two of which governed by the CDU, and the SPD opposition in the Bundestag supporting the Albrecht-Initiative, there was a technical majority that should have ensured its safe passage through the legal decision-making process.\(^6\)\(^0\)

The reason why the Albrecht-Initiative never became law has to do mainly with its proposed financing. The supporters of the Bundesrat bill had wanted to raise taxation on fuels to pay for the additional burden placed upon the federal coffer. This would have increased the price of petrol to the consumer by around 20 Pfennings per litre, something the federal government, and the leadership of CDU and CSU, found politically impossible to realise. The other consideration playing into the collapse of the Albrecht-Initiative was, of course, the question which of the Länder would gain from it, and which ones would lose: apart from Lower Saxony and Berlin, the proposals would have disproportionally favoured the five SPD-led Länder which is why Bavaria, Baden-Württemberg, Hesse and

\(^{5} Renzsch, "Föderale Finanzbeziehungen im Parteienstaat" 339-40.\n\(^{5} Name after the then Minister President of Lower Saxony, Ernst Albrecht.\n\(^{5} For details of the Albrecht-Initiative, see: Rudiger Voigt, "Financing the German Federal System in the 1980s," \textit{Publius} 19 (1989): 111.\n\(^{5} As can be detected from Exler's essay on the Bavarian position. See: Exler \textit{88-9}.\n\(^{6} Werner Patzig, "Regionale Ungleichgewichte und bundesstaatliche Finanzverfassung - Probleme der 'Albrecht-Initiative' und des Bundesstrukturhilfegesetzes -," \textit{DÖV} 8 (1989): 330.\n
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Rhineland-Palatinate opposed them. Within the CDU/CSU leadership there was thus a two against four divide over the issue. Uncertainty over whether a majority could be found to oppose the bill even in the Bundestag eventually led to renewed negotiations with Lower Saxony which still had the trump card of whether or not it would support the still not realised tax reform.

The compromise found within the CDU/CSU circles resulted in settling for half the originally envisaged fiscal transfers to the Länder, and a totally different approach over their distribution. Based on an earlier idea by the Baden-Württemberg Minister President Lothar Späth for a 'structural fund', the proposal foresaw, for the next ten years, annual investitive aid payments of DM 2.45 billion. The rules of the new instrument were so drafted that they included Bavaria and Rhineland-Palatinate as its beneficiaries, while leaving Lower Saxony in a position not too far removed from the one sought with the Albrecht-Initiative. By the end of 1987 the compromise found within the CDU/CSU leadership became the Strukturhilfegesetz which, nevertheless, and only half a year later, Hesse and Baden-Württemberg went to contest before the Federal Constitutional Court.

While western Germany's co-operative federalism appeared to be deteriorating at ever increasing speed, a political crisis in the GDR, which had begun to gradually unfold since the summer, came to a head with the fall of the Berlin Wall on 9 November 1989. Early plans to form a loose confederation very quickly proved to run against public opinion and, before long, unification between the two Germanies looked the only way forward as thousands of GDR citizens flooded into the FRG in the pursuit of a better life. The prospect of unification, which was soon agreed to take place in the form of the GDR being split into five Länder which, together with the reunified Berlin, would then join the FRG under the provisions of Article 23 GG, threatened not only to have serious consequences for the financial relationship between Bund and Länder, but in particular to result in severe repercussions on the fiscal balance amongst the Länder.

5.6 The Challenges of Re-Unification

The main problem of unification was that the GDR was substantially poorer than any of the western Länder, not only in terms of the large budget deficit the FRG stood to inherit straight away, but also due to the more persistent structural weakness of the joining territories. The western Länder quickly realised that if the FRG was going to be simply

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61 Already discussed in Section 4.1.
62 Renzsch, Finanzverfassung und Finanzausgleich 270-3.
enlarged - by extending the rules of the Basic Law to apply also in the East - the consequences would be likely to dwarf any of the conflicts over money the 'old' federation had seen. The threat to the western Länder came, of course, from the provisions of the financial constitution and the secondary legislation linked to it, most importantly the Financial Equalisation Act. If the GDR had joined the FRG under the existing rules, the horizontal equalisation mechanism would have risen from a volume of DM 3.5 billion before unification to a size of more than DM 20 billion afterwards. This would have turned all western Länder but Bremen into contributors to the scheme, and shifted the bulk of BEZ eastward - all in all, a truly devastating scenario for the Länder of the 'old' FRG. In order to avoid what would almost certainly have amounted to a financial crisis of a scale that could have seriously threatened the stability of the federal system itself, the heads of government from Bund and (western) Länder got together and, on 16 May 1990, agreed to temporarily exclude the new Länder from the provisions of the financial constitution.

The agreement between Bund and Länder (West) centred around the *Fonds 'Deutsche Einheit'* (German Unity Fund) which, until the end of 1994, was to transfer DM 115 billion to the joining territories in lieu of an all-German financial equalisation scheme. The fund was financed jointly by Bund and West German Länder by a direct payment from the federal government of DM 20 billion it expected to save from overcoming the division of Germany, with the remaining DM 95 billion to be borrowed on the markets and paid back in equal shares by the Bund on the one hand, and the western Länder, including their local authorities, on the other. This compromise formed the basis of Article 7 of the Unification Treaty between the GDR and the FRG, in which a number of the provisions of Article 106 GG and the whole of Article 107 GG were suspended from applying to the new Länder and East Berlin until 31 December 1994. Instead, the Unification Treaty laid down a set of different rules on the financial relationships within the joining territories. The Länder share of revenues from turnover tax was to be divided into two separate allocations to the eastern and the western Länder in such a way that the per-capita share of the former was to rise from 55% of the per-capita revenue from turnover tax of the latter in 1991 to 70% of that figure in 1994. Similarly, 85% of the

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64 The five 'new Länder' plus East Berlin.
65 For a detailed analysis of the German Unity Fund, and its effects on the financial positions within an enlarged FRG, see: Peffekoven 346-52.
67 The only exception to this rule was the Land of Berlin which had its share calculated in advance, based on its population.
Unity Fund was to replace horizontal equalisation, with the remaining 15% to go to the federal government to finance measures it was going to undertake in the new Länder.

All this was based on a correct assessment of the financial requirements of the eastern Länder, and the expectation of a relatively swift improvement of their fiscal positions.\(^6^8\) However, as had been anticipated by many\(^6^9\), the situation of the former GDR was much more desperate than first assumed, which, as early as the beginning of 1991, became increasingly clear. In a first amendment to the Unity Treaty the new members of the FRG were thus allowed to receive their full share of turnover tax, and the Bund also gave up its 15% part of the German Unity Fund. The next problem was that the financial capacity of the new Länder rose much more slowly than had been forecasted at the time of unification.\(^7^0\) However, based on the idea that the joining areas would relatively quickly begin to improve their fiscal position, the Unity Fund had been designed to pay out gradually declining amounts to the East.\(^7^1\) The resulting gaps made another financial injection necessary, and in March 1992 the Bundestag, with the consent of the Bundesrat, passed a law aimed at enlarging the German Unity Fund\(^7^2\). This was achieved by allocating the entirety of an increase in turnover tax (from 14% to 15%) to the new Länder for the years 1993 and 1994, amounting to DM 23.4 billion. Together with additional allocations by the federation of DM 7.9 billion for the years between 1992 to 1994, the Unity Fund thus rose by DM 31.3 billion for this period.\(^7^3\) The legislation with which the Unity Fund was topped up also altered the wider fiscal relationship between Bund and Länder, by terminating the Structural Aid Act, and by updating the Financial Equalisation Act. The latter had been due anyway, and it was agreed to keep the ratio for the distribution of revenues from turnover tax at 65% for the Bund and 35% for the Länder in 1992, but to readjust it to 63% and 37% respectively for the years 1993 and 1994, probably as a compensatory measure for the cancelling of structural aid.

While reappearing financial problems in the East kept the decision-makers of the FRG busy, the deadline by which an all-German Finanzausgleich had to be agreed upon naturally drew closer. Given the past difficulties between Bund and Länder, as well as the

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\(^7^0\) And that despite additional structural assistance, among others by the Federation under the *Aufschwung Ost* programme. See: Werner Patzig, "Zwischen Soliditat und Solidarität - Die bundesstaatliche Finanzverfassung in der 'Übergangszeit'" *DÖV* 14 (1991): 584-6.


\(^7^3\) BRD, Bundesministerium der Finanzen, Referat Öffentlichkeitsarbeit, ed. 24-5.
division between rich and poor among the latter, negotiations for a revision of the financial constitution, with the aim of finding a permanent structure for financial equalisation in post-unification Germany after 1 January 1995, had to be expected to be both lengthy and difficult. All this was not made easier by the prospect of a general East-West divide among the Länder stemming from pre-unification days when the ‘old’ Länder looked for ways of losing as little as possible from the merger (by negotiating the Unity Fund with the federal government), a move that now threatened to make their eastern counterparts turn to Bonn to solve financial problems. The scope for a reform to the old financial constitution was as open as it was for the general examination of the Basic Law the Joint Constitutional Commission of Bundestag and Bundesrat had already begun in January 1992: apart from trying to solve the difficult issues postponed by the Unification Treaty, the Commission also looked at a possible wider need to reform the now all-German constitution.\(^7\) Due to its particular sensitivity, Article 7 of the Unification Treaty had been excluded from the agenda of the Constitutional Committee, and was to be discussed at the highest political level, between the leaders of the federal government and their Länder counterparts,\(^5\) in what became known as the Solidarity Pact negotiations.

Meanwhile, numerous proposals for a reform of the financial constitution from outside the official governmental circles showed considerable imagination\(^6\) which, nevertheless, was in sharp contrast to the ideas brought forward by Bund and Länder. This phenomenon can be partly explained by the fact that political decisions take place in the real world, requiring consensus between differing opinions which is in disagreement with the liberties academic thinking can afford. Despite this, neither Bund nor Länder showed much willingness to compromise over certain, by now familiar, positions in the discussion over financial equalisation. All their proposals were marked by - at least some - display of self-interest. Five Länder (Baden-Württemberg, Bavaria, Bremen, Hesse and Saarland)

\(^{7}\) See: BRD, Gemeinsame Verfassungskommission.
\(^{5}\) In March 1993.
presented their own ideas over how to reform financial equalisation, but with the exception of the Bremen proposals they all foresaw an outcome for themselves that would have been less burdensome than any of the competing plans. It appears, however, that all Länder had already - at least in principle - gradually moved towards supporting the Bavarian reform-model when, in September 1992, the federal finance minister Theo Waigel published his Thesenpapier over a reform of the financial relationship between Bund and Länder.

The Waigel Thesen were based on the existing rules of the Basic Law. In other words, they did not contain any radical change such as, for instance, a different approach to the general criteria for equalisation. The main points were: "a readjustment of federal and Länder shares of revenues from turnover tax in favour of the federation, dedicated to federal financing of extra initiatives in the new Länder; special federal complemenal grants for the new Länder; transitional complemenal grants for the weaker old Länder, which would gradually be phased out; special subsidies to restore the budgetary equilibrium of the weakest, effectively bankrupt, old Länder Bremen and Saarland; and a large tranche of mixed-financed investment aid for the new Länder. These proposals were not an unattractive offering to the poorer members of the federation, especially those in the East. Given the way past negotiations between Bund and Länder over matters concerning financial equalisation used to be conducted though, this was most probably designed explicitly to, once again, split the Länder community into two. After all, the old rift between richer and poorer Länder had always provided the federation with a chance to win over the financially weak by promising additional vertical assistance.

This time Waigel proposed to keep the horizontal equalisation scheme with which the poor Länder used to be brought up to 95% of the all-Länder average. This would have inflated the transfer volume from DM 6 billion to DM 30 billion. However, the federal finance minister was only prepared to contribute an amount of DM 7 billion in the form of 'deficit BEZ' to this new transfer total, less than a quarter of the sum-total to be reallocated. The remaining DM 22 billion were to be paid for by the western Länder. This

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77 In an interview with experts from the finance ministry of Schleswig-Holstein in Kiel on 6th May 1993, the author was told that this Land too had been working on an own proposal to reform the Finanzausgleich scheme, one which would have been based on financial requirements (bedarfsorientiert) rather than financial capacity. However, the plan was abandoned when it became clear that no Länder majority would be found to support it.


80 Jeffery, Plus ça change 33-4.
would have turned all of them, except Bremen and Saarland, into net contributors to the horizontal equalisation system,\textsuperscript{81} and caused outrage among them. Baden-Württemberg’s finance minister Mayer-Vorfelder complained that, should Waigel’s plans become law, all of the old Länder might as well ‘hoist the white flag’ - his Land alone would end up with an additional financial burden of DM 3.5 billion annually.\textsuperscript{82} The situation in the Autumn of 1992 actually turned critical for the Länder when it seemed as if the four CDU-led eastern Länder had deserted their counterparts and joined the Waigel camp. This prompted some quite malicious responses by some of the Länder’s finance ministers. Heide Simonis from (SPD-governed) Schleswig-Holstein suspected that her colleagues from the eastern Länder were trying to clinch a deal directly with Waigel. Heinz Schleußer from North Rhine-Westphalia sharply commented that in his opinion some of the political leaders in Germany’s East had not yet realised that they represented sovereign entities rather than being mere provincial governors subordinate to the Bund.\textsuperscript{83} It looked as if Waigel had achieved his aim to split the Länder into sub-groups with differing aims. Even after the Bundestag had accepted the ‘Federal Consolidation Programme’, the federal government’s proposals for the financial future of the FRG, there was considerable disagreement among the Länder over details of a future Finanzausgleich.\textsuperscript{84}

The Federal Consolidation Programme not only addressed the issue of financial equalisation, but covered also many other problems caused by unification, including their financing. The sheer size of this package would have made the normal legislative process too cumbersome, and therewith too slow, to find agreement before the end of 1994. Thus a summit meeting of the heads of government from Länder and Bund was convened to take place in Bonn in March 1993, the aforementioned Solidarity Pact negotiations. In the running up to this event, the Länder met in Potsdam at the end of February to lay down the basics and particulars of a solidarity pact, as well as to prepare their talks with the federal government.\textsuperscript{85} At Potsdam the Länder managed “to agree a common position for the forthcoming discussions with the federal government which could both hold in check the burden placed on the old Länder in the financial equalization process, and offer the


\textsuperscript{84} Baden-Württemberg and Hesse, for instance, were concerned about the possible consequences of a future settlement which might be based more on the needs of the eastern Länder than the quality of federalism, and thus the financial indepence of the Länder as a whole: “‘Abschwung-Mann’ rügt ‘Striptease des Föderalismus’,” and “‘Die Schwäche der Starken macht die Schwachen nicht stark’,” \textit{Frankfurter Allgemeine Zeitung (FAZ)} 18 February 1993: 5.

\textsuperscript{85} Ergebnisprotokoll der Konferenz der Regierungschefs der Länder in Potsdam am 26./27. Februar 1993.
new Länder benefits in the field of investment aid, environmental and housing policy.\textsuperscript{86}
As far as financial equalisation was concerned, the Länder basically united behind the Bavarian proposal\textsuperscript{87}, which was both simple and effective.

Just like the Waigel model, the scheme adopted at Potsdam foresaw to keep the mechanism largely unchanged.\textsuperscript{88} Naturally this would also have led to a future transfer volume of around DM 30 billion. The difference between the two proposals lay with the way the scheme was to be financed. While Waigel’s model foresaw a federal contribution of less than a quarter of the total amount to be redistributed, the scheme adopted by the Länder envisaged a federal share of the burden of two thirds. The money was to come from an adjustment in the vertical Finanzausgleich: the Bund-Länder shares of revenues from turnover tax would be altered from then 63:37 to 55:45 - a demand of unprecedented proportion. Yet, the way it was to work made sense. The increase in turnover tax revenues would go straight to the new Länder and bring them up to 92% of the Länder average, the point at which horizontal equalisation had also started under the old system. As before, the Länder themselves would perform this horizontal equalisation and bring their poorest members up to 95% of the average. The outcome would have been more or less the same as what the Waigel scheme would have produced. The big difference was - of course - that the Länder model passed the main financial burden onto the federation.

Almost shockingly, given past experience, and the substantial gap between the two models discussed at the Solidarity Pact negotiations, it was the Länder scheme which the conference adopted with only minor amendments.\textsuperscript{89} For the first time in the history of financial equalisation in the FRG had the Länder managed to maintain a united front against the Bund, and succeeded. This explains part of their success, but not all of it. The fatal blow to the position of federal negotiator Waigel, and thus his proposal, came when the Länder exposed as wrong the calculations upon which his arguments had been based.\textsuperscript{90} With the Waigel scheme discredited, only the Länder model remained on the table. There was no time left for the federal team to come up with a revised scheme, as Chancellor

\textsuperscript{86} Jeffery, \textit{Plus ça change} 35.
\textsuperscript{88} Minor alterations were made to the horizontal equalisation in the form that the so-called ‘dead zone’ was to be given up. This meant that all Länder with a financial capacity above the all-Länder average had to pay into the scheme, thus slightly lowering the burden for the richest.
\textsuperscript{89} The Länder suffered a slight setback in the readjustment of the vertical Finanzausgleich. Instead of the Bund-Länder ratio demanded, i.e. 55:45, a one percent point concession had to be made, so that from 1995 onwards revenues from turnover tax are shared between federation and Länder at a ratio of 56:44.
Kohl pushed for agreement. It appears that, in a final round of talks, the Bavarian Minister President Max Streibl secured the Länder victory by convincing his - by then rather confused - party leader Waigel to agree to the remaining items on the agenda.

At the time, the outcome of the Solidarity Pact negotiations was hailed as a tremendous success by the Länder, a historic test German federalism had passed. At first glance that may even look true. After all, the Länder had been able to maintain a united front against the Bund for the first time in negotiations over financial equalisation. However, the increase in their overall income did not give the Länder more room for political manoeuvre - they merely achieved a return to the position the 'old' Länder had found themselves in before 1990. With the problems of the past in mind, it should become clear that the result of the Solidarity Pact negotiations was not really such a big success. More likely is that the chance for a true reform to the system has been forgone.

For horizontal equalisation to have a real impact on the income positions between the Länder, its main objective would have to be changed. The current nominal system of giving each Land around the same per capita financial capacity to fulfil its, mostly predetermined, governmental duties would have to be replaced by one which acknowledged structural deficiencies and attempted to tackle the causes of divergence between the Länder. As the experience so far clearly indicates, the Länder themselves are most unlikely to change the system. Despite the united front against, and ultimate success over, the Bund concerning vertical equalisation, any discussion over horizontal redistribution would immediately re-expose the old divisions between rich and poor, payers and recipients.

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91 At the time, Politikverdrossenheit (frustration with politics) was very much an issue, and elections in Hesse shortly before the Solidarity Pact negotiations had already resulted in gains for the right-wing Republicans. See: Gerhard Hennemann, "Der Schock hat gesessen," Süddeutsche Zeitung [SZ] 15 Mar. 1993: 4.
92 Information obtained by the author in various interviews with Länder experts on financial equalisation in Berlin, Bremen, Dresden, Hamburg, Hanover, Kiel, Magdeburg, Munich, Schwerin and Stuttgart in 1993 and 1994.
95 For a comprehensive summary of the outcome of the Solidarity Pact negotiations, as well as a critical look into the future problems for the fiscal relationships within Germany, see: Renzsch, "Neuregelung der Bund/Länder-Finanzbeziehungen."
6. THE HISTORY OF STRUCTURAL AND COHESION POLICIES IN THE EU

Unlike the FRG the EU is not a federal state, but a *sui generis* union of states. For this reason alone difficulties such as those faced by the German Länder over financial equalisation have not (yet) troubled the relationships between the Union's Member States. This is not to say though that the latter have never encountered conflicts of their own over policies and mechanisms concerning the reduction of regional disparities among themselves. In accordance with the still dominating role played by the Member States, and the subsequently rather limited mandate of the Union level of government, a degree of heterogeneity is not only to be expected, but almost desired as part of the diversity element of the integration process. However, the notions of Community and Union also require a certain commitment towards mutual assistance and a narrowing of the welfare gaps within the EU. As will be seen in the following, the Union's regional policies evolved in parallel with the general development of the European Community. Mainly two forms of progress can be identified. The policies advanced in terms of structure and quality as the result of a learning process. They grew in size in reaction to either accepting new members, or the taking of significant steps towards further integration, since both resulted in, or at least threatened to intensify, an increase in the EC's internal regional disparities. What will also become evident as this chapter gradually unfolds is that the Member States are, and indeed have been, as divided in respect to their positions towards whether or not to reduce the income gap between themselves, as the German Länder were and are over issues to do with financial equalisation.

6.1 The Slow Emergence of Structural Policies

What is now the European Community started in 1958 as the European Economic Community, a project of functional integration between six countries with reasonably similar living standards. Even though its eventual aim was to build an "ever closer union among the European people"\(^2\), the EEC began - overall - as a free-trade association\(^3\) and,

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\(^1\) According to Axt the term 'regional policy' refers to measures aimed at supporting areas within one national economy, and for that reason the term 'cohesion policy' should be used to describe similar efforts within the ECs. This notwithstanding it has been decided for this thesis to give 'regional policy' a Community-wide application in order to distinguish it more clearly from the policies pursued by the Cohesion Fund, explained below. See: Axt 192.

\(^2\) Preamble to the EECT.
as a consequence, it was economic considerations that came to dominate its agenda. Regional policies, with their political and interventionist tendencies, had not become part of the direct mandate of the EEC because the founders of the new Community believed in the forces of the market as the best instrument to alleviate regional disparities.\(^4\) Besides, the relative homogeneity within the Community of the Six - the only valuable exception at that time being the Italian *mezzogiorno* - meant that the Member States could have largely been expected to deal with their regional disparities themselves.\(^5\) Thus the Treaty of Rome only contained provisions with an indirect effect on the EEC’s regional divergences: the European Investment Bank, certain activities of the European Social Fund, and - after the establishment of the CAP - the expenditure for structural improvements in the agricultural sector.\(^6\) Most of these measures had other primary objectives, and only addressed regional disparities insofar as there existed a positive statistical relationship between their allocation criteria and the existing regional income gaps.\(^7\) All this notwithstanding, the Treaty did contain the general desire, expressed by the High Contracting Parties, to strengthen the unity of their economies and to ensure their harmonious development “by diminishing both the disparities between the various regions and the backwardness of the less favoured regions”\(^8\).

A first step towards creating a more positive instrument to alleviate the Community’s regional disparities was made when, in 1973, Denmark, Ireland and the UK joined the ECs. The latter two new members in particular increased the regional welfare divisions within the enlarged Community because Britain suffered from the decline of its old industries, and Ireland simply lagged behind the rest of the Community in terms of its economic development. In view of this new situation, but also because the UK had made her joining the Communities dependent upon the establishment of a regional fund,\(^9\) the Council decided to have national regional policies co-ordinated by a newly created Regional Policy Committee\(^10\), and to set up a European Regional Development Fund.\(^11\)

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\(^1\) Even though it very soon set up the Common Agricultural Policy which was, of course, to establish a common market in agricultural goods. Furthermore, the ECSC, which came into force in 1952, also represented a common market in coal, coke, steel, iron and scrap metal.


\(^3\) This position is confirmed in the *Protocol Concerning Italy*, annexed to the EEC Treaty.

\(^4\) There were also certain loans by the ECSC which had a regional policy effect.


\(^6\) Preamble to the EEC Treaty.

\(^7\) See: Schäfers and Fetzer 72.


This has often been marked as the beginning of EC regional policy, especially since the aim of the ERDF was "to correct the principal regional imbalances within the Community resulting in particular from agricultural preponderance, industrial change and structural under-employment." The reason why the new fund did not really signal the start of an 'own' EEC regional policy was that it only represented an additional tool to aid the regional measures pursued by the Member States. An early proposal by the Commission to create a substantial European regional fund with a redistributive function, and direct subsidies to the recipients according to the Community's own regional programmes, had been opposed by the Member States. Under the principle of 'juste retour' they had preferred the new instrument to support national regional schemes in such a way that payments from the fund went directly back into their own coffers, and thus prevented any reduction in their regional disparities. In the end, a quota system was adopted which did include a genuine redistributive element, but its volume was very small, the allocation criteria were determined more in the national capitals than by the Community's authorities, and in some of the Member States the affected regions were not being consulted either. The projects supported by the Fund stood in relative isolation to each other, just as there was very little co-ordination between the activities of the various departments and fund administrations with a regional impact.

Regional disparities within the Community which, during the 1960s, had begun to decline started to widen again in the 1970s. Even though this can be blamed first and foremost on the differing effects global economic developments had on individual Member States, a Community response to reverse this trend, or at least bring it to a hold, did not come about. Only with the southern enlargements of the ECs - Greece joined in 1981, and Portugal and Spain became members in 1986 - which brought with them another drastic increase in the Communities' regional disparities, did a discussion over the effectiveness and efficiency of the EEC's regional instruments re-emerge. There were two other aspects supporting a wholesale review of the Community's regional policy tools. To begin

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12 Art. 1 Council Regulation 724/75 (EEC).
14 Marx 70-1.
15 The resources of the Fund were distributed as follows: Belgium 1.5%, Denmark 1.3%, France 15%, Ireland 6%, Italy 40%, Luxembourg 0.1%, Netherlands 1.7%, FRG 6.4%, UK 28%. A sum of six million units of account were granted to Ireland, deducted from the share of the other Member States, except for Italy. Art. 2 Council Regulation 724/75 (EEC).
with, the ECs had virtually run out of money. This was due mainly to the exploding cost brought upon the Communities’ budget by the CAP, and the subsequent refusal by some of the Member States to increase the ECs’ own resources in advance of a substantial cost-cutting reform of that policy. The other consideration was political. One of the main reasons for the three newest Member States to join the ECs was to cement their relatively young democracies and to prevent them from plunging back into dictatorial or authoritarian rule.

This notwithstanding, all three, Greece, Portugal and Spain, were comparatively poor and therefore stood to gain most from regional re-distribution. Greece was the first to realise that it could use the way decisions on major ‘constitutional’ change - such as the entry of new members or amendments to the Founding Treaties - had to be taken at Community level (i.e. by unanimous agreement) would represent a bargaining tool with which to extract, what Marks calls, ‘side-payments’. As will be seen in the following, the poorer Member States later frequently resorted to this tactic in order to extract financial concessions from the Communities. In this respect their behaviour mirrors to a large extent that of the poorer German Länder which have a long history of holding the federal government to ransom over financial issues by withholding their support in the Bundesrat.

The stabilisation of the southern European fringe did, however, come at a price not only for the Community but the new members as well. Integrating the structurally more backward countries of southern Europe meant that they themselves had to open up their markets and compete directly, meaning on a level par, with those of their counterparts in the ECs, just as the latter faced a significant increase in competition in agricultural products and the fisheries industry. The early experience of Greece, which had joined the Communities five years earlier than Spain and Portugal, showed that the EEC’s regional policies of the day were quite insufficient to address the problems. A general overhaul of the regional policy instruments of the EEC was urgently needed to stop the Community from diverging any further - and that was even before the 1987 Single European Act was

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17 Franzmeyer and Seidel 192.


19 See Chapter Five.

20 During the first year of its membership Greece experienced a 24% decline in exports of manufactured goods while imports from the rest of the ECs rose by 27%. In contrast to Spain, both Greece and Portugal also had uncompetitive agricultural sectors which made joining the ECs even more painful for them. See: Marx 92-3.
to transform the ECs from a customs union into a common market\footnote{It ought to be stressed, once again, that whilst the ECs contained sectoral common markets (agriculture, coal, steel, etc.), it remained - overall - a mere customs union.}, which meant the extension of competition from trade in goods to the free movement also of services, labour and capital.

\subsection*{6.2 Rapid Changes during the Late 1980s}

There had been minor amendments to the ERDF Regulation in 1979 and 1984, slowly but gradually leading to an increase of the EEC's role in regional policies throughout the Community. In 1979 the rules governing the ERDF were amended to the effect that 5\% of its resources could be used outside the national quotas, thus giving the EEC a first - if small - amount to use for its own regional projects.\footnote{"Council Regulation (EEC) No 214/79 of 6 February 1979 Amending Regulation (EEC) 724/75 Establishing a European Regional Development Fund," \textit{OJ} L35 (9 Feb. 1979): 1-7.} In 1984 the ERDF Regulation was amended to replace the strict quotas with more flexible `bands' within which allocations from the Fund to the Member States could move.\footnote{"Council Regulation (EEC) No 1787/84 of 19 June 1984 on the European Regional Development Fund," \textit{OJ} L169 (28 June 1984): 1-16.} The revised Regulation also, and for the first time, explicitly referred to a Common Regional Policy, co-ordinating the structural measures of both Community and Member States.

A first genuine common regional policy instrument was introduced in 1985, after threats from Greece to veto Portuguese and Spanish membership eventually led to the setting up of the Integrated Mediterranean Programmes - the kind of `side-payment' mentioned earlier.\footnote{An attempt to create some form of `Mediterranean programme' had found broad support in the EP back in February 1982. A month later a request from the Greek government for more protection and support for its economy was responded to positively by the Commission, expressing its believe that the IMPs would be an appropriate instrument to tackle Greece's economic backwardness. A proposal by the Commission to carry through the IMPs in 1983, however, did fail to win the support of the Council, thus prompting the use of the national veto by the Greek government in December 1984. Marx 116-7.} Aimed at improving the socio-economic structures in southern Europe, in order to give the affected regions a better chance of adjusting to the admission to the ECs of Spain and Portugal, the IMPs were integrated regional development programmes, meaning they mobilised funds at the EEC, the national and the local levels of government and put them to use in a comprehensive development strategy. The IMPs were solely run by the Community: the Member States entitled under the rules had to submit their proposals to an EEC committee, and the Commission, which was given also the task to administer the IMPs, had the ultimate authority to accept or refuse them. Once a proposal
was accepted, the Commission and either the Member State in question, or any institution authorised by the respective government, concluded a contract of assistance.

Beneficiaries from the Programmes were the whole of Greece, large areas of Italy, and the South of France. Rather than spreading them among countless individual projects, allocations from the IMPs were to be deployed in a more focused manner, their integrative aim expressed by a Community support quota of 70% of the total cost of any agreed project. Altogether around ECU 6.6 billion were made available under the new schemes for the period 1986 to 1992. The size and nature of the IMPs reveal that, ten years after its establishment, the ERDF was no longer capable of fulfilling its task, and for that reason was in desperate need of reform. Greece’s joining the Communities, and the prospect of a more substantial, second southern enlargement, had already exposed the Fund’s shortcomings. The early amendments to the ERDF Regulation are proof that what was really needed was a shift towards a common policy aimed at tackling the structural causes of the EEC’s regional disparities.

The IMPs may have been aimed at making more palatable to the poorer Member States the accession to the ECs of Spain and Portugal, but the next challenge was already on its way. The process to move the ECs towards further integration had begun in June 1985 with the publication of the Commission’s White Paper Completing the Internal Market, and the setting up of an IGC to examine respective matters, including a revision of the Founding Treaties. Six months on, the European Council, meeting in Luxembourg, agreed the principles of the Single European Act. Greece, by now familiar with the nature of European Council negotiations, had insisted on having the objective of ‘economic and social cohesion’ inserted into the Treaty, thus ensuring a future Community mandate for regional policy. The SEA came into force on 1 July 1987, and with it the ECs received the first proper legal basis for a common policy to tackle their regional disparities.

As has been already discussed in Chapter Three, the aim of the new provisions were to strengthen the Community’s economic and social cohesion and to reduce “the disparities between the levels of development of the various regions and the backwardness of the least-favoured regions, [including rural areas]”. The Member States were called upon to

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25 Axt 194-5; Marx 117-8.
26 In comparison to the IMPs the EDRF was to grow from around ECU 3.1 bn. in 1986, to ECU 3.3 bn in 1987, and almost ECU 3.7 bn in 1988, the year the structural funds were reformed. Source: ECs, Commission, ERDF in Figures 1988: 1975-1988 (Luxembourg: EUR-OP, 1989) 3.
27 The SEA was not, however, signed until February 1986.
28 Axt 198.
29 The delay was caused by ratification problems in Ireland.
30 Art. 130a EECT.
pursue and co-ordinate their economic policies in such a way as to meet these objectives, whilst the EEC itself was to support them "by the action it takes through the Structural Funds (European Agricultural Guidance and Guarantee Fund, Guidance Section; European Social Fund; European Regional Development Fund), the European Investment Bank and other existing financial instruments."31 The ERDF was singled out to become the EEC’s principal tool to "help redress the main regional imbalances in the Community through participation in the development and structural adjustment of regions whose development is lagging behind and in the conversion of declining industrial regions."32

All this represented nothing less than the establishment of a genuine ECs regional policy, and the Commission was given the job of submitting a comprehensive proposal to the Council, the purpose of which was to alter the existing structural funds to the extent necessary to clarify and rationalise their tasks. The aim was to contribute to the achievement of the objectives set out above, to increase their efficiency, and to co-ordinate their activities between themselves and with the operations of the existing financial instruments. The Council was then given one year to act - unanimously - on the Commission proposal.33 This turned out to be a difficult task, because of the direct impact the reforms were likely to have on an already seriously stretched ECs budget.34 In February 1987, even before the SEA came into force, the Commission had submitted what became known as the ‘Delors Package’, its ideas over how to reform the financing of the Communities, and also accommodate the likely expansion of the ECs tasks. Jacques Delors, the Commission President, had given his proposals the appropriate title “Making a Success of the Single European Act”, and his main argument was indeed that the creation of a common market required an increase in the Communities’ activities which naturally needed to be financed - and none of the new policies so much, and so obviously so, as the provisions aimed at reducing the welfare gaps within the ECs, those targeting economic and social cohesion.

In a very similar manner to the way in which fiscal disputes are being fought in the FRG, the Member States of the ECs are divided between those expecting to benefit from an increase in redistributive measures, and those likely to have to foot the bill. Yet, it must not be forgotten that Germany and the ECs are entities at different stages of the federal process - and that finds its reflection in the way decision-making varies between the two systems looked at here. Whilst the FRG, as a highly integrated federation, readjusts the

31 Art. 130b EECT.
32 Art. 130c EECT.
33 Art. 130d EECT.
34 As has been referred to earlier, the ECs finances had been running scarce since the early 1980s, and a structural shake-up of the budget was desperately needed.
federal balance only occasionally, and usually deals with fiscal matters via secondary legislation (requiring a majority in both chambers of the Federal Parliament, Bundestag and Bundesrat), the ECs are still in a much more dynamic process of federal integration. This, however, means not only that primary law is required to shift sovereignty away from the Member States and on to the Community level of government, but the still rather loose nature of the European venture also means that such decisions are being made by the very same institutions from which responsibility is taken away: the Member States' governments with the requirement of ratification according to respective national provisions. An increase in the financial ceiling of the Communities' budget is one example of how sovereignty over their own resources is transferred by the Member States to the ECs level of government: after hearing the opinion of the European Parliament, the Council has to agree unanimously on the proposal drafted by the Commission. Even though this means that Commission and Parliament play only a small role in the process, the Commission's exclusive right to propose legislation should not be underestimated either. It certainly explains why Delors figured much more prominently in the 1987/88 financial reforms than his statutory position as Commission president may otherwise indicate.

Nevertheless, the decisive actors remained the Member States, and they were as divided over the Delors Package as the Länder used to be over financial equalisation in the FRG during the 1980s. The most outspoken critic of the reform package proposed by the Commission was the British Prime Minister, Margaret Thatcher. This was hardly unexpected given that she had been fighting for years to gain a budget rebate for her country, and this rebate - likely to be threatened by the Delors Proposals - she was determined to keep. She did, however, welcome Delors’s plans to limit CAP expenditure and impose overall budgetary discipline. More surprisingly, perhaps, was that Chancellor Kohl turned out to dislike the Commission proposals too. Like Thatcher he opposed an increase in the Communities’ budget for this would most likely result in his country having to pay substantially more into the Brussels coffers. In contrast to the British Prime Minister though, Kohl also condemned the curbing of agricultural spending, as this threatened support for his party at home by the small but influential lobby of farmers. The poorer Member States meanwhile welcomed the Delors Package, not only for the direct financial support they expected from increased Community regional policy

35 See, for instance, Art. 247 ECT, or Art. R of the TEU.
37 Dinan 152.
measures, but also because the proposals foresaw a change in the ECs’ revenue system that would have had a beneficial indirect effect on them. The suggestion was to replace the Communities’ own revenues from VAT with a 1.4% share of the Member States’ GNP. This way the richer members would have to contribute more to the common budget, and their poorer counterparts less, than under the existing rules.38

It took three European Councils to resolve the budgetary problems, and eventually also to come to an agreement over the future of the structural funds as required by the SEA. At the Brussels summit, in June 1987, the political leaders of the Member States actually did make quite some headway towards finding agreement over the Delors Package, but Mrs. Thatcher still had objections to a communiqué signed by her eleven colleagues stressing their commitment to budgetary discipline and CAP reform. The issue of how to strengthen economic and social cohesion was not, however, adequately tackled at the meeting. In the run up to the next European Council, in Copenhagen in December 1987, the differences between the richer and poorer Member States, as well as between Mrs. Thatcher and the other leaders, had become more evident. The poorer members, which had been rather accommodating at the Brussels talks, now rigorously pressed for the acceptance of the original Delors Package of which their richer partners were still sceptical. At Copenhagen itself, then, the full magnitude of the divisions among the leaders over the future financing of the Communities came to the fore. While Spain’s Felipe González, unofficially speaking for the poorer Member States, argued for additional resources, Chancellor Kohl and President Mitterand, for domestic political reasons, had problems with the cuts in agricultural spending, and Mrs. Thatcher still did not like the idea of any increase in the ECs budget. In short, the summit was a disaster which not only meant that no decision had been taken in respect to the budgetary question, but other pressing issues, such as advancing the Single Market programme, also got totally overshadowed by the disputes over the future financing of the Communities. To make matters worse, the Council had also failed to bring to an end a stand-off between the EP and the Council of Ministers, the ECs’ joint authorities in this field, over the 1988 budget.39

The situation looked seriously deadlocked, and President Delors got increasingly concerned that the budgetary crisis could block progress in other fields of European integration for the duration of another presidency which, during the first half of 1988, was

38 This would have resulted in higher fiscal contributions to the Communities by the FRG, France, the Benelux countries, Italy and Denmark, and financial relief for the UK, Ireland, Spain, Portugal and Greece. See: Marx 139.

39 For more details on this particular point, see: Michael Shackleton, Financing the European Community, Chatham House Papers (London: The Royal Institute of International Affairs, 1990) 9-12.
in the hands of the FRG. Chancellor Kohl, generally in favour of integration and thus
dissatisfied with recent developments, must have been thinking along similar lines.
However, he also sensed the potential for political gains at home that a solution to the
latest stalemate at Community level could bring him. Used to multi-level negotiations
within his own country’s federal system, he was prepared to accept the increase in the
FRG’s contribution to the Communities’ coffers in exchange for a solution to the
budgetary stand-off - and the credit he could claim for it. He thus called for a special
European Council to convene at Brussels in February 1988 in order to solve the financial
troubles and also to come up with the reforms of the structural funds demanded by the
amended EEC Treaty before the next presidency.

There was no reason to expect that, just because the FRG was more willing to accept an
increase in the ECs budget, the Brussels summit would be a success. To begin with, Mrs.
Thatcher was still opposed to the Delors Package, and the French Prime Minister Jacques
Chirac still wary about reforming agricultural spending. However, with the FRG
indicating its support for the Commission’s proposals, thereby de facto aligning itself with
the poorer Member States, the balance had begun to shift.40 After long and hard
negotiations agreement was eventually reached on a solution acceptable to all: the
structural funds were to be doubled by the year 1992, the UK’s rebate was guaranteed,
and CAP spending underwent only a few structural changes, rather than a wholesale
reform. All this was made possible by first approving a new financial regime for the
Communities. The Council had accepted “that the overall ceiling on own resources
[should] be expressed in terms of the GNP of the Twelve but the percentage was set at
1.2% for payments and 1.3% for commitments up to 1992.”41 What this meant was that
the richer Member States had agreed to a readjustment of the Communities’ financing to a
fairer system in which they had to pay in proportionally more, thus easing some of the
financial pressures of their poorer counterparts.

With the incoming side of the budget not only rearranged, but also increased, discussions
over its spending had received an ascertained, concrete base from which to proceed. Of
interest to this thesis is of course what happened to the structural funds. Here, the
European Council eventually accepted the Commission’s general suggestions for a more
efficient use of the funds. These proposals had included: a more rational identification of
the funds’ objectives; the concentration of the funds’ activities on criteria set by the EEC,
respecting the need of some regions to catch up in their development, or prevent those in
industrial decline from falling behind; and a generally more pragmatic procedure. The

40 Dinan 152-4.
41 In the own resources decision of 24 June 1988, intermediate, annual GNP ceilings were also laid down
European Council also demanded a grading of the intervention allowances, taking special account of the wealth of the recipient country. On the basis of all this, the Council thus supported the proposal, brought forward by the Commission, for a real doubling of the sum total for regional spending, from ECU 7 billion in 1988 to ECU 14 billion in 1992.

As far as the reforms of the structural funds, as demanded by the SEA, were concerned, they got underway on 24 June 1988 with a Council Regulation 'on the tasks of the Structural Funds and their effectiveness and on co-ordination of their activities between themselves and with the operations of the European Investment Bank and the other existing financial instruments'. This Regulation was followed by legislation laying down provisions for its implementation as far as co-ordination was concerned, and legislation on the implementation of the Framework Regulation of 24 June 1988 regarding the individual structural funds. The reform of the structural funds, which came into force on 1 January 1989, had thus taken up the rest of 1988, and had required five Council Regulations. Embodied in the text of the Framework Regulation of June 1988 was also a re-examination of the reforms, scheduled to take place five years later.

The difficulties encountered amongst the Member States, as well as between them (in their collective capacity as the ECs' Council) and the Commission at Community level, bear a striking resemblance to the intractability of decision-making - particularly over fiscal matters - common to the German federal system. The general reluctance by the richer members to increase their net input to the Communities' budget; the bargaining position taken up by the poorer Member States to gain side-payments, i.e. giving up sovereignty in exchange for more financial allocations from the ECs; and the centralising role taken up by the Commission (in the absence of a stronger position for the EP the Communities' main supranational institution) are all patterns well known from the way in which fiscal disputes are, and have been, settled within the FRG. It shows that, apart from

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42 Schäfers and Fetzer 73.
the structural similarities described in the earlier chapters of this thesis, the dynamics within ECs and FRG are also very much alike - despite the different stages of federalisation the two systems are at.

6.3 Towards a Cohesion Policy

As has been hinted at before, the 1988 reforms represented a turning point in the ECs’ regional policy. The three structural funds, ERDF, ESF and EAGGF Guidance Section, which had hitherto existed next to each other, meaning largely detached from one another, had received a strong legal base and been turned into the Structural Funds, indicating their now integrated effort to serve the quasi-constitutional goal of economic and social cohesion. It was at this stage that the Structural Funds received the shape and objectives they largely maintain to this day, and in this thesis already discussed in Chapter Four.

At the time, the Framework Regulation identified five main objectives for not only the Structural Funds, but also the EIB and other existing financial instruments to achieve in accordance with the general objectives set out in Articles 130a and 130c of the EEC Treaty. Objective 1 had as its target the promotion of the development and structural adjustment of the regions whose development was lagging behind. Objective 2 aimed at converting the regions, frontier regions or parts of regions seriously affected by industrial decline. Objective 3 was to combat long-term unemployment, and Objective 4 to facilitate the occupational integration of young people. Objective 5, which was directed at reforming the CAP, was split into two. Objective 5(a) aimed at speeding up the adjustment of agricultural structures, and 5(b) targeted the promotion of the development of rural areas. The Structural Funds had to contribute to the attainment of the Objectives according to the following breakdown:

- Objective 1: ERDF, ESF, EAGGF Guidance Section;
- Objective 2: ERDF, ESF;
- Objective 3: ESF;
- Objective 4: ESF;
- Objective 5(a): EAGGF Guidance Section;
- 5(b): EAGGF Guidance Section, ESF, ERDF.  

This is not the place to analyse in detail the technicalities of the Structural Funds. Of more importance is an analysis of the progress towards a common regional policy the 1988 reforms brought about. Apart from the doubling of their means, and the new approach to integrate the three Funds, the main features of the reforms were the establishment of a genuinely Common Regional Policy and the concentration of its measures to regional and structural effects. One commentator talks of the reforms to have institutionalised, as the guiding principle for the Communities' regional policy measures, a new 'philosophy of support', and that the common European interest had become the focal point. This means, in other words, that the ECs had gained more independence vis-à-vis the Member States, which meant also an increase in direct collaboration with decision-makers in the affected regions.

The other main qualitative improvement was the disproportionally high increase in the means especially designated for regional purposes, and to concentrate these onto the genuinely backward regions. Last, but not least, the general approach towards the ECs' regional policy had been changed from targeting single projects, to using more programmatic common support concepts. Programming and the concentration of effort are, of course, only two of the four guiding principles for the Communities' regional policies, introduced and described in Chapter Four. The other two, additionality (then referred to as 'complementarity') and partnership, had already been in place before the reforms and, proven to be positive and effective features, became also part of the Framework Regulation reforming the Structural Funds.

The re-evaluation of the 1988 reforms, laid down in Article 19 of the Framework Regulation, roughly coincided with the next leap forward in the history of West European integration, the signing in 1992 of the Maastricht Treaty to establish a European Union. Apart from the general declaration to create a political union (with all the implications this holds for concepts such as solidarity between the Union and its members as well as among the Member States themselves) the Treaty's main effect on economic and social cohesion was to be expected to come from its provisions on establishing an economic and monetary union. As has been discussed elsewhere in this study, the latter project - in effect a continuation of the process of creating a single EU economy - threatened to exacerbate the side-effects already facing the poorer regions because of the SEA. Against this background, the TEU amended Article 130d of the re-named EC Treaty to the effect that

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50 Marx 146.
51 See: Franzmeyer and Seidel 192; or: Schäfers and Fetzer 79. The difference between projects and programmes is that the former represent isolated individual cases, whilst the latter stand for a conceptual, inclusive approach which takes into consideration other social and/or structural measures.
52 See Section 4.2.
the Council was called upon to set up a Cohesion Fund before 31 December 1993. The Protocol on Economic and Social Cohesion, annexed to the Maastricht Treaty, further clarifies that the new Fund was to "provide Community financial contributions to projects in the fields of environment and trans-European networks in Member States with a per capita GNP of less than 90% of the Community average which have a programme leading to the fulfilment of the conditions of economic convergence as set out in Article 104c [EC Treaty]." The latter requirement, however, indicates that the aim of the Cohesion Fund is not only to generally reduce the regional disparities within the Community, but primarily to allow all Member States a smooth transition towards stage three of the planned EMU.\textsuperscript{54}

In the light of the Maastricht conclusions the Commission published a number of documents outlining its plans for the future development of the Communities' policies. The first of these was published in February 1992, and aptly titled \emph{From the Single Act to Maastricht and Beyond: the Means to Match Our Ambitions}.\textsuperscript{55} This paper served a double purpose. On the one hand it gave the Commission's verdict in respect to the re-examination of the reforms to the Structural Funds. On the other hand it represented the Commission's opening bid for more money to finance what it regarded as the principal challenges for the nascent European Union in the period 1993 and 1997: the strengthening of its international competitiveness and its internal cohesion.\textsuperscript{56} On the first point, the Commission regarded the reforms to the Communities' regional policy instruments a success as far as their main objective, the strengthening of economic and social cohesion in the EEC, was concerned. This judgement was not, however, based necessarily on the degree to which economic and social cohesion had or had not been achieved, as this depends largely also on the amount of money re-allocated. What the report referred to mainly were the positive qualitative improvements the Funds had received.\textsuperscript{57}

In the second part of the paper, its proposals to the Council on the time after the TEU, the Commission, although calling for a continuation of the qualitative improvements to the Communities' Structural Funds, mainly demanded a significant increase in the size of regional policy measures. In accordance with the decisions taken at Maastricht, the Commission highlighted the potential contradiction between the objective of economic and social cohesion, and the requirement of meeting a number of convergence criteria to qualify for membership of EMU. Welcoming the decision by the European Council to establish a Cohesion Fund aimed at assisting those Member States with the lowest

\textsuperscript{54} Hade 407.
\textsuperscript{55} ECs, Commission, \textit{From the Single Act to Maastricht and Beyond}.
\textsuperscript{56} ECs, Commission, \textit{From the Single Act to Maastricht and Beyond 2}.
\textsuperscript{57} ECs, Commission, \textit{From the Single Act to Maastricht and Beyond} 8-9.
standards of living, the Commission nevertheless made the point that reconciling the aims of cohesion, convergence and economic growth requires "adequate financial resources". To this end it proposed "to raise the own resources ceiling from 1.20% to 1.37% of Community GNP between 1992 and 1997 [which] would provide an additional ECU 20 billion in payment appropriations." Of the latter amount, representing an annual budgetary growth rate of 5%, ECU 11 billion were earmarked for regional measures. Combining support from the proposed Cohesion Fund with an increase in Objective 1 funding by 66% was set to double the financial support given to the four poorest Member States, Greece, Portugal, Ireland and Spain. Some of the Objective 1 money was to go to the five new German Länder which had already received a special appropriation from the Structural Funds for the period 1991 to 1993. The Commission also proposed to increase the other Objectives by 50%, and to introduce a new Objective 6 for ‘regions dependent on fishing’.

On the face of it, the Delors II proposals to secure the financing of the ECs up to 1997 looked uncontroversial. They highlighted and reconfirmed the principles of budgetary discipline and management already agreed in 1988, and as such represented no fundamental change from what had become accepted practice. Besides, Delors II focused upon policy objectives the European Council had itself repeatedly championed. All this notwithstanding, the Commission’s proposals soon ran into trouble. On 10 June 1992, and after intense debate, the EP underlined the fact that an increase of the ECs’ budgetary means had to be regarded as the inevitable consequence of the decisions taken at Maastricht. It criticised the proposed expansion of the ECs’ own resources from 1.2% of the Communities’ GNP to 1.37% as insufficient, but still approved the Delors II package in principle. More seriously though, the Member States were again split, and once more along geographical lines. As in the past, the poorer countries located at the southern and western periphery of Europe pushed for the adoption of the full Commission proposals for financial redistribution, whilst their richer counterparts in the North were rather critical of yet another increase in their contributions to the ECs’ budget. Germany and the UK were particularly reluctant to accept Delors II against a background of economic difficulties at home, already putting considerable strains on their respective domestic fiscal situations.

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58 ECs, Commission, From the Single Act to Maastricht and Beyond 3.
59 ECs, Commission, From the Single Act to Maastricht and Beyond 30.
60 Dinan 410.
61 Scott 79.
An agreement on the financial future of the European Communities had to be found by
the end of 1992, by which time the previous budgetary agreement, based on the Delors I
proposals of 1987, was due to run out. These were, however, difficult times, not only
because of the economic recession that had taken grip of the whole of Europe. German
unification had turned the formerly rich FRG into an only average Member State when
measured in terms of per capita GNP. The Lisbon summit of June 1992 had not achieved
much progress on the Delors II proposals, so it was left to the British Presidency to
ensure the Communities’ financial future. Ironic as its seems that the country most
reluctant to finance the European venture should be expected to broker the vital
breakthrough leading to an increase in the ECs’ budget, it may well have been exactly this
contradictory position which did in the end provide for the passing of the Delors II
package. In order to explain why this should have been so, it appears necessary to be
reminded that each Member State aspires to make its presidency a success. In happier
times there often is room for manoeuvre over which aspect a Member State wants to
bring progress on. The UK, however, had its presidency almost completely hijacked by
events to which the ECs had to react.

The rejection of the Maastricht Treaty by the Danish people in their June referendum had
thrown the Community into a deep political crisis. Then there was the ERM crisis of
September 1992 which culminated in the ejection from the mechanism of the British and
Italian currencies. A hastily organised special summit, convened at Birmingham in
October 1992, only produced declarations of intent, rather than any real results. Thus the
last chance the British Government had to make its presidency a success was to prevent a
budgetary stalemate which would seriously have brought into question the Member
States’ commitment to solidarity amongst each other and thus the European venture at
large. However, in the run up to the regularly scheduled summit at Edinburgh in
December 1992, the positions between the poorer, mostly southern members and their
rich northern counterparts still looked irreconcilably apart. The countries in which most of
the Objective 1 areas were located pressed for the full acceptance of Delors II, while the
net contributors to the ECs budget called for the commitment to cohesion to be limited.
At the far end of an imaginary spectrum of positions, the UK tried to prevent any increase
to the 1.2% ceiling in place at the time.

Britain, the country holding the Communities’ Presidency, argued that ECs spending in
1992 had only amounted to 1.15% of GNP, thereby indicating there was still considerable
room for budgetary growth. Furthermore, it was argued that a continuation of CAP
reforms would release resources to finance other Community policies. Finally the planned
enlargement of the ECs to include a number of the relatively prosperous EFTA countries

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was said to raise the - by then - Union’s GNP, with the effect of also increasing its revenues. On top of all this, the British were adamant to keep their budget rebate, originally secured by Mrs. Thatcher. What they considered to be a first compromise proposal was put forward by the British delegation in November 1992. It contained three main suggestions. First, that any agreement should extend the budgetary period by two years to last from 1993 until and including 1999. Second, that the resources allocated to each item of expenditure should be substantially less than envisaged by Delors II. Finally, the British proposal did allow for an increase in the GNP ceiling, but only up to 1.25% and over the period to 1999. The southern Member States utterly rejected all this and once again called for the full implementation of the Delors plan.

Just before the Edinburgh summit, another compromise paper was issued by the Presidency, further moving into the direction of the demands made by the poorer Member States. This latest proposal contained a slight improvement on the November offer as it accepted a further increase in ECs spending on structural and cohesion policies, naturally benefiting the four poorest members. This notwithstanding, the proposal still fell short of the original plan brought forward by the Commission. Again, the Presidency’s attempt to find agreement on the future financing of the to be Union before the summit had failed. The economically weaker members knew only too well that they had very little to lose, but everything to gain from playing hard to get. The uncertainty over the Communities’ financial future thus became the central issue to determine whether the Edinburgh summit, and therewith the entire British Presidency, would be a success, or not. As had been the case the previous time around, the key to solving the looming financial crisis lay with Chancellor Kohl. Almost acting as if his country was still as prosperous as it used to be before unification, he conceded most and so, once again, laid the foundations for a compromise solution: the richer Member States managed to push through an extension of the budgetary period to last until 1999, while simultaneously limiting the Communities’ expenditure to increase up to only 1.27% over this time; Britain kept her rebate; and the four poorest Member States got their side-payments by having their combined allocations from the Structural Funds and the Cohesion Fund doubled by 1999.

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63 According to one expert on German financial equalisation in the Finance Ministry of Mecklenburg-Western Pommerania, who the author interviewed in Schwerin on 5 May 1993, Dr Kohl had uttered at Edinburgh that Germany would be able to cope with unification on her own.

64 For more information on the technical details of the Edinburgh deal and the leading up to it, see: Scott 79-82. For a much more general summary of the summit and its conclusion, see: Dinan 410-1.
6.4 From Structural Policy to Financial Equalisation?

The deal struck at Edinburgh set aside to the Communities a sum total of around ECU 176 billion aimed at regional measures for the years 1993-1999, an increase by more than ECU 100 billion over the 1988-1992 period. However, since the budgetary period had been extended from five to seven years, it appears better to break this down to annual figures. For the period 1993-1999 an average ECU 25 billion had been agreed, which compares to a yearly figure of ECU 13 billion between 1988 and 1992. This almost provided for the doubling of expenditure on regional policies called for in the Delors II package. Though other ideas the Commission had put forward, such as the creation of an Objective 6 to deal with areas heavily dependent on the fishing industry, and a 50% increase in the size of Objectives 2 to 5, were not adopted by the Edinburgh Council.

Out of the above mentioned overall increase in regional spending, the new Cohesion Fund was to be given ECU 15.15 billion for the period 1993-1999. There was, however, a problem with this latest instrument to help the ECs in their pursuit of stronger economic and social cohesion. In contrast to the Structural Funds, which had been inserted into the then EEC Treaty by the SEA, and as such had a firm legal basis, the Cohesion Fund did not yet exist. It was a creation of the Maastricht Treaty - and that had still not been ratified by the time of the Edinburgh summit. Accepting that the deadline to establish the Cohesion Fund would probably be missed, the Edinburgh Council agreed to set up an interim Cohesion Financial Instrument (CFI) before 1 April 1993. The instrument that was subsequently established, on 30 March 1993, contained the same criteria and funding methods as those originally proposed for the Cohesion Fund proper. The CFI Regulation had been intended to remain in force until the Cohesion Fund was installed, but until 1 April 1994 at the latest. In the event it finished on 25 May, because it had taken until 16 May 1994 to adopt the Cohesion Fund Regulation.

In the meantime the Council had passed, on 20 July 1993, six revised Regulations governing the EEC's Structural Funds for the period 1994-1999. These measures did not touch upon the financing of the Funds, as this had already been approved at Edinburgh. What they aimed at was a further improvement of the Funds' ability to serve its constitutional task of strengthening the Community's economic and social cohesion. To this end Objectives 3 and 4, as well as Objective 5(a) and 5(b) were slightly, but by no

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68 Council Regulations (EEC) No 2080/93, 2081/93, 2082/93, 2083/93, 2084/93, and 2085/93.
means insignificantly refocused. Similarly, the four guiding principles, referred to earlier in this Section, were sharpened in their application. Some new regions were added to the list of those eligible for support under Objective 1, and a new Financial Instrument on Fisheries Guidance became the latest Structural Fund, to serve Objective 5(a).\(^{69}\)

Ratification of the TEU was eventually completed in October 1993, which meant that, according to the Treaty’s own provisions, the European Union could come into existence on 1 November 1993. This also opened the way for entry of the four EFTA countries applying for membership of the new Union. Negotiations to this end were concluded by March 1994, and respective referenda subsequently held in all four applicant states resulted in Norway rejecting EU membership, while Austria, Finland and Sweden joined the Union on 1 January 1995. Compared to the other twelve Member States, the three newest members were relatively prosperous, and as such they stood to receive very little back from the Brussels coffers in the way of support from the Structural Funds. The only area eligible to receive Objective 1 allocations, for instance, was the Austrian region of Burgenland. Given the pledge embedded in the Founding Treaties, and accepted by the new members as part of the \textit{acquis communautaire} for solidarity between the Member States and between their peoples, there should have been no need to alter the EC’s structural policies to accommodate the three former EFTA countries.

Yet, politics is more complicated than that. The Scandinavian countries in particular felt they needed a gesture from the Union that they had not merely been asked to join in order to boost the number of richer Member States, and thus prop up the EU’s budget. Even though membership is, of course, not just about nominal contributions and reallocations, but also, and probably much more so, about chances and opportunities impossible to measure in financial terms, this aspect of European integration is only too often ignored by both national governments, and their respective electorates. Accepting the fact that solidarity works both ways, the EU thus agreed to set up a new Objective as a way of assisting the Nordic countries with regional aid. Objective 6 aims to assist with the development of underpopulated regions, the criterion for which is a population density of less than eight inhabitants per square kilometre. This only applies to, predominantly northern, areas in Finland and Sweden, and the kind of support available under the new Objective is similar to that for Objective 1 areas.\(^{70}\)


\(^{70}\) For more detailed reading on the impact the 1995 enlargement to the Union has had on the Structural Funds, see: EU, Commission, Directorate-General for Regional Policy and Cohesion, \textit{The Community’s Regional Policy in the Three New Member States}, Info Regio, Enlargement Fact Sheet 31.10.1995.
To briefly sum up, the EU's current regional policy instruments now consist of four Structural Funds and the Cohesion Fund. The Structural Funds - ERDF, ESF, EAGGF Guidance Section, and the FIFG - serve six Objectives which identify sub-national areas as eligible for assistance from one or more of the Funds. The task is to ameliorate very specific problems in narrowly defined areas. In contrast to this, the Cohesion Fund aims to support those EU Member States which have a per capita GNP of less than 90% of the Union's average. Here the objective is to support the economy of eligible Member States by way of funding up to 85% of projects in the fields of transport infrastructure and the environment. The difference in approach, and therewith ultimately also in aim, between the Cohesion Fund and the Structural Funds is that for the latter the Member States in question have to strictly adhere to a programme of economic convergence as referred to in Article 104c of the EC Treaty. This reveals that, even though the Fund does aim at strengthening the Community's economic and social cohesion, its primary objective, nevertheless, must be regarded as a financial injection from the richer Member States to improve their poorer counterparts' budgetary situation in the run up to EMU, for which the convergence criteria were inserted into the Treaty in the first place.

The argument in this thesis has repeatedly been that the establishment of the Cohesion Fund represents a departure away from the classic instruments of regional policies, such as the Structural Funds. It has also been said that the Cohesion Fund could be regarded as a first step into the direction of a system of financial equalisation, the ultimate example of which, of course, only exists in the FRG. Figure 6 below aims to set out a very general comparison of some of the differences between the two main forms of regional instruments the EU has at its disposal. At first glance the points just made seem unfounded. After all, there is (central) EU involvement, and the recipient Member States are obliged to honour their convergence programmes in order not to forfeit their Cohesion Fund entitlements. Only when looking behind the rules does it become clear that there are resemblances also with an equalisation mechanism. To begin with, the target areas are Member States rather than sub-national regions. Then, the conditions concerning the convergence criteria as well as the limitation of spending to the two target fields of transport infrastructure and the environment should make it reasonably clear that the primary intention behind the Cohesion Fund is actually to support economic convergence. The requirement of working towards a convergence programme is just a safety measure to make sure the recipients actually adhere to this requirement. The targeting of transport infrastructure and the environment, however, directly represents a welcome financial injection to the national coffers of the poorer Member States for projects of which many are actually needed to comply with EU legislation. Furthermore, as there still is plenty of room for manoeuvre in respect to exactly which projects to single
out for support from the Cohesion Fund, the new instrument definitely contains elements of financial equalisation.

Figure 6: Differences between the Cohesion Fund and the Structural Funds

<table>
<thead>
<tr>
<th></th>
<th>Cohesion Fund</th>
<th>Structural Funds</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Aims</strong></td>
<td>To reduce economic disparities between the Member States</td>
<td>To reduce regional disparities</td>
</tr>
<tr>
<td><strong>Parties involved</strong></td>
<td>Projects are agreed between the Commission and the Member State concerned</td>
<td>While the Member State bears the main responsibility, the regional authorities and the promoters play a prominent role in the management of programmes</td>
</tr>
<tr>
<td><strong>Conditions</strong></td>
<td>Strict conditions: compliance with the convergence programmes is a condition of funding</td>
<td>No conditions</td>
</tr>
<tr>
<td><strong>Geographical coverage limits for the other</strong></td>
<td>Four Member States</td>
<td>Objective 1, 2, 5b and 6 regions. No regional objectives</td>
</tr>
<tr>
<td><strong>Areas</strong></td>
<td>Environment and transport infrastructures only</td>
<td>In principle, no sector is excluded</td>
</tr>
<tr>
<td><strong>Procedures</strong></td>
<td>Funding is granted on a project-by-project basis</td>
<td>Most of the funding is granted for programmes</td>
</tr>
<tr>
<td><strong>Funding available</strong></td>
<td>ECU 13.65 billion for the period 1994-1999⁷⁴</td>
<td>ECU 141.14 billion for the period 1994-1999⁷⁵</td>
</tr>
</tbody>
</table>

To thus conclude the findings in this chapter it can be said that the ECs’ regional policy has come a long way since the days of little, and more or less uncoordinated, financial assistance and redistribution within the three Communities of the 1950s and 1960s. Not only has the amount reallocated under respective schemes been increased manifold. The

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⁷¹ Source: EU, Commission, Directorate-General for Information, Communication, Culture and Audiovisual Publications Unit, *The European Union’s Cohesion Fund* (Luxembourg: EUR-OP, 1994). Updated to include Objective 6 and the financial assistance to the three new Member States.

⁷² ‘Parties involved’ here refers mainly to the implementation of respective measures. As far as the overall framework decisions are concerned, the Structural Funds require far more centralised, i.e. Community, decision-making than does the Cohesion Fund.

⁷³ The reference to ‘conditions’ is rather misleading and would be better served by the term ‘additional conditions’, for - in general terms - the Structural Funds require far more concrete conditions to allow for financial payments to be made from them than is the case with the Cohesion Fund.

⁷⁴ In nominal figures. Source: Art. 4 Council Regulation (EC) No 1164/94.

schemes themselves have been steadily improved from the first, rather hapless, attempts at regional assistance within the comparatively homogeneous ECs of the Six, to the relatively sophisticated and highly integrated Structural Funds of the present day, structurally much more diverse, EU of 15 Member States. Along the way, the Communities began to experience the kind of behavioural patterns that have been familiar to decision-makers within the FRG for more than fifty years: when it comes to the financial relationship between the members of a union of states, the vertical division between centre and constituent units is complemented by a horizontal split between ‘rich’ and ‘poor’ members; and whilst the wealthier units proclaim their support for the principle of subsidiarity, thereby trying to keep as much of their own revenues as possible to themselves, the poorer members will collaborate with the central authorities in order to extract side-payments, financial allocations in return for supporting union legislation that requires their consent. The biggest prize yet for the EU’s poorest Member States is the establishment of the Cohesion Fund which not only deals exclusively with their financial difficulties, it also gives them more freedom of choice over the use of respective payments.

The emergence of the ‘bargaining’ pattern just described is in itself a sign that the EU is beginning to mature as a quasi-federal system - beyond the mere institutional structures of an entity with more than only one level of government. The other indication that something appears to have changed is the establishment of the Cohesion Fund. Accepting the argument that the EC’s latest regional policy instrument represents a shift towards a more direct form of financial assistance between the richer and the poorer Member States, the overall conclusion must be that the general centralisation trend is being counterbalanced by a more subsidiaristic approach to regional assistance. However, whether or not this development represents an improvement for the EU - in particular as far as the reduction of regional disparities is concerned - is not so clear. It is the task of the following chapter to shed some further light on this issue by analysing a number of concepts closely related to the question of how a reduction in regional disparities may actually be brought about.
7. **COMPARING THE FUNDAMENTAL ISSUES AT STAKE**

At this stage it appears worthwhile to pause for a moment and take stock of what has been established so far. To recapture: the aim of this thesis is to look at the political/constitutional circumstances that determine how, and to which extent, regional disparities can be reduced within the EU. Such disparities would of course exist naturally, even in a union that remained static. But the dynamic nature of the European venture provides for an additional challenge. Economic and monetary integration, like the establishment of the SEM before, carries with it a threat to widen the Union’s regional disparities, and this means that respective policies have to first counteract these effects, before entering the positive territory of actually beginning to reduce the welfare gaps which existed in the first place.

The dynamic processes experienced by the EU are, as has been argued in Chapter One, one of the characteristics of federalism, and so is the sharing of sovereignty between at least two levels of government. For that reason it was decided to look at another federal entity in order to find an existing example from which to draw useful conclusions. As has been discussed at great length in Chapter Two, the choice fell on the FRG for mainly two reasons. First the Federal Republic is a mature and highly integrated federation, and as such can be regarded as being positioned at the far end of a process of federalisation the Union has really only just embarked upon. However far down that road European integration may or may not go, the experience of the FRG must be seen as an indication of what the EU might ultimately be heading for. The other explanation for why the FRG, rather than any other highly integrated federation, was selected has to do with the close resemblance between the institutional structures of the two entities compared, and the gradual emergence of decision-making procedures within the realm of the ECs that match those in place in the German federal legislative system.

Whilst all this appears logical and conclusive, there are problems with the chosen approach. The difficulty lies with how to compare policies - even though they may be aimed at solving the same problems - in sharply contrasting political circumstances. Policy outcomes are, of course, determined by the decision-making processes in place, but these are based on historic developments, the political culture, and - in a federal entity - not least the degree of political integration, of any given polity. Consequently both the constitutional provisions from which regional policies are derived and the policies themselves can hardly be expected to be directly comparable. Chapters Three to Six
actually confirm that the EU and the FRG do have quite different regional objectives - and ways of meeting them.

However, the principal aim of the present exercise is not simply to compare the regional policies in place in federal Germany and the EU, neither is it to just contrast their constitutional provisions in this field. The objective set for this thesis is to look at the political circumstances that determined the provisions portrayed in the previous four chapters, and to try and learn lessons from Germany for the EU’s future regional policy. The underlying assumption here is, of course, that European integration is going to continue, and there are good reasons to believe that it will. The latest IGC, set up in March 1996 to review the Maastricht Treaty, had as its core subject the reform of both the Union’s institutions and the ways in which decisions are taken in and between them.1 Even though the June 1997 European Council failed to produce a decision on the much-needed reform of the EU’s institutional structures, the treaty agreed at the Amsterdam summit still carries the Union further along the supranational path towards more integration: certain aspects of JHA are to be transferred from the intergovernmental ‘third pillar’ into the decision-making structures of the European Communities; and a new ‘flexibility clause’, already - if indirectly - endorsed by the TEU, now enables those Member States wanting to press ahead with closer collaboration, in fields others are not willing (or able) to follow suit, to do so.2

What all this means is that either the whole of the EU, or at least an ‘inner core’ of federal-minded countries, can be expected to adopt measures that will lead to more political integration, as well as institutions and/or decision-making processes which are very likely to close up on those in place in the FRG. Political integration does, of course,

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aim at that prominent goal of an ‘ever closer union’, in which are embedded notions such as mutual assistance and solidarity. How far down the road of further political integration, and thus fiscal redistribution, the Union is going to go remains at present highly speculative. The one safe assumption that can be made is that the former will not happen without a dose of progress on the latter. The question that arises is what shape or form such increased fiscal assistance for the poorer Member States will take in future. The trade-off is between pure structural support measures, usually decided upon and administered by the central authorities, as one extreme, and an unattached financial equalisation scheme of the German sort as the other. Naturally it will be the political constellation of the day which will at any moment in time determine what exactly will happen. This realisation shall not, however, stand in the way of taking a look at the issues at stake, and trying to point to the various possibilities open to the Union’s decision-makers.

7.1 Investitive versus Consumptive Spending

Before looking into the political feasibility of certain regional policy instruments at the various stages of a process of federalisation, it appears necessary to discuss first the economic case for redistribution. The ultimate issue to be addressed under such a banner would, of course, be whether regional intervention does have any economic justification at all. This question, however, has got as much to do with political conviction as it has with economics. Champions of the free-market economy, amongst which Margaret Thatcher must be regarded as one of the most strident, consider any form of intervention as a distortion to the natural forces of supply and demand. To them the free market is the most efficient way to growth and prosperity. Others though object to this view and regard the free market itself as one of the problems. The argument here is that a laissez-faire approach creates inequalities of such magnitude that they are themselves detrimental to an efficiently functioning economy.

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3 In an interview with a member of staff at the UK’s Representative Office in Brussels, on 17 Dec. 1993, the author was told that, since 1979, successive Conservative Governments had been gradually reducing regional assistance within the UK. Regional intervention, according to the interviewee, went against Conservative doctrine, hence the policy of the current Government was to cut regional aid to all but the most deprived areas. Consequently, in line with its policy stance at home, the British Government also opposed the principle of a European regional policy.

4 This is, in very basic terms, the position of the ECs. Even the original Treaty of Rome, establishing the EEC, has as one of its principle “to promote throughout the Community a harmonious development of economic activities” (Art. 2). However, an active regional policy commitment was only adopted in 1975, with the setting up of the ERDF - ironically as the result of pressure coming mainly from the UK!
With both the FRG and the EU having firm constitutional provisions committing their constituent units, as well as their people, to solidarity with one another, the principle of employing redistributive measures as such is not in question. The earlier reference to economics therefore applies to the efficiency of the policies and instruments with which regional disparities are attempted to be diminished. In this respect the yardstick is the degree to which money reallocated is successful in reducing the underlying causes of regional inequalities, and this is directly linked to the kind of spending respective measures cause. Two basic forms of expenditure can be identified, one which is immediately consumed and thus only has a 'one-off' effect, and another that leads to investment, thereby creating a chance for longer-term improvements. In other words, the former has a static effect, whereas the latter is of a more dynamic nature as it bears the potential for change. These two distinct forms of expenditure are - in this dissertation - being referred to as consumptive and investitive spending respectively. In the context of the present discussion the distinction between whether redistribution goes into consumption or into investment is of crucial importance - and testing the various regional policy instruments in place in Germany and the EU to this avail should expose whether and, if so, how economically efficient these tools are in reducing regional disparities. However, before entering any such test it appears useful to outline just a little bit further what exactly consumption and investment stand for, how they differ from one another, and how respective expenditure is affected.

In a general definition, the *Encyclopaedia Britannica* explains consumption as “literally, the act of consuming or destroying.” A more specific interpretation of the term can be found in the *Penguin Dictionary of Economics*. It defines consumption as “[t]he use of resources to satisfy current needs and wants.” Bringing the two definitions together then illustrates what happens to consumptive spending: the money involved is used, and used up in the process, to pay for immediate needs and wants. In terms of regional policies this means that allocations from respective schemes are used to pay for such budgetary items as social security payments, wages for civil servants, or the running cost of public facilities - all of which have no effect on the underlying economic structure of the country, region or area in question.

In contrast to consumption investment aims at “[r]eal capital formation, such as the production or maintenance of machinery or the construction of dwellings, that will produce a stream of goods and services for future consumption. Investment involves the sacrifice of current consumption and the production of investment goods which are used

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to produce commodities ...". This is a rather micro-economic definition of investment as it focuses on the production of goods and services. Regional policies, however, are macro-economic tools, and for that reason the definition needs to be slightly altered. Brought into line with the current argument, it can thus be said that investitive spending leads to the creation or improvement of infrastructures which bear the potential for (more) economic growth. To make absolutely sure that investitive spending is understood correctly, it has to be stressed that it distinguishes itself from consumptive spending by more than the simple conclusion that everything not spent on consumption is spent on investment. Investment in the true sense of the word goes beyond the buying of financial or real assets. The latter merely represents a shifting of finances from one use to another. Investitive spending hence needs to at least aim at improving the status quo. Examples for investitive spending are: the building or upgrading of roads, railways, airports and waterways; the provision or improvement of telecommunication links; and the supporting of research and development activities; to name but a few.

So with the difference between consumptive and investitive spending established, the ground should be firmly prepared to allow for the above mentioned testing of the policy instruments with regional effect used in the FRG and the European Union. Rather than performing a painstaking investigation into each and every initiative, which would not only go beyond the scope of this dissertation, but also be of relatively little benefit to the current discussion, the approach chosen is to finally confront the constitutional provisions, on which fiscal redistribution with regional effect is based, with the respective instruments actually in place. The idea is, of course, to expose whether investitive spending is imperative in order to meet the constitutional requirements, or whether the latter would also condone consumptive spending. Expressed in a cruder way, the issue is to find out whether the constitutional provisions allow for a real reduction in regional disparities, or just a 'balancing of the books' without structural effect. For reasons which will become clearer as the discussion evolves it appears most beneficial to start by looking into the EU’s regional policies first.

All of the EC’s regional policy instruments are directly aimed at the constitutional objective of strengthening the Community’s economic and social cohesion. As has been discussed in Chapter Three, this should mean a real reduction in regional disparities within

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7 Bannock, Baxter and Davis 221.
8 For further reading on the difference between real investment on the one hand, and what may be called 'nominal investment' on the other, see: The New Encyclopaedia Britannica, 1985 ed; or Bannock, Baxter and Davis 221.
9 Both the Structural Funds and the Cohesion Fund are based upon the provisions of Title XIV, Economic and Social Cohesion, (Articles 130a - 130e) of the Treaty Establishing the European Communities as amended by the TEU.
the EU. Yet, the question is not so much whether or not this has actually been achieved. The real issue is whether the methods and means used to reduce regional disparities have the potential to bring about a reduction in regional imbalances within the Community - in other words, whether the projects targeted are of a consumptive, or an investitive nature. In order to find out how the EC’s regional policy tools fare in this respect, the four Structural Funds shall be tested one after another, before the attention will be turned towards the performance of the relatively recent Cohesion Fund.

As has been shown in Chapter Four, the Structural Funds serve together a total of six Objectives. Of these Objective 1, Objective 2, Objective 5(b) and Objective 6 have a predominantly geographical application, whilst Objective 3, Objective 4 and Objective 5(a) apply to the whole of the Union. This means that the latter, first and foremost, target social integration, whereas the former directly aim at reducing the EU’s regional disparities. The four Structural Funds serve a mixture of Objectives, each of them according to its particular focus - and the following graph shall act as a reminder of how the Funds contribute to which of the Objectives.10

![Figure 7: The EU’s Structural Funds and Their Objectives](image)

<table>
<thead>
<tr>
<th>Objective</th>
<th>ERDF</th>
<th>ESF</th>
<th>EAGGF (Guidance)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Objective 1</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Objective 2</td>
<td>ERDF</td>
<td>ESF</td>
<td></td>
</tr>
<tr>
<td>Objective 3</td>
<td></td>
<td>ESF</td>
<td></td>
</tr>
<tr>
<td>Objective 4</td>
<td></td>
<td>ESF</td>
<td></td>
</tr>
<tr>
<td>Objective 5(a)</td>
<td></td>
<td>EAGGF (Guidance)</td>
<td>FIFG</td>
</tr>
<tr>
<td>Objective 5(b)</td>
<td>ERDF</td>
<td>ESF</td>
<td>EAGGF (Guidance)</td>
</tr>
<tr>
<td>Objective 6</td>
<td>ERDF</td>
<td>ESF</td>
<td>EAGGF (Guidance)</td>
</tr>
</tbody>
</table>

Of direct interest to this thesis are of course only those measures which aim to reduce the regional disparities of the European Union. However, as the above table shows, it is only the ERDF that - as its name strongly indicates - exclusively serves the ‘regional’ Objectives, whilst ESF and EAGGF (Guidance) support a mixture of ‘regional’ and ‘social’ Objectives, with just the FIFG singularly linked to Objective 5(a). The latter notwithstanding, all of the Funds shall be looked at in a little more detail below in order to establish whether their financial allocations are used for investitive purposes or whether

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they are simply consumed while attempting to achieve a strengthening in the EC's economic and social cohesion.

By far the largest, and therewith the most important, of the EC's Structural Funds is the ERDF. It has as its task "to help to redress the main regional imbalances in the Community through participation in the development and structural adjustment of regions whose development is lagging behind and in the conversion of declining industrial regions."1 In other words, the ERDF targets the poorest and most backwards regions as its main field of operation, and aims to develop and structurally adjust them. This to achieve clearly requires investitive spending, and the ERDF regulation12, the legal basis upon which the Fund's scope rests, actually supports this view. It contains a detailed list of the fields of assistance the ERDF covers, and this confirms the Fund's commitment to investment. The list includes:

- productive investment to permit the creation or maintenance of permanent jobs;
- investment in infrastructure, with a varying scope depending on the objective, including trans-European networks for regions eligible under Objective 1;
- investment in education and health in regions eligible under Objective 1;
- development of indigenous potential: local and SME development;
- research and development measures;
- investment linked to the environment.13

One question which imposes itself at this stage is whether this legal commitment for investment is actually being fully implemented. For a long time the Communities' redistributive policies, such as cohesion and the CAP, have had the stigma of fraudulent use, misspending and maladministration attached to them - and not without justification. There have been a number of incidents, also to do with regional and social spending, where the apparent investment later proved to be of no real use at all. A bridge built without respective connecting roads will clearly not help to improve the infrastructure of any given area in question. However, as has been discussed in more detail in Chapter Four, the four guiding principles introduced to the Structural Funds in 1988 - concentration of effort, partnership, programming and additionality - should have greatly reduced the scope for misuse in this field. A more political sign that the Communities' decision-makers are eager to make sure that Community expenditure goes towards

11 Art. 130c ECT.
12 Council Regulation (EEC) No 2083/93 34-8. These rules were updated by the "Decision of the Council of the European Union of 1 January 1995 Adjusting the Instruments Concerning the Accession of New Member States to the European Union (95/1/EC, Euratom, ECSC)," OJ L1 (1 Jan. 1995): 1-13, which accommodated the new Objective 6 into the framework of existing legislation.
projects that are in line with EU legislation is the upgrading of the European Court of Auditors to become one of the Union’s five official institutions following the TEU.\textsuperscript{14}

Even though all this cannot rule out entirely the possibility of misuse of structural and cohesion spending, the measures just described should help to limit the occurrence of investment allocations going into consumptive projects to levels which have to be regarded as normal. In other words, they should not exceed respective national levels of ‘budgetary wastage’. What holds true for the ERDF will, naturally, also apply to the other Structural Funds, and indeed to the Cohesion Fund, even though the rules of the latter are somewhat different. But this point will be discussed later. The next Fund to be looked at is the European Social Fund, the oldest of the Structural Funds.

As its name strongly indicates, the ESF aims at reducing social imbalances within the Community. This it tries to achieve by reducing unemployment throughout the EC.\textsuperscript{15} Nevertheless, as shown in Figure 7, the ESF does allocate money to projects covering the ‘regional’ objectives too. However, as has been stressed before, the current investigation is into the general question of whether support from the Structural Funds goes into investment or into consumption. Even though it is often more difficult to draw a line between the two forms of expenditure when it comes to social issues, it can be safely said that the ESF’s focus on reducing unemployment has led to a firm commitment on investment in training and education. A summary of the Fund’s scope substantiates this view. It covers:

- occupational integration of unemployed persons exposed to long-term unemployment;
- occupational integration of young people in search of employment;
- integration of persons exposed to exclusion from the labour market;
- promotion of equal opportunities in the labour market;
- adaptation of workers to industrial change;
- stability and growth in employment;
- strengthening of human potential in research, science and technology;
- strengthening of education and training systems.\textsuperscript{16}

The third Structural Fund, the EAGGF Guidance Section, is directly linked to the Community’s CAP.\textsuperscript{17} This means that even though the Fund, like the ESF, may have as its

\textsuperscript{14} Art. 4 ECT.

\textsuperscript{15} See: Art. 123 ECT.

goal to address a combination of regional and social objectives, its concentration on the agricultural sector gives it an almost automatic geographical application, since its finances are aimed primarily at the EC’s rural areas. Once again, the question of importance to the present discussion is whether money from the EAGGF Guidance Section is aimed at investment or at consumption - a question made more immediate by recent reforms to the CAP which saw a policy shift away from price guarantees and towards direct income support for farmers.\footnote{For further reading on this point see, for instance: Dinan 331-3.} However, a look into the legislation on which the Fund is based\footnote{Council Regulation (EEC) No 2085/93; just like ERDF and ESF amended by the “Decision of the Council of the European Union of 1 January 1995 Adjusting the Instruments Concerning the Accession of New Member States to the European Union”.} strongly suggests that this shift in policy direction must have affected first and foremost the Guarantee Section of the EAGGF. The scope of the Fund’s Guidance Section still supports investment, such as:

- supporting farming income and the maintenance of viable farming communities in mountain or less-favoured areas;
- start-up support for young farmers;
- improving the structural efficiency of holdings;
- encouraging the establishment of producers’ associations;
- conversion, diversification, reorientation and improvement in the quality of agricultural production;
- development of rural infrastructure;
- encouragement for tourist investment;
- other measures such as the prevention of natural disasters, villages renewal, protection of the rural heritage, development and exploitation of woodland, protection of the environment and countryside and financial engineering.\footnote{EU, Commission, \textit{Structural Funds and Cohesion Fund 1994-99} 19.}

The newest of the Structural Funds, since only established in 1993, is the FIFG - in effect an upgraded version, and therewith an official recognition of their importance, of the former fisheries sector instruments that operated outside the Structural Funds or were included under Objective 5(a). In this respect the FIFG could be described as a branched-out version of the EAGGF Guidance Section, especially designed to focus on the fisheries sector. Accepting this interpretation, most of what has been directly said about the EAGGF Guidance Sector should then apply also to the FIFG, with the principal difference
that it concentrates on the EC’s fisheries sector. A summary of its scope actually confirms that the FIFG too promotes investment in its field of operation as it supports:

- adjustment of efforts in the fisheries sector;
- fleet modernisation;
- development of fish farming;
- protection of some maritime areas;
- facilities at fishing ports;
- processing and marketing of fishery products;
- promotion of products.

All this should have established that projects which are (co-)financed by the EU’s Structural Funds are - at least in their overwhelming majority - of an investitive nature. The question that imposes itself next, then, is whether the Union’s latest instrument to help strengthening the EC’s economic and social cohesion, the Cohesion Fund, differs from its older cousins in respect to which form of expenditure it causes. Its name certainly suggests that it does not, and so does the fact that the Fund’s legal foundations, just as those of the ERDF, lie in the EC Treaty’s Title XIV, ‘Economic and Social Cohesion’. Where the Cohesion Fund does vary from the Structural Funds is in its focus, since its objective is to “provide Community financial contributions to projects in the fields of environment and trans-European networks in Member States with a per capita GNP of less than 90% of the Community average which have a programme leading to the fulfilment of the conditions of economic convergence as set out in Article 104c [EC Treaty]”. However, the additional condition of having to have a ‘convergence plan’, as well as the fact that the Fund targets Member States rather than sub-national regions and areas, are of no relevance to the current debate. This remains strictly limited to the question of whether or not the projects supported by the Cohesion Fund actually do address the Community’s economic and social cohesion. In other words the task is, once again, to find out whether the Fund’s allocations are aimed at investment or whether they are likely to go into consumption straight away.

In the search for an answer it appears necessary to look into the Council Regulation which set up the Cohesion Fund, first. It reiterates that the Fund’s scope is “to provide

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21 The FIFG is, after all, also based on the CAP provisions of the EC Treaty. See: Council Regulation (EEC) No 2080/93 1.
23 Art. 130d ECT.
24 Protocol on Economic and Social Cohesion.
financial contributions to projects, which contribute to achieving the objectives laid down in the Treaty on European Union, in the fields of the environment and trans-European transport infrastructure networks. More specifically this means that the Cohesion Fund supports "environmental projects contributing to the achievement of the objectives of Article 130r of the [EC] Treaty, ... [and] transport infrastructure projects of common interest, financed by the Member States, which are identified within the framework of the guidelines referred to in Article 129c of the [EC] Treaty. Whilst the latter "aim at promoting the interconnection and interoperability of national networks as well as access to such networks ... [and ] shall take account in particular of the need to link island, landlocked and peripheral regions with the central regions of the Community", the former consist of:

- preserving, protecting and improving the quality of the environment;
- protecting human health;
- prudent and rational utilisation of natural resources;
- promoting measures at international level to deal with regional or world-wide environmental problems.

Even though assistance may also be granted for consumptive measures, like preliminary studies related to eligible projects, or technical support measures such as comparative studies to assess the impact of Community assistance, they have to be seen as part of respective wider schemes that are themselves of an investitive nature. The construction of roads, railways airports and waterways, i.e. the building or upgrading of transport infrastructure, is one of the classic examples of investment. A more controversial case to argue seems to be that of linking environmental protection with investment. In the past, natural resources were treated as if they were inexhaustible with air and water, regarded as free goods, being taken for granted. Only over the past two or three decades have ecological and environmental considerations begun to enter economic thinking. The deterioration of air and water quality, as much as the realisation that nature's reserves in oil, coal, its metals and minerals, are going to run out at some point, do - of course - have an impact on the global economy. This impact is a negative one, as natural resources cannot be restored, and bad air and water quality gradually lead to a deterioration in human health, as well as causing substantial changes to the way nature at large functions.

27 Art. 3 (1) Council Regulation (EC) No 1164/94.
28 Art. 129b (2) ECT.
29 Art. 130r (1) ECT.
31 Since the SEA the EC is obliged to consider the environment in every policy it pursues. See: Art. 130r 2. ECT.
Consequently, investment in the environment is not so much about establishing something which itself creates an added value, but about limiting the damage already done, preventing more from happening, and ultimately maybe even turning the trend around. If this explanation is accepted, then the Cohesion Fund - just like the Structural Funds - allocates the bulk of its financial contributions to be used for investment, rather than consumption.

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**Figure 8: Growth of GDP per Head in the Cohesion Countries**

1983-95

<table>
<thead>
<tr>
<th></th>
<th>GR</th>
<th>E</th>
<th>IRL</th>
<th>P</th>
<th>EUR4</th>
<th>EUR11</th>
<th>EUR15</th>
</tr>
</thead>
<tbody>
<tr>
<td>Growth rate</td>
<td>1983-1993</td>
<td>1.8</td>
<td>3.0</td>
<td>3.9</td>
<td>2.8</td>
<td>2.9</td>
<td>2.4</td>
</tr>
<tr>
<td>in GDP (%)</td>
<td>1983-1995</td>
<td>1.8</td>
<td>3.0</td>
<td>4.5</td>
<td>2.6</td>
<td>2.8</td>
<td>2.4</td>
</tr>
<tr>
<td>Annual population</td>
<td>1983-1993</td>
<td>0.5</td>
<td>0.2</td>
<td>0.2</td>
<td>0.0</td>
<td>0.2</td>
<td>0.4</td>
</tr>
<tr>
<td>growth (%)</td>
<td>1983-1995</td>
<td>0.5</td>
<td>0.2</td>
<td>0.2</td>
<td>0.0</td>
<td>0.2</td>
<td>0.8</td>
</tr>
<tr>
<td>GDP per head (PPS)</td>
<td>1983</td>
<td>61.9</td>
<td>70.5</td>
<td>63.6</td>
<td>55.1</td>
<td>66.2</td>
<td>107.4</td>
</tr>
<tr>
<td>EUR15=100</td>
<td>1988</td>
<td>59.6</td>
<td>72.4</td>
<td>65.0</td>
<td>56.5</td>
<td>67.4</td>
<td>107.2</td>
</tr>
<tr>
<td></td>
<td>1993</td>
<td>64.5</td>
<td>77.8</td>
<td>80.2</td>
<td>68.2</td>
<td>74.2</td>
<td>105.3</td>
</tr>
<tr>
<td></td>
<td>1995</td>
<td>64.3</td>
<td>76.2</td>
<td>89.9</td>
<td>68.4</td>
<td>73.8</td>
<td>105.4</td>
</tr>
</tbody>
</table>

So the instruments with which the EC works towards achieving its constitutional goal of strengthening the Community’s economic and social cohesion look as if they were capable of actually doing just that. The Commission’s first Cohesion Report identifies a substantial improvement of the relative position of the four ‘Cohesion countries’, Greece, Ireland, Portugal and Spain. As Figure 8 serves to demonstrate, the GDP per head in these Member States increased from 66.2% of the EU average in 1983 to 74.2% in 1993. However, the good news, that income discrepancies among Member States have begun to decrease, is somewhat overshadowed by the realisation that a similar trend is not taking place when comparing the development of the income gaps between the individual regions in the European Union. Here, not much progress has been made at all.

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Figure 9: Regional Disparities in the EU
Income, productivity and unemployment in 1983 and 1993

<table>
<thead>
<tr>
<th></th>
<th>GDP per head (PPS, EUR15=100)</th>
<th>GDP per person unemployed (EUR15=100)</th>
<th>Unemployment (% labour force)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Between Member States</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Best-off</td>
<td>134.8</td>
<td>160.1</td>
<td>124.2</td>
</tr>
<tr>
<td>Worst-off</td>
<td>55.1</td>
<td>63.2</td>
<td>51.3</td>
</tr>
<tr>
<td>Best-off/Worst-off*</td>
<td>2.4</td>
<td>2.5</td>
<td>2.4</td>
</tr>
<tr>
<td><strong>Between Regions</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Best-off</td>
<td>184.0</td>
<td>189.0</td>
<td>398.0</td>
</tr>
<tr>
<td>Worst-off</td>
<td>39.0</td>
<td>37.0</td>
<td>32.1</td>
</tr>
<tr>
<td>Best-off/Worst-off*</td>
<td>5.0</td>
<td>4.5</td>
<td>12.4</td>
</tr>
<tr>
<td>10 Best-off</td>
<td>154.0</td>
<td>158.0</td>
<td>146.0</td>
</tr>
<tr>
<td>10 Worst-off</td>
<td>44.0</td>
<td>48.0</td>
<td>49.4</td>
</tr>
<tr>
<td>10 Best-off/Worst-off*</td>
<td>3.2</td>
<td>3.1</td>
<td>3.0</td>
</tr>
<tr>
<td>25 Best-off</td>
<td>140.0</td>
<td>142.0</td>
<td>131.3</td>
</tr>
<tr>
<td>25 Worst-off</td>
<td>53.0</td>
<td>55.0</td>
<td>63.3</td>
</tr>
<tr>
<td>25 Best-off/Worst-off*</td>
<td>2.5</td>
<td>2.5</td>
<td>2.1</td>
</tr>
</tbody>
</table>

* For unemployment, highest unemployment rate/lowest unemployment rate

Figure 9 shows that the ten worst-off regions improved their per capita GDP from 44% in 1983 to 48% ten years later, but at the same time the ten best-off regions also bettered their GDP per head during this period, from 154% to 158%. Similarly, the 25 worst-off regions managed to increase their respective per capita GDP figures from 53% in 1983 to 55% in 1993, whilst their 25 best-off counterparts also improved their GDP per head from 140% to 142% during the same time.

The apparent contradiction between the two observations just made, the reduction in income discrepancies among the Member States on the one hand, yet the relative lack of progress as far as the reduction of income gaps between the Union’s regions is concerned, allows for only one conclusion: namely that “[m]ost of the growth in the poorer countries have been centred around those countries’ richer areas.” In other words, the gap between the richest and poorest regions remains almost unchanged. The question that needs to be asked at this point is though, why there has not been more progress in this

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After all, the assumption of the current examination is that investment, to which the EU’s Structural Funds and its Cohesion Fund all contribute, ought to lead to economic growth, which in turn should narrow the gaps between the richer and the poorer regions.

Well, this is where the dynamic nature of economic integration returns to the debate. Apart from the general economic climate in which regional policies operate, the richer areas usually produce enough income to finance their own investments, whereas the poorer areas do not. Quite to the contrary, some of them actually have higher-than-average expenditures of a consumptive nature, due to high levels of unemployment. This is why, in the absence of regional policy intervention, the poorest of the regions would be falling behind even further. The reason why the EU’s efforts at strengthening its economic and social cohesion have not been more successful has to do with the volume of structural assistance, rather than a lack in the efficiency of the Union’s five respective funds. The fact that the poorest regions have been prevented from falling behind even further indicates that the EU’s regional policies did have a positive effect on cohesion. In order to enter ‘positive territory’, i.e. for the Structural Funds and the Cohesion Fund to narrow regional income disparities, a quantitative improvement of the Union’s regional instruments would be required.

Having established that all of the EC’s regional instruments - at least in principle - fund investment projects, the next step is to examine the financial equalisation scheme between the German Länder, and to find out whether its redistribution also goes mainly into investment, or whether it is spent mostly on consumptive measures. A first answer to this question is found quickly, but it is not a satisfying one. The problem lies in the nature of horizontal equalisation. As discussed in more detail in Section 4.1., the equalisation scheme represents what could be described as ‘solidarity with no strings attached’. In other words, the money reallocated through the equalisation scheme is in no way earmarked for any specific purpose and thus enters the balance sheets of the poorer Länder in more or less the same manner as their own, directly raised, revenues from taxation. This, however, not only means that the recipient Länder are free to spend the additional income whichever way they like - the fact that these allocations ‘submerge’ in their budgets also means that the extra revenue from horizontal equalisation cannot be directly linked to any specific expenditure.

36 The early 1990s were marked by recession, with a real reduction in output in 1993, and an increase in unemployment to 11% of the workforce - all of which does not create the ideal circumstance for a reduction in interregional disparities. See: EU, Commission, Fifth Periodic Report on the Social and Economic Situation and Development of the Regions of the Community, COM(94) 322 final 19 July 1994.
So, if it cannot be positively proven whether financial equalisation allocations are being spent on investment or consumption, at least a negative test shall be tried in an attempt to bring more clarity to the issue. What is meant by the term ‘negative test’ is best explained by looking at Karl Popper’s idea of ‘verification through falsification’. In its original context, this approach deals with the issue of truth. Popper’s argument is that verifying truth would require infinite evidence which, naturally, is impossible to gather. Consequently, the best that can be done is eliminating what can definitely be established as false, and close up on the truth that way.\(^3\)7 Adapted to the current debate this means that, as positive proof cannot be found to establish how equalisation allocations are being spent, an alternative method might be to look at other data and try to trace back a link between financial equalisation and investitive spending. So what needs to be done - instead of looking at what causes certain outcomes - is to investigate how such results may have come about.

The closest starting point for this test is the expenditure side of the Länder’s balance sheets and there, to be more precise, their investitive spending. The question that arises though is whether it is at all possible to dissect this budgetary item to the extent that after subtracting all identifiable sources the remainder can be safely said to have been paid for - exclusively - by allocations from financial equalisation. Not surprisingly, the answer has to be ‘no’. The only links that can be established are for investment projects totally or partly funded by external sources, such as vertical allocations from the federal level for structural projects in the Länder, because they are what can be called ‘passing items’ in the budgets concerned.

If it cannot be established, neither directly nor indirectly, how money from financial equalisation is being spent, the focus of the present testing has to be altered. The argument throughout this chapter, and indeed the whole of the thesis, is that investment has the potential to reduce regional disparities, whilst consumptive spending has no effect on them. In respect to the current investigation this means that investitive spending should have begun to narrow the income differences amongst the Länder, whereas spending on consumption would have had no effect on the disparities between them. Accepting the validity of the negative testing method (as a means to show a general trend only), one way of finding out whether equalisation actually achieves what it supposedly stands for - namely a gradual reduction in, and eventual elimination of, the existing income gaps between the German Länder - is to look at the volume of redistribution under the horizontal equalisation scheme over time. A narrowing of the inter-Länder disparities

\(^3\)7 This is, of course, a very simplistic summary of an elaborate philosophical concept. For further reading, see: T.E. Burke, *The Philosophy of Popper* (Manchester: Manchester University Press, 1983) 82-131.
should be indicated by a gradual decline in volume of horizontal redistribution, and vice versa.38

The danger the chosen approach carries is that it is rather simplistic. A number of considerations has to be borne in mind. To start with, all of the Länder have various ‘fixed commitments’ to investment which would have to be honoured even if the Land in question ceased to be a recipient from the equalisation mechanism. Such schemes include their own long-term investment projects, as well as any Land’s fifty per cent stake in undertakings co-financed by the Federation under the auspices of the Joint-Tasks. Furthermore, another serious difficulty the present test faces comes in the form of the above mentioned structural aid from the federal level. The dilemma they all cause for the present examination is that they aim at reducing regional disparities, and thus directly distort the very picture that should produce an idea as to whether financial equalisation does or does not go into investment. In the end, however, all this is of no relevance whatsoever, since the test clearly reveals that income gaps between the German Länder have not at all been closed - quite to the contrary.

In order to get a good picture of the results financial equalisation produces, it appears best to look at the period 1970 to 1989, and therewith the former western German Länder only.39 This particular time span was chosen because it represents an era of relative little constitutional change, beginning just after the 1969 grand financial reform and ending with the year before unification. Figure 10 shows that the nominal volume of horizontal redistribution between the - then ten - West German Länder almost trebled in the twenty years between 1970 and 1989, from DM 1.2 billion to DM 3.5 billion respectively. But these figures are deceptive since they ignore the multiplying effects brought about by inflation. In order to be able to really compare the annual transfers, it becomes necessary to bring them all onto the price level of one chosen reference year - 1991 in the current example.40 Only by putting all amounts involved onto an equal footing is it possible to conduct the kind of examination required here.

38 Again it has to be stressed that such a test can only produce a general trend. The rules governing the horizontal equalisation mechanism were changed several times over the four decades before unification, and even though many of those alterations applied equally to all of the participants, others, such as the city-state weighting and the incorporation into the system of Lower-Saxony’s mining levy, did not.
39 The five eastern Länder and Berlin, which had always been a special case due to its particular political status, only joined the equalisation mechanism in 1995, and thus cannot be part of the current examination.
40 For the purpose of the present study it is of no importance which year is chosen for this kind of calculation. The year 1991 was used for reasons to do with access to the required data.
The first noticeable impression, when looking at the development of the real transfers, is that they still grew between 1970 and 1989 by about DM 1 billion. This certainly corrects the rather exaggerated impression the development of the nominal transfers give. More importantly, however, is that the real transfers do not simply shadow, on a lower scale, the gradual increase of nominal transfers over the years. A closer look at the annual amounts transferred in real terms reveals that it may even be wrong to talk of a trend at all. Whilst yearly transfers range between DM 2.6 billion and just under DM 3.8 billion,

these amounts only seem to represent the lower and upper limit of overall transfers for the time period looked at. If anything, short to medium term cycles in the development of the real transfers between the ten Länder could be identified.

Whatever the reasons for the fluctuations between the overall annual transfers, the crucial observation must be that the volume of financial exchanges between the West German Länder has not yet come down. And this should prove that income disparities between the Länder have not been reduced. In accordance with what has been said earlier, it thus has to be concluded that allocations from financial equalisation will most probably not have gone into investitive spending.

This result should hardly come as a surprise. Even though additional income from horizontal equalisation naturally gives the governments of the Länder in question more room for manoeuvre in how to spend their resources, there is very little reason to assume that this should automatically lead to an increase in their expenditure on investment. If anything, the contrary has to be expected. The principal justification for being a recipient from the equalisation mechanism is a Land’s comparative lack in per capita income. However - and this is, of course, the main purpose of financial equalisation - the Länder all have to provide about the same level of public services in order to meet the constitutional objective of maintaining equal, if not uniform, living conditions. This, in turn, leads mainly to consumptive spending, as it goes into such budgetary items as social policy payments of which, and here the story turns full circle, the poorer Länder have higher per capita expenditures than their richer counterparts, due to the very reason that they are structurally weaker.

To thus conclude the present investigation, it can be noted that the EU’s regional policy instruments, the Structural Funds and the Cohesion Fund, all co-finance projects which in their overwhelming majority are of an investitive nature, something that cannot be said about the German system of financial equalisation. The latter reallocates finances with the only direct aim to top-up the coffers of the poorer Länder, and comes with no conditions attached as to how the money has to be spent. And a closer look at the way the mechanism operates, substantiated by the fact that income disparities between the Länder have so far failed to narrow, suggests that it is most likely that the bulk of finances received through equalisation is being spent on consumptive measures.
7.2 Efficiency versus Democracy

Having established the socio-economic effects of both, the EU’s regional policy instruments and the German financial equalisation scheme, the attention shall now turn to the decision-making processes behind these redistribution tools, and thus the political circumstances from which they derive. The backdrop to the current examination is, of course, the existence of at least two levels of government - or, in other words, a federal structure. As has been discussed at length in the earlier chapters of this study the EU, like the FRG, represents a union of states in which sovereignty is split between a central decision-making level, legislating on certain matters, and the governments of the constituent units, responsible for others. This, however, means that - unlike in a unitary state where all power is concentrated at the centre - there is the whole question of what shall be decided where. For each decision to be made the spectrum of possibilities ranges from exclusive legislative authority by the central level of government, to exclusive legislative power by the governments of the union’s members, with many forms of joint decision-making in between.

Whether decisions are being taken by the central authorities, by the constituent units, or by all of them is not simply a matter of constitutional principle. This thesis argues that a link exists between where decisions are made and the consequences of these decisions. In other words, the argument is that different decision-making processes lead to policies with different effects. For the field of regional policy the hypothesis is that centralised decision-making leads to more efficient results than can be expected from a situation in which each of the constituent units applies its own individual instruments. Reasons for that are relatively straightforward. A union-wide approach to reduce regional disparities means a pooling of resources, and (at the very least) bears the potential for a pin-pointed effort to tackle the most needy areas first. In contrast to that, individual policies will only aim to reduce regional disparities within each of the member states of any union of states. This, however, must be expected to not really address the disparities between them, since richer members are generally better equipped to afford investitative spending than their poorer counterparts. The downside to all this is, of course, that the farther away from the electorate decisions are taken, the less democratic they normally are expected to be. As has been argued in the introduction to this study, democracy can be looked at in a number of ways but, in accordance with the principle of subsidiarity, one aspect certainly is the question of proximity to the voter.

42 There are sub-national regions, provinces, districts, communes, etc. in a number of the EU’s Member States which also have - to varying degrees - legislative authority on certain matters. This is of no real relevance to the thesis though, and shall thus only be pointed out, but not discussed, here.
Hence, the trade-off in the selection of regional policies is between those which are likely to lead to more efficient results and others that are apparently more democratic. Deriving directly from the question of where regional policy decisions are taken the imaginary scale on which the various options for legislative authority are plotted along, ranging from the exclusive right to legislate by the central authorities to individual decision-making power by a union’s constituent units, can be paralleled by a second scale that shows the range of qualitative effects respective policies are likely to have.

\[ \text{Figure 11: Federal Decision-Making and Its General Effects} \]

<table>
<thead>
<tr>
<th>‘Degree of Centralisation’</th>
<th>Totally Centralised</th>
<th>↔</th>
<th>Completely Decentralised</th>
</tr>
</thead>
<tbody>
<tr>
<td>Decision-Maker(s)</td>
<td>Central Authority</td>
<td>↔</td>
<td>The Constituent Units</td>
</tr>
<tr>
<td>Principal Expected Effect</td>
<td>High Level of Efficiency</td>
<td>↔</td>
<td>More Democracy</td>
</tr>
</tbody>
</table>

Figure 11 aims to demonstrate a very general link only and thus concentrates on the extreme ends of the two scales just mentioned. The various options which exist between the two extremes are not shown, mainly because joint decision-making by the two levels of government can take many forms, and can itself range from being dominated by one level, via complete equality of both levels, to domination by the other level. In accordance with what has been said above, and which is the general idea Figure 11 attempts to convey, policies resulting from joint decision-making will either have a stronger emphasis on efficiency, or tend to favour the issue of more democracy.

The bulk of decisions taken in federations and other unions of states actually does involve both levels of government. This is true in particular for such federal entities as the two studied here, the European Union and the FRG. They both represent the branch of federalism, in earlier chapters referred to as ‘co-operative federalism’, that has at its core the representation of the union’s members at federal level in the form of the Federal Council (Bundesrat) in Germany, and the Council of the European Union in the EU. Even though these councils are, of course, institutions which are part of the central level of government, they nevertheless do represent the governments of the constituent units. In principle this does not equal joint decision-making between a union’s central decision-makers and its members, but in practice it amounts to very much the same. The question that imposes itself next then is, where on the two scales debated above can the EC’s regional Funds and the German system of financial equalisation be found. As will be seen in the following, the answers are not as straightforward as the simplified scales of Figure 184.
suggest. In contrast to Section 7.1., the examination of the regional instruments studied in this thesis will begin with a look at the German financial equalisation mechanism.

As discussed at length in Chapter Four, horizontal financial equalisation is - as its name strongly suggests - performed exclusively by the German Länder. In other words, the federal level is not involved in the direct redistribution of revenues from the better-off Länder to their less wealthy counterparts. This does not, however, mean that the federal Parliament has no say at all in the way the mechanism functions. The history of financial equalisation in the FRG has shown that in the absence of a ‘higher authority’, i.e. respective constitutional provisions or federal legislation, the Länder would have found it nearly impossible to agree on an equalisation scheme in the first place. Due to the virtual monopoly to raise taxes by the federal level of government, the Länder also have to engage in negotiations with the decision-makers in Bonn if they want to alter the overall volume of revenues from which equalisation is conducted. All this notwithstanding though, the equalisation mechanism as such takes place without any intervention by the federal authorities and, equally as important to the current discussion, the recipient Länder can decide for themselves, individually, over how to spend the money they receive from the scheme.

As an example of regional redistribution performed exclusively by the constituent units of the FRG, horizontal equalisation definitely represents an instrument of, what could be called, a ‘subsidiaristic nature’. Subsidiarity, however, is not about decentralising decision-making per se, but represents a principle that advocates decision-making as closely to the citizen as possible unless a ‘higher’ level of government can be expected to produce a better result. In the current efficiency versus democracy debate the crucial question thus is what exactly must be expected to be the outcome of financial equalisation in Germany. The Basic Law refers to ensuring a reasonable equalisation of the financial capacity of the Länder, and this the mechanism by and large achieves. Though as far as the subject of the current investigation, the reduction in regional disparities, is concerned, the German scheme does not deliver - as has just been seen in Section 7.1. The failure to narrow the income gaps between the German Länder is a direct result of the fact that in the absence of any discipline imposed by a central institution the Länder would not have managed even to agree on the equalisation mechanism in place today, let alone on any measures requiring investitive spending and thus going beyond the mere nominal balancing of the books that horizontal equalisation stands for. Hence the German

\[43\] Art. 107 (2) GG.

\[44\] See Section 5.1 for more details on the failure of the Länder to agree on a financial equalisation scheme before the Basic Law came into force.
Finanzausgleich shows nicely that the trade-off between efficiency on the one hand and more democracy on the other really does exist: the decentralised decision-making leads to sub-optimal outcomes as far as the efficiency to reduce regional disparities is concerned. The next query thus is, whether this holds true also the other way around. For this to find out, the EC’s Structural Funds shall be examined in terms of where decisions are taken and how efficient their results are.

In contrast to the financial equalisation scheme operated amongst the German Länder, the Structural Funds are decided upon and administered centrally, by the European Community. The fact that within the decision-making structures of the EC the Council holds a dominant position, and therewith indirectly the Member States, does not matter. The importance lies in the difference between collective and individual decision-making. Whilst the German system of financial equalisation is handled by the Länder individually (admittedly under the auspices of a constitutional framework), the Structural Funds are a clear example of centralised legislation, binding in the entire Union. Just as the German equalisation mechanism functions in a wider framework that requires elements of centralised decision-making, the Structural Funds do give some say to the sub-national areas and regions they support. This notwithstanding their role is, nevertheless, a very restricted one since it is limited to proposing structural projects and, in the case of a successful bid, to co-finance them. The principal decisions, as to how much is spent for what purposes and where, are taken by the Community’s authorities. This makes the Structural Funds the perfect antidote to the German system of financial equalisation.

Whereas the latter leaves the redistribution, as well as the questions as to which use allocations from the scheme are going to go into, to the individual Länder, the former contain strict rules, decided upon at central level, and applying to the Union as a whole, about how much money is used for which purposes. To highlight the difference more clearly, the German system primarily equalises financial imbalances, whilst the Structural Funds attempt to reduce structural disparities which are - of course - the underlying problem that brings about the use of regional policies in the first place.

So the Structural Funds do represent the other extreme shown in Figure 11. Due to their highly centralised nature, the Funds’ rules apply to the entirety of the EU, yet only target those regions (and social groups) that have been identified as particularly needy in order to have a real impact on the welfare discrepancies within the Union. Moreover, there is next to no room for manoeuvre as to how money allocated from the Funds can be spent, other than the original choice of whether or not to apply for financial support from the

\[45\] Some of the Structural Funds, so for instance the ESF, leave to the Member States more room for manoeuvre as to exactly where to spend their financial allocations than, say, the ERDF. Nevertheless, the Member States still have to adhere to the often strict parameters set by the EC.
respective schemes on offer. As has been shown in Section 7.1., the bulk of allocations from the Structural Funds are aimed at investitive projects, and with this in mind it has to be concluded that - in principle - these regional instruments at the EC's disposal do represent a rather efficient tool in the pursuit of strengthening the Community's economic and social cohesion. On the negative side of the balance stands the fact that the decisions on structural aid are being taken quite far away from the small, often not just sub-national, but mostly sub-regional areas.

All this appears rather simple and straightforward, in particular since it seems to prove so easily the predictions made in Figure 11 to be correct. The question that imposes itself though is whether not decentralised decision-making could (be made to) also produce more efficient results, or - in correspondence with the principle of subsidiarity - centralised schemes could leave more room for manoeuvre for decision-makers closer to the citizen. A dose of the former can be found in the German system of financial equalisation in the way that without any involvement of a central authority even this nominal mechanism would probably not have come about. A measure of the latter, and at that a better contestant for an example of how to combine elements of both efficiency and more democracy, is the EU's Cohesion Fund. Even though the broad decisions, concerning its main objectives, the general scope and financial volume, as well as the principal criteria as to who qualifies for support from the Fund, are taken by the EC, there is plenty of room for individual decision-making left for the recipient Member States.46

It is this separation of responsibilities between the central level of government and the constituent members of a union of states which has led this thesis to argue that the Cohesion Fund is a cross-breed between the EC's centralised Structural Funds and the FRG's decentralised horizontal financial equalisation scheme. The goal of efficiency is being upheld by the union-wide application of the Fund's rules, as well as the commitment to investitive spending. Meanwhile the objective of taking decisions more closely to the citizens is being fulfilled by leaving it up to the recipient Member States to exactly how, within the general framework of the Cohesion Fund regulations, they can spend the money that is being set aside for them. This closer proximity to the voter arguably makes the Cohesion Fund, in at least one respect, a more democratic instrument than the Structural Funds.

A stronger indication that the Cohesion Fund is as much related to financial equalisation as it is to structural policies is its link to EMU and the fulfilment of the convergence criteria imposed upon the Member States in the run-up to it by the TEU. Although

46 See Section 4.3.
convergence and cohesion are linked to one another, the two concepts do represent rather different approaches. Whilst the latter refers to the *structural situation* within the EU, the former stands for a *nominal trend* in some key economic indicators. Apart from also aiding the strengthening of the Union’s economic and social cohesion, the Cohesion Fund was more immediately designed to relieve the poorest Member States of some of the harsh fiscal pressures brought upon them by the convergence criteria of the Maastricht Treaty. It is this ‘helping hand’ for those who, due to their original structural weakness, find it most difficult to catch up with their richer counterparts that makes the Cohesion Fund somewhat remnant of the German equalisation mechanism.

This thought may be a rather daring one because it, admittedly, encourages to find more disagreement than agreement between the two schemes. The German equalisation mechanism is an almost absolute one, as far as nominal (per capita) financial equalisation is concerned, but there are no strings attached in terms of how the money received from it has to be spent. In contrast to this, the Cohesion Fund is of a comparatively small size, and has to be spent on projects to do with transport infrastructure and/or the environment. All this notwithstanding though, the Cohesion Fund must be regarded as marking a departure for the EC away from the (potentially) highly efficient, but not-so-democratic, Structural Funds into the direction of more democratic regional policy tools, which nevertheless come at the price of reduced efficiency. The question only is, whether this development is likely to continue, and if so how far towards a German-style equalisation mechanism the Union is prepared to go. Despite the good news such a trend would provide for democracy within the EU, there would be cause for concern as to the impact such a trend would have on the efficiency of the Union’s regional policies and eventually therewith its regional disparities. As has been argued over and again throughout this study, the answer to all this lies with the circumstances under which decisions are taken. To this end the following section will widen the focus of the current debate to the most fundamental dilemma of the federal principle, the attempt to somehow reconcile the two opposing concepts of unity and diversity.

7.3 *Pluralism versus Equality*

As has been seen above, one of the key elements of federalism is that, due to its very nature of dividing sovereignty between at least two levels of government, each time decisions have to be taken the question is *where* they should be taken - something unitary states do not have to worry about. Even though each individual policy may undergo the ‘efficiency versus democracy test’, which is nothing else than applying the principle of
subsidiarity, this is itself influenced also by the general degree of centralisation of the federal entity in question. Federal entities come in all shapes and forms, and the range extends from highly integrated federations, in which the overwhelming majority of decisions is being taken at central level, to the loosest, and thus most decentralised, of unions of states where the constituent units still have the bulk of legislative authority to themselves. The degree to which decision-making in a federal union either takes place at the centre, or remains the domain of its members, is not simply determined by summing up where individual policies are being decided upon (according to respective constitutional rules), but also by what could be called its general political culture. In this respect it can be said that a reciprocal relationship exists within a federal entity between where decisions are being taken, and its overall degree of centralisation.

With the delicate balancing act of having to combine the rather irreconcilable goals of unity and diversity, federal unions can - on the whole - be divided into two broad groupings. There are those in which notions of more equality, supporting the unity aspect of federalism, dominate over the desire to maintain a certain degree of pluralism, and thus diversity, and there are others in which the balance of priorities is the other way around. The two unions of states studied in this thesis each represent one of the above groupings. The FRG, for instance, is generally seen as putting a stronger emphasis on equality which is not least reflected by the constitutional objective of maintaining equivalent, if not uniform, living conditions throughout its territory. As discussed in earlier chapters, the FRG began its existence as an already highly integrated federation. This was guided not only by the belief of a majority of its leaders that a strong federal state, rather than a weak union of German Länder, would be the best way of defending their new country against foreign threats in general, and the fear that the Soviet Union might want to extend its domination westward in particular. The German tradition of federalism has always been distinct from its Anglo-Saxon counterpart which promotes the clear separation of governmental rights and duties between the vertical levels of government, earning it the description 'dual federalism'. As Renzsch so aptly remarks,

[the rationality of American federalism is the independence of the individual States. The rationality of German federalism, however, is not that of the 'dual state' but the postulate of the Basic Law of 'uniformity of living conditions'. ... The history of German federalism is based on the functional division of competences. Though historically the Reich, and later the federation, took over more and more legislative power, the execution of Reich and federal legislation respectively remained in their majority the task of the territorially structured all-responsible administration that was and is provided by the Länder and local authorities. The governmental levels each execute their tasks individually for themselves only in a minority of cases. The rule is rather the co-operation between Bund and Länder, the combined governing of the

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two levels. Efficiency and uniformity within the federation are the principal justifications for this procedure, the ‘unitary federal state’ the result.\(^47\)

In contrast to the FRG, with its rather centralised structures and its equality culture, the European Union is still a decentralised union of states in which the majority of decisions are being taken in its constituent units rather than by its communal institutions. Even at central level, decision-making is ultimately dominated by the Council of the European Union, and therewith - indirectly - by the Member States. All this is of course due to - among other things - the fact that European (political) integration only began in the 1950s, whereas Germany had been a unified nation since 1871. As has been discussed in Chapter Two, the situation in western Europe after World War II was more like the one in post-Napoleonic Germany, as far as willingness (or indeed reluctance) to co-operate amongst sovereign states was concerned. As a consequence it can be said that the EU at present not only accepts, but positively welcomes, a degree of diversity amongst its Member States. In other words, and in contrast to the FRG, the European Union prefers pluralism over equality. This is reflected by the adoption in the Maastricht Treaty of the concept of subsidiarity as a (quasi) constitutional principle. All this notwithstanding the EU, like the FRG, is a union of states belonging to the broad grouping of ‘dual federalisms’. It should thus be hardly surprising that, just as has been happening in the FRG over the more than four decades since it was set up, the Union is gradually taking over more and more responsibilities from its Member States and, where they exist, their lower levels of government.

In the light of what has been said about respective regional policies in Germany and the EU in the previous two sections of this chapter, the current debate so far must be rather confusing, given that it is the apparently egalitarian FRG in which a subsidiaristic principle of horizontal equalisation is at work, and that more centralised instruments, such as the Structural Funds and the Cohesion Fund, are employed by the supposedly pluralistic European Union. Far from being a mystery, though, this realisation represents a first clue

to an explanation of how federalism actually manages to reconcile the irreconcilable - i.e. how, in a federal entity, equality and pluralism may be mutually exclusive, yet also seem to complement each other. In simple terms, it seems that the more integrated a federal entity is, the more 'subsidiaristic' its regional policies have to be, and the more disintegrated an entity, the more it can allow itself to have regional policy instruments that are decided upon and administered at the centre. This way a balance is being struck in the equality-versus-pluralism dilemma.

Far from being that simple though, such outcomes depend - in reality - on a complicated combination of circumstances in a union of states, so for instance the overall degree of integration, the constitutional objectives secondary legislation has to meet, and the relative position of the governmental levels in the federal decision-making processes - not to mention the political composition of the legislative bodies in charge at any given time. All these elements are strongly interlinked, and that makes it difficult to discuss them separately. Therefore the best way forward in the present discussion appears to be to turn to the two entities studied here, and see how the regional policy instruments perform the difficult balancing act between pluralism and equality.

The horizontal exchange scheme in Germany, for instance, leads to the *de facto* equalisation of the Länder's finances which, in other words, means the mechanism creates more or less complete equality in the per capita strengths of the German Länder. At the same time the country's federal structure requires also the maintaining of pluralism and, in the case of financial equalisation, this is achieved by using the principle of subsidiarity which leaves it to the recipient Länder to decide over how to use the revenues they get from the horizontal mechanism. The constitutional requirement to ensure (at least) equivalent living conditions throughout the federation, then, makes certain that those structurally weaker Länder which benefit from equalisation will need most, if not all, of their additional income for consumptive, rather than investitive spending, as explained in more detail in Section 7.1. As a result, the *structural* diversity within the FRG is not being seriously challenged by financial equalisation.

The German experience with financial equalisation seems to show nicely how, in a federal entity, pluralism and equality can actually coexist. The same should therefore hold true for the EU, and it does, but it does so in a different way - and that requires some explanation. The key realisation in identifying the differences between financial equalisation and - for the moment - the EU's Structural Funds is that, despite the differences in their degrees of centralisation, the Union and the FRG are nevertheless both unions of states to which the principles of federalism apply. They have in common also a tendency to move towards
even further centralisation, and that means that - ultimately - the notions of equality and pluralism do not have quite the same standing. While equality may be argued to be needed, pluralism could be said to be wanted. With a trend towards more and more centralised decision-making, and therewith towards more equality, the objective of maintaining a degree of pluralism could, then, almost be said to amount (or be reduced) to an exercise of 'damage limitation'. Which objective is given precedence over the other is, however, mainly decided by who dominates the political and legislative processes in the entity in question, the centre or the constituent units.

Financial equalisation in Germany may simultaneously create equality and preserve pluralism, but a closer look at the earlier analysis reveals that equality and pluralism apply to different issues, and that the equality aspect does not really fall into the subject area discussed here: the reduction of regional disparities. As has been seen earlier in this chapter, the German horizontal mechanism is an unsuitable tool to this end. In contrast to all this, the EU's Structural Funds and its Cohesion Fund serve the constitutional goal of strengthening the EC's economic and social cohesion. Since they have been proven to be potentially more efficient than the financial equalisation scheme, they can therefore be said to directly aim at more equality. The reason why they do not really achieve it has a different root: the fact that decision-making in the EU is still dominated by the Member States.

In very much the same way as the German Länder would have found it very difficult (to say the least), had not the federal constitution obliged them to do so, to agree on the comprehensive exchange of finances their horizontal scheme represents, it is at present inconceivable that, in the absence of any such centralising force, the EU's Member States could ever decide on anything remotely amounting to financial equalisation. The way in which even the EU's own budget is still frequently being divided, by commentators and national decision-makers alike, into which members are net contributors and which ones are net recipients, underlines - once again - that the EU is still dominated by its Member States and their preference for diversity within the Union. In contrast to the FRG, where financial equalisation represents a remarkable display of solidarity, the EU can politically afford a structural policy, because it is limited in size. After all, its task is to strengthen the EC's economic and social cohesion, and not to eradicate completely the regional

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48 They also both have recently experienced attempts to not only stop the centralization trend, but even to reverse it.

49 In a federal entity in which the overall tendency is to decentralize, such as Belgium, the above should apply the other way around, i.e. a greater desire for pluralism, with the knowledge that certain aspects of equality need to be maintained. The reference to damage limitation would thus apply to the equality aspect, rather than the pluralism element, there.

50 See Sections 7.1. and 7.2..
divisions which exist between and within the Member States. This is where the difference between simultaneously achieving degrees of pluralism and equality in Germany and the EU lies. Whilst in the former equality and pluralism apply to different aspects of regional disparities, the combination of the two aims are an integral part of, at least, the Union’s Structural Funds. The role played by the Cohesion Fund is not quite so straightforward.

As has been argued before, this thesis regards the Cohesion Fund as an instrument which contains a combination of characteristics from both, financial equalisation and structural policy, and as such represents a cross-breed between these two distinct approaches. In accordance with what has been established so far, this should thus mean that the Fund also manages to simultaneously achieve degrees of equality and pluralism. The question of interest is, how this is achieved: by addressing the two aims for different aspects of disparities, like the German mechanism of financial equalisation does, or by directly preventing equality through quantitative restriction, such as is the case with the Structural Funds. The answer is, not surprisingly, a bit of both. A good way of approaching a more satisfactory response, though, seems to be to look - once again - at the constitutional objectives served by the regional policy tool in question. The Cohesion Fund, as its name suggests, and just like the Structural Funds, has its roots in Title XIV of the EC Treaty, ‘Economic and Social Cohesion’. However, Article 130d only really specifies that the Fund’s general task should be “to provide a financial contribution to projects in the fields of environment and trans-European networks in the area of transport infrastructure.” For further clues of the nature of the Cohesion Fund, and its link to the Treaty’s objective of strengthening the Community’s economic and social cohesion, the Protocol on Economic and Social Cohesion, annexed to the TEU, has to be looked at. It specifies that the above mentioned financial contributions shall be provided for projects “in Member States with a per capita GNP of less than 90% of the Community average which have a programme leading to the fulfilment of the conditions of economic convergence as set out in Article 104c” of the EC Treaty.

The conditions laid down in the Protocol are the ones that indicate resemblances with the German redistribution system of financial equalisation. Whilst - as has been seen in Section 4.3. - the main procedures of the Cohesion Fund still very much resemble those of the Structural Funds, the departure from the principles of the latter, and the ERDF in particular, is clear to see: the Cohesion Fund’s territorial targets are not the needy sub-national regions, or even sub-regional areas, but the poor Member States, just as it is those Länder in Germany with less than average revenues that benefit from financial equalisation. Less obvious - as a link between the Cohesion Fund and the German mechanism - is the requirement of having to work towards fulfilling the convergence
criteria. Neither financial equalisation, nor the Structural Funds come with any such additional, and seemingly unrelated, condition. Only when looking at the reason underlying the issue of convergence does it become apparent what the ulterior motive behind the Cohesion Fund is: convergence is linked to the aim of meeting the requirements laid down in the TEU to qualify for membership of the proposed EMU from 1 January 1999.

At this point an explicit distinction needs to be made between fiscal and structural objectives. As has been seen above, financial equalisation in Germany aims at the former, whilst the EC’s Structural Funds, as their name unmistakably indicates, target the latter. The Cohesion Fund, however, combines elements of both. Its apparent goal is structural since it is one of the Community’s regional instruments supporting the strengthening of economic and social cohesion. This notwithstanding, the requirement to simultaneously achieve cohesion and convergence exposes the fiscal aspect supported by the Fund. The problem is that cohesion requires additional spending while convergence demands fiscal discipline. Just as is the case with the poorer German Länder, the structurally weaker Member States of the EU face a double strain on their budgets: how to work towards more equality with less-than-average financial means. The task of the Cohesion Fund is thus to support cohesion in a way that does not undermine the recipients’ attempts at meeting the convergence criteria. In this respect allocations from the Cohesion Fund are - at least to an extent - budgetary ‘prop-ups’ and as such are reminiscent of the way in which the wealthier Länder support their poorer counterparts through financial equalisation in Germany.

So the question that remains is what all this means for the simultaneous pursuit of equality and pluralism by the Cohesion Fund. In accordance with its nature as a hybrid between structural and fiscal measures, it has to be located somewhere in-between the positions taken by the Structural Funds and the German system of financial equalisation. Like the former, the Cohesion Fund does not aim to achieve regional equality, but aims to work towards it, and as such maintains a degree of structural pluralism at the same time. Since the Fund’s rules are relatively broad though, it can be said that it performs also an embryonic financial exchange, for it allows the recipient Member States more room of fiscal manoeuvre. However, unlike the German equalisation mechanism, which achieves nominal financial equality, but maintains structural diversity, the Cohesion Fund remains somewhere in the middle, meaning it goes some way towards equality, but maintains

51 Similar to the situation the poorer German Länder find themselves in, those EU Member States currently entitled to receive from the Cohesion Fund are marked by less-than-average income from taxation and related duties, resulting from not realising their full economic potential, yet higher-than-average social spending due to high levels of unemployment.
enough pluralism, not only in terms of the structural disparities between the EU’s Member States, but also as far as their general financial capacities are concerned. The Cohesion Fund therefore seems to embody the very desirable effect - at least within a union of states - of maintaining a degree of pluralism whilst simultaneously (at least potentially) working towards more equality.

7.4 Cohesion versus Financial Equalisation

The title of this thesis not only contains the study’s main aim, which is to look at the experience with financial equalisation in the Federal Republic of Germany in order to learn possible lessons for the way in which internal regional disparities are attempted to be reduced within the European Union. It also embodies the underlying assumption that within the Union a trend exists, away from Cohesion Policy, and towards some form of financial equalisation. The presence of such a development is imperative to the validity of a direct comparison between the German Finanzausgleich and the EU’s regional instruments as undertaken by the present study.

The assumption that the EU may be moving into the direction of financial equalisation is rooted primarily in the decision taken at Maastricht to depart from a single-track cohesion policy, as provided by the Structural Funds, and to open a second regional policy avenue by way of the new Cohesion Fund. Even though this new regional policy instrument was given less than 10% of the overall sum for regional and structural spending, the question must be asked why a new instrument, with quite significantly differing rules to those of the Structural Funds, was at all needed.

The key to an answer lies with the particular political situation the European Council found itself in at the time of the Maastricht negotiations. Whilst a majority of Member States - led by the, then still very much intact, Franco-German axis - was in favour of substantial progress towards both identified overall goals, EMU and political union, they found themselves opposed mainly by the British Prime Minister, John Major. He strongly disagreed with the most vital aspects of further integration and could only be won over on many issues by a number of substantial concessions. Major completely refused to accept any progress on the subject of more co-operation in the field of social policy, but did allow the other eleven Member States to sign an extra-Treaty Agreement on Social Policy. The British Prime Minister also secured an opt-out from stage three of EMU for his country, and successfully prevented too much progress for the Common Foreign and Security Policy, and the issue of Co-operation in Justice and Home Affairs. It is said to
have been his opposition to a substantial increase in the Communities’ supranational features which had led to the invention of the ‘three pillar approach’ in the first place, and which thus caused the intergovernmental character of the two non-Community pillars. Not surprising, then, that the UK negotiators should have been rather enthusiastic about incorporating the concept of subsidiarity into the revised EC Treaty.\textsuperscript{52}

Subsidiarity, however, was not only promoted by the UK for hope that this may help reverse the federalising trend. It was also embraced by many of the Union’s regions. Just like those Member States which had been demanding a more democratic European Union, many regions regarded subsidiarity not as a means to stop the process of federalisation, but as a way of strengthening it. The fallacy of the British approach was (and arguably still is) to equal federalisation with centralisation. This, however, is not necessarily so, and subsidiarity is actually meant - at least in theory - to prevent too much centralised decision-making from taking place in a federal union. As has been discussed elsewhere in this thesis, federalisation describes the process of either integrating formerly independent states into a union of states, or disintegrating a hitherto unitary state into a federation. In this respect it only describes the change from one system of government to another. Subsidiarity, on the other hand, is a major guiding principle of federalism, and it is this characteristic which makes British support for it seem so ironic: by promoting subsidiarity, the UK indirectly supports federalism.

The incorporation of the principle of subsidiarity into the EC Treaty is only one of the reasons behind the apparent shift in the EU’s regional policies, away from a centralised cohesion policy and into the direction of a German-style financial equalisation scheme. The other development at Maastricht of importance to this discussion is the increasing role played by sub-national levels of government, commonly referred to as ‘the regions’. Naturally their most influential representatives are the sub-national units of government from Member States which themselves have a federal structure. Only they have the political clout their dependent counterparts lack. At the time of the Maastricht negotiations the FRG was the only real federal Member State\textsuperscript{53}, hence the Länder were the only sub-national actors with a degree of political independence that put them in a position to influence decision-making even at Community level. This influence they used to push not only for the adoption of the principle of subsidiarity, but also for the setting


\textsuperscript{53} Since then Belgium has been turned into a fully-fledged federation (in 1993) and, in 1995, Austria became the Union’s third federal Member State.
up for a new institution, at EU level, to represent the Union’s ‘third level’ of government, the Committee of the Regions.\textsuperscript{54}

Summarising the above, it can be noted that both the UK and the German Länder wanted to bring to a halt the centralising trend which had accompanied each and every step towards further integration within the ECs so far. However, whilst the UK very much regarded integration and centralisation as merely two sides of the same coin, and therewith almost categorically opposed any further transfer of sovereignty, the Länder took a more flexible and pragmatic approach. They promoted subsidiarity not because they wanted to stop centralisation \textit{per se}, but because they wanted to keep control over matters that needed not to be decided at a ‘higher’ level of government, whilst maintaining a say over issues transferred from their direct sphere of influence to the Community institutions.

Whatever the particular reasons behind all this, it can be safely said that Maastricht must now be regarded as the point in the ECs’ history at which the hitherto accepted wisdom that integration and centralisation amounted to very much the same was challenged, and arguably even refuted. The problems which soon occurred over the ratification of the Maastricht Treaty only served to show a general desire, and thus the need, for the principle of subsidiarity to be applied wherever possible. One of the early signs of just that beginning to happen was an initiative by the Commission to withdraw 14, and amend a further six, measures of Community law. Furthermore, following the Edinburgh summit - at which the meaning of subsidiarity, as laid down in Art. 3b of the revised EEC Treaty, had been clarified - the Commission also began to substantially cut down on its role as an initiator of ECs legislation. The emphasis now was to avoid Community legislation where possible, and where needed to limit it to as general a legal framework as possible.\textsuperscript{55} In other words, the ‘new tendency’ within the, now, EU is not to stop integration, but to slow down centralisation. And the Cohesion Fund is a perfect reflection of this new

\textsuperscript{54} The Länder had realised that, by signing the SEA, the German federal government had not only transferred parts of its own sovereignty to the ECs, but also significantly cut into the already eroding sovereignty of the federation’s constituent units. However, since the SEA had to be ratified not only by the Bundestag, but also the Bundesrat, the Länder realised that they had a weapon with which to fight such transfers of power. Pro-European in their general conviction, the Länder did not want to derail the SEA, nor did they want to stop the integration process \textit{per se}. Their plight was, and still remains, to gain a say at EU level. To this end they decided, in 1990, to pass a resolution outlining their position on a federal structure for the European Union. See: BRD, Bundesrat, \textit{Beschlüß des Bundesrates zur Entschließung des Bundesrates zum föderativen Aufbau Europas im Rahmen der Politischen Union}, Drucksache 780/90 (Beschluß), 9 Nov. 1990. For a more detailed discussion of this point see: Charlie Jeffery, “Towards a ‘Third Level’ in Europe? The German Länder in the European Union,” \textit{Political Studies}, 44 (1996): 253-66.

\textsuperscript{55} For these points and a wider discussion of subsidiarity in the context of the European Communities, see: Andrew Duff, “Towards a Definition of Subsidiarity,” \textit{Subsidiarity Within the European Community}, ed. Andrew Duff (London: Federal Trust, 1993) 7-32.
approach. Instead of simply increasing the financial provisions of the highly centralised Structural Funds, the new instrument is designed to give the Member States a strong say in determining the detailed issues of where to invest respective allocations, whilst leaving to the Union only to decide on the Fund’s overall scope.

Despite all this, the issue of subsidiarity only partly, and therefore inadequately, explains the preference shown by the Maastricht Council for the adoption of a new Cohesion Fund over a simple increase in the finances of the established Structural Funds. The other reason, as has been discussed elsewhere in more detail, is that the Cohesion Fund is also linked to the EU’s plan to form an economic and monetary union. However, since this EMU is not just meant to consist of largely convergent member economies, but of members which have all low levels of inflation, a limited public debt, limited budget deficits and low interest rates, it is these restrictive convergence criteria which stand in direct contrast to the Union’s goal to strengthen its internal economic and social cohesion. Whilst the convergence criteria limit the Member States’ scope for spending, cohesion requires investment (spending) in the very countries which, due to their economic weakness, have least financial means to do so.

Section 7.3. already established that the Cohesion Fund contains elements of financial equalisation. These elements are - naturally - only rudimentary, and as such should not be interpreted as necessarily representing a trend. However, the departure away from purely structural cohesion measures to more ‘unattached’ fiscal transfers is by no means insignificant either. The need for financial assistance the Convergence Criteria indirectly exposes (and which the Protocol on Economic and Social Cohesion more directly acknowledges) has to be seen against the background of the general discussion over where within the EU’s multi-level system of government decisions should ideally be taken. The comparison between the German system of financial equalisation and the EU’s Structural Funds made at the beginning of Section 7.2. comes to the conclusion that federations with a high degree of centralised decision-making, such as Germany, almost need the horizontal redistribution scheme to serve the notion of subsidiarity, and to maintain some form of diversity between its constituent units. In very much the same way it was argued that loose unions of states, such as the EU, can afford a highly centralised and thus efficient regional policy because they are, in general terms, still not very integrated - and the small overall volume of redistribution ensures that their pluralistic nature is not seriously undermined.

This is where the current debate turns full circle. In the light of the earlier realisation that the Maastricht Treaty represents a turning point, as far as the ECs’ vertical division of
power is concerned, it seems that the creation of the Cohesion Fund is not just a reflection of the ‘new thinking’, but a direct product of it. The shift towards a regional policy instrument containing an element of more direct financial redistribution can be seen as indicating that the overall amount of regional spending has begun to exceed the level deemed ‘safe’ to have it all decided upon solely by the central level. It looks as if the time had come for a readjustment of the overall balance at EU level. In other words, it appears that demands for both more integration and more subsidiarity have led to a reassessment of the general (vertical) distribution of responsibilities.

Fiscal policies may themselves remain very much the domain of the Member States, but national governments are finding their room for manoeuvre in this field already severely restrained in the running up to EMU - and since the adoption of the proposals for a Stability and Growth Pact at the 1996 Dublin summit, this is very likely to remain the case in the future.\(^5\)\(^6\) However, if convergence and cohesion are to go hand in hand, a certain amount of financial redistribution is absolutely imperative. It is here that cohesion meets financial equalisation.

The question that imposes itself is, whether the current provisions are sufficient to achieve both convergence and cohesion, or whether not a further shift in approach is needed towards even more direct financial assistance. As the EU increases its sphere of influence over more and more policy areas, subsidiarity demands closer scrutiny as to what exactly needs to be decided upon centrally, and which decisions can still be taken nationally, regionally or locally. The field of regional policy is the pivotal link in the battle between uniformity on the one hand, and diversity on the other.\(^5\)\(^7\) More integration will, over time, require more decentralised decision-making for the field of regional disparities, as the volume of redistribution is likely to increase - particularly so in the light of the envisaged enlargement of the EU to the far poorer countries of central and eastern Europe.\(^5\)\(^8\) In this respect, the creation of the Cohesion Fund may indeed mark but only the beginning of a

\(^{5}\) The Stability and Growth Pact is the direct product of German pressure to ensure national fiscal discipline beyond the day of entry into EMU. Despite its undeniable economic effects, the principal objective of this initiative was political. The German government wanted to diffuse the doubts many people still had about the stability of the future European currency, the Euro. For more about the technical details of the Pact, see: EU, Commission, “The Stability and Growth Pact,” *InfEur*o 2 (1997): 12.

\(^{5}\) This statement refers to the political and socio-economic situation of the European Union, and does not extend to such elementary issues as, for instance, culture.

\(^{5}\) No enlargement of the Union and its predecessors has so far gone ahead without at least some demands for side-payments. And it seems totally unthinkable that the current ‘Cohesion countries’ would agree to the poorer countries of central and eastern Europe joining the EU without a substantial increase in regional spending, for otherwise they would turn from net recipients to possibly even net contributors of the EU budget. Even in the absence of the prospect of enlargement, any further political integration should increase the need for more solidarity within, which in turn would also lead to an increase in the volume of regional, or national, redistribution.
trend towards more financial redistribution, with less and less centralised decision-making as a concession to both subsidiarity, and the maintaining of pluralism and diversity within the Union.

So, the EU has definitely begun to embark on a development away from its strict, centrally controlled structural policy, and towards more of a decentralised and less rigid form of financial assistance. However gradual this shift may be, the general direction seems clear. The crucial issue though is not how far down the road the Union will eventually go, but whether it should be taking this path at all. It is the latter consideration which justifies the original decision to use the 'extreme case scenario' of financial equalisation in Germany, as a helpful example for the EU to look at, in the first place. For the Union will ultimately have to decide what is going to be the better way of reducing the regional disparities between and within the Member States without compromising its other constitutional objectives: using cohesion policies or adopting some form of financial equalisation.
8. CONCLUSION

The constitutional objective of the EU in reducing regional income gaps is the strengthening of the EC's economic and social cohesion. So, with cohesion policies already in place, and no mentioning of financial equalisation anywhere within the treaty framework that represents the Union's primary law, it appears as if there was no real choice for the EU's decision-makers over how best to tackle cohesion. This view, however, is not only deceptive, but positively misleading. The revised EC Treaty states, among others, as one of its overall objectives the promotion of economic and social cohesion and solidarity among Member States. Financial equalisation may not be found in the Treaties, but the explicit mentioning of solidarity, as has been discussed in Section 3.1., should give any form of financial redistribution a firm, if rather general, constitutional footing.

In other words, there is indeed room for choice over whether cohesion policy or some form of financial equalisation is the more appropriate instrument to address the EU's economic and social cohesion. The only problem is that, whilst already being able to look back at more than two decades of employing various forms of cohesion policy, the Union has not had any direct experience of how financial equalisation works. It is here that the German experience in this field comes in as an example for the EU to draw useful conclusions from.

8.1 Financial Equalisation and Cohesion

The first question that springs to mind in the present context is, why financial equalisation should be a better way of addressing cohesion than something explicitly, and presumably for good reasons, called cohesion policy. The key to an answer lies in the fact that trying to reduce the regional (and social) welfare gaps within the EU cannot take place in a political vacuum. Any attempt at stronger cohesion has to happen within the wider framework of activities and constitutional aims the Union has set for itself. This means also that, in comparison with some of the EU's other objectives, the tackling of regional disparities may actually not be of the highest priority. On the other hand, some other constitutional requirements, such as the convergence criteria on fiscal discipline, and the recently agreed provisions of the Stability and Growth Pact, have the effect of severely

1 Art. 2 ECT.
reducing the room for financial manoeuvre for the Member States' governments. Consequently it becomes more difficult for the poorer countries within the Union to reduce the welfare gaps that exist between themselves and their richer counterparts if no respective counterbalancing measures are in place. It is the nature of these measures which is of crucial importance to the current discussion of whether the EU should opt for cohesion policies or whether some form of financial equalisation would be the more appropriate instrument to tackle the Union's regional disparities.

As has been concluded at the end of the previous chapter, the increasing complexity of EU legislation may actually make financial equalisation the more desirable of the two instruments, since it delegates responsibility over regional policy to the Member States, whilst simultaneously giving them additional income with which to fulfil the objectives set out in the Treaties, one of which is to help strengthening the EC's economic and social cohesion. The German horizontal equalisation scheme aims at very much the same: enabling all Länder to fulfil their constitutional objectives, amongst which is the maintaining of at least equivalent living conditions throughout the FRG.

What needs to be established though is whether, and if so to what extent, financial equalisation, or any lesser form of financial redistribution, is actually capable of meeting the required tasks. And here a look at the German example serves as a useful reminder as to where the shortcomings of horizontal equalisation lie: despite the near balancing out of per capita rates of revenue the mechanism ensures, the scheme does not serve to eradicate at all the underlying structural differences between the German Länder from which the varying levels of income originate in the first place.² The constitutional objective to maintain uniformity, or at least equivalence, of living conditions does not seem to have enough command to force the less well-off Länder to spend their additional revenue on structural measures.³ Their wealthier counterparts even go as far as claiming that it was not even in the interest of the poorer Länder to improve on their structural backwardness, because then they would lose their recipient status within the horizontal equalisation system.⁴

Even though all of the poorer Länder probably do have some room for budgetary consolidation and spending cuts, the accusation by some of their wealthier counterparts that certain of the Federal Republic's constituent units have fallen victim to a kind of

² See Section 4.1.
³ As has been seen in Section 3.3.
'dependency culture' must really be dismissed as polemic. The principal cause of why the poorer Länder find it so difficult to invest into structural improvements lies with their constitutional role as the main executive of federal legislation. In this capacity they have to make sure, among other things, that levels of social protection are the same throughout the country, which is nothing else than ensuring the maintaining of at least equivalent living conditions as demanded by the Basic Law. Yet, many payments for social policies, the most prominent of which must be the German equivalent of income support, come out of the Länder’s own coffers, and it is here that the poorer Länder feel the fiscal squeeze: structural weakness vis-à-vis their wealthier counterparts usually means higher rates of unemployment and ultimately higher social pay outs. In other words, the additional income received through financial equalisation is not only desperately needed, but - as far as the scope for investment, i.e. real structural improvement, is concerned - also rather inadequate.

In order to find out whether or not any form of unconditional financial redistribution would actually be more successful in reducing regional disparities within the EU, it becomes necessary to envisage a hypothetical scenario under which such a scheme would operate. The chief difference between the existing German Finanzausgleich and the theoretical attempt at financial redistribution within the EU outlined in this thesis, is that the former serves to achieve nominal equalisation to enable the German Länder to ensure at least equivalence of living conditions throughout the FRG, whereas the latter is argued to be working towards the objective of strengthening the EC’s economic and social cohesion. In other words, the advantage of EU financial redistribution over the German equalisation mechanism would be that it more directly addressed the structural gaps within the Union. The question only is, whether this would be enough to really reduce the regional disparities between and within the EU’s Member States.

The answer has to be that it would not. Even if the Union could agree on a financial equalisation scheme, similar to the one in place in Germany, it must not be forgotten that any such development is only likely to go hand-in-hand with, and thus be a direct result of, further transfers of sovereignty by the Member States to the Union level of government. In other words, by the time a comprehensive horizontal equalisation scheme would be acceptable to all Member States, the EU would be responsible not only for social legislation, but would also have at least harmonised tax levels, if not adopted a common tax regime. All this may appear rather far fetched, given the reluctance displayed by some Member States to give up certain aspects of national sovereignty, and also in the light of enlargement to the far poorer countries of central and eastern Europe.5

5 See Section 2.3.
And yet, there are signs that the EU is - if only very slowly indeed - moving in exactly the direction outlined above. Some indications are: the signing up to the Social Agreement of the UK under the Blair administration, elected into office on 1st May 1997; the general need for ‘constitutional’ reform to ensure that further enlargement does not paralyse decision-making at EU level; and a recent debate over tax harmonisation, ignited by claims from high-taxation Member States that ‘tax competition’ from lower charging members could lead to an overall reduction in revenue from taxation throughout the EU.

All of that, however, would mean that the problems facing the poorer EU Member States would be, more or less, the same as those encountered by the less well-off German Länder - and if financial equalisation does not lead to a reduction in regional disparities in Germany, there should be little reason to believe it could do any better at European level.

As far as the constitutional demand to strengthen the EC’s economic and social cohesion is concerned, it would be of as little importance to a horizontal equalisation mechanism between the EU’s Member States, as the postulate to maintain at least equivalent living conditions throughout Germany has proved to be for the Länder. As has been argued throughout this thesis, financial equalisation is - by definition - free from any condition in terms of what the money reallocated has to be used for. This means that constitutional demands, such as ensuring uniform or equivalent living conditions, or strengthening an entity’s economic and social cohesion, only really apply to the decisions taken at federal (or union) level in connection with the general framework of legislation to do with taxation and fiscal redistribution. Once reallocated, the money received under a subsidiaristic equalisation mechanism will enter the books of the members of a union of states just like any other revenue that is rightfully theirs. This realisation reduces the link between financial equalisation on the one hand, and the constitutional objectives

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7 Constitutional reform in this context refers to the need to review not only the composition of a number of EU institutions, but also the decision-making procedures within and between them. See: “Union in Disarray over Reforms,” European Voice 18-24 Sept. 1997: 1; or: EU, Parliament, “Initial Analysis of the Treaty of Amsterdam: Section IV - The Union’s Institutions,” published on the internet at: http://www.europarl.eu.int/dg7/treaty/en/section4.htm.

8 On this point, see: Andreas Oldag, “Gelbe Karte für unfaires Wettbewerb,” SZ on Net 18 Sept. 1997; or “Waigel will die Steuer-Oasen austrocknen,” SZ on Net 18 Sept. 1997. The latter argument is actually reminiscent of a division of opinion between the richer and the less well-off Länder in Germany over whether or not they should be able to set their own tax levels. Whilst the better-off Länder see tax competition as a way in which their poorer counterparts can be forced to get their financial situations in order, the latter fear that rivalling tax rates would leave them with even less revenue to fulfill their (centrally set) duties. This information was, among others, obtained by the author of this thesis in a number of personal interviews with experts on financial equalisation in Baden-Württemberg, Bavaria, Berlin, Bremen, Hamburg, Lower Saxony, Mecklenburg-Western Pomerania, Saxony, Saxony-Anhalt, and Schleswig-Holstein, between 26 March 1993 and 21 March 1994.
connected with reducing regional disparities on the other, to one of feeble hope, rather than firm obligation.

So, if the EU can draw any lesson from the German experience with financial equalisation, it has to be a negative one. The mechanism may represent a remarkable display of solidarity, but it does not go far enough to enable the weaker Länder to even begin reducing the structural gaps which exist between them and their richer counterparts. In this respect, financial equalisation does not lead to stronger economic and social cohesion, and as such is not the right instrument for the EU to reduce its regional disparities.

8.2 Cohesion and Regional Disparities

If financial equalisation cannot achieve cohesion, the only alternative left for the EU seems to be to see whether or not the more promisingly-termed cohesion policy can do the job. An early answer is found quite quickly, since it requires only to look back at the findings of the previous chapter where it was established that respective policies do have the potential to make a difference.

To briefly reiterate the main points: cohesion policy - unlike financial equalisation - refers to centrally controlled measures, earmarked for specific projects which themselves are aimed at improving the structural deficiencies between and within the EU’s Member States. This means that, even though respective allocations will still represent a financial relief for the recipient Member State, the latter cannot use them for any other purpose than the one for which the money has been given to it. Even though this way the recipient Member States could still be regarded as having been given more room for budgetary manoeuvre, the truth of the matter is that those countries qualifying for contributions from cohesion policies are, by the nature of the process, comparatively poor and, for all the reasons outlined when discussing the horizontal equalisation scheme, have - as a rule - higher than average spending requirements anyway. Cohesion policies, such as the EC’s Structural Funds, which allocate money not to the Member States but to sub-national regions and areas instead, demonstrate even more clearly that they do not represent mere financial injections, but that they directly and positively aim at more cohesion.

Following a number of improvements on the way in which the EC’s cohesion policy targets economic and social disparities, made over the past decade or so,9 the efficiency of

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9 See Chapter Six.
its instruments should be in no doubt. The reason why the EU has still seen only little, if
any, improvement in its economic and social cohesion has thus less to do with the quality
of its cohesion policy, than with the quantity of money redistributed under respective
schemes, because a real strengthening in the EC’s economic and social cohesion requires
higher financial resources.

Another question that needs to be addressed at this point though, is just how much of a
reduction of the EU’s regional (and social) disparities even an increase in the provisions
for the Union’s cohesion policy large enough to strengthen cohesion would represent. If
this thesis was looking for ways of radically tackling regional imbalances, it would
perhaps not so much be the instruments which were in need of examination, but the
constitutional provisions behind them. After all, in the narrowest of definitions, the
objective to strengthen the Community’s economic and social cohesion should already be
satisfied with the tiniest of improvements on that score. And in this respect, the cohesion
goal is nearly as elusive as the demand to maintain equivalent living conditions throughout
the FRG: neither of them actually aims at achieving equality. Almost to the contrary they
might as well be seen to represent diversity, since they both accept quite a degree of
difference between the levels of wealth within the respective entities in which they are
applied.

The experience with both cohesion policy and financial equalisation brings to the fore that
it is, ultimately, the amount of money available for redistribution which is of paramount
importance when it comes to positively eradicating regional disparities. The crucial
difference between these two distinct approaches is, however, that financial equalisation,
as the term clearly indicates, redistributes enough money to achieve a nominal per-capita
equalisation, whereas the volume of cohesion policy appears to be determined by a
political judgement as to how much redistribution is needed to strengthen the EC’s
economic and social cohesion. Given the requirement to spend cohesion allocations on
structural projects, the assumption would have to be that if the amount of finances
reallocated under the auspices of cohesion policy was to equal that of a (fictitious)
equalisation scheme, the likely outcome would be a drastic reduction in the Community’s
regional disparities.

Notwithstanding the above though, it is questionable whether - in a federal system - such
a high degree of equality is realistically achievable. And yet, the notions of solidarity,
community and union all point into the direction of more cohesion. In contrast to the
German concept of ‘uniformity of living conditions’, which refers to the maintaining of
the status quo, the EU’s objective to strengthen cohesion clearly envisages an
improvement of the economic and social situation within the EC. In this respect the EU does have a constitutional mandate to positively tackle its regional disparities. Quite to which extent progress will *de facto* be made on the basis of this, then depends on the political willingness by the Union’s decision-makers to reduce regional (and social) disparities, which finds its expression in the amount of money allocated to respective policy schemes.

To summarise briefly: current Treaty provisions on economic and social cohesion have the potential to lead to a gradual, but not radical, reduction in the EU’s economic and social disparities; and cohesion policy is the instrument preferable over financial equalisation to achieve stronger cohesion. However, cohesion policy can only be effective if enough financial backing allows it to make a positive impact.

### 8.3 The Way Forward

The EU is - of course - still only a union of states in the earlier stages of a process of federalisation. It may already be quite highly integrated economically, but as far as political integration is concerned, it is the Member States which to this day hold the overall power within the European Union. This is reflected in the field of regional disparities not only by the quite substantial gaps that still exist between and within Member States, but also by the relative lack of progress as far as the reduction of such disparities is concerned.

For this reason it may seem rather utopian to have projected a full-scaled financial equalisation onto the Union of the future. But the purpose of this exercise was not to speculate over what may or may not be the way in which, at some point in the future, fiscal revenue would be received by, and redistributed between, the various levels of government within the EU, but to draw helpful conclusions for current developments in this field. The latter of course refers to the creation of the Cohesion Fund which, it was argued, represented a departure away from the hitherto very strict provisions of the Structural Funds, and thus marked a first step towards financial redistribution of the kind known from the German scheme of horizontal financial equalisation.

Nevertheless, this thesis comes to the conclusion that, as far as the reduction of regional disparities within the EU is concerned, the Cohesion Fund does not offer any advantages over the way in which the ‘older’ cohesion instruments, the Structural Funds, approach the problem. If anything, the Cohesion Fund must be regarded as less efficient, since its
focus and criteria are far less pin-pointed than those of the Structural Funds. In order to illustrate this point, a scenario could be envisaged in which Spain, for example, receives financial support from the Cohesion Fund for transport infrastructure, yet the project co-financed by the EU is an airport improvement scheme in the relatively wealthy Pais Vasco region, rather than, say, a new road link in more needy Galicia. This exposes the second aim of the Cohesion Fund, its objective to help the Member States with a per-capita GNP of less than 90% of the EC average to meet the convergence criteria for EMU, as set out in Article 104c ECT.10

However, helping the poorest of the EU Member States financially represents a first shift towards fiscal equalisation, and this in turn carries with it the threat that the link between the money allocated and the uses it goes into begins to loosen. This is not to say that the Cohesion Fund is already too ‘weak’ to work towards a reduction in the Community’s regional disparities, but merely to highlight the potential dangers for the achievement of more cohesion represented by a softening of the criteria underlying respective policies.

If the issue of strengthening economic and social cohesion within a union of states could be looked at in isolation, the EU’s Structural Funds would have to be regarded as being clearly more efficient, and thus more desirable, than its Cohesion Fund to reduce the regional disparities that exist between and within the Union’s Member States. The reality though is - as has been highlighted in Section 7.4. - that any form of fiscal redistribution takes place within the wider political and constitutional framework of the entity in question. And here the dynamic nature of federalism comes into play.

At present the EU is still only a (politically) relatively loose union of states, and under these circumstances the limited but highly efficient Structural Funds would be the best instrument to achieve a strengthening in the Community’s economic and social cohesion. However, as developments at the Maastricht negotiations suggest, the level of integration reached there already seems to have necessitated a counter-development on the issue of regional policy: in order to achieve certain constitutional demands, the poorest of the Member States needed more direct support than the Structural Funds could provide. To be more precise, the meeting of the convergence criteria for EMU required more direct budgetary assistance to the Member States themselves, rather than their most needy sub-national regions or sub-regional areas. The Cohesion Fund bridged the gap between direct financial assistance on the one hand, and too narrowly defined, and therefore too restrictive allocations from the Structural Funds.

10 See: Protocol on Economic and Social Cohesion, annexed to the TEU.
With integration likely to continue, given the implications of eastern enlargement and the usual spill-over effects of existing policies, a need for more direct financial redistribution not only results from purely practical considerations, as was the case over convergence, but may also be supported for ideological reasons. The principle of subsidiarity may well be brought into a future discussion over whether regional imbalances would not better be addressed by a direct equalisation scheme between the EU’s Member States, rather than a centrally-run Cohesion Policy.

The Cohesion Fund may only be a second-best contender for the optimum way in which to reduce regional disparities within the EU. But under the very real challenges of further integration it looks like the ideal compromise between an all too strict structural policy, and a mere nominal balancing of per-capita revenues with ‘no strings attached’. The former may be efficient, but can also be interpreted - by those who object - as already representing too much supranationalism. In contrast to this, financial equalisation may please the proponents of subsidiarity but, as the German experience with the horizontal mechanism shows, it does not really address the problem of regional income gaps between the Länder.

It thus seems as if the lessons from Germany for ways of reducing regional disparities in the European Union have been largely negative ones: after all, financial equalisation does not lead to more equality beyond the nominal balancing of the Länder’s per-capita incomes. And yet, the comparative look at the FRG has been both instructive and constructive nevertheless. It has been constructive because the experience of the FRG can serve as a warning to the EU’s decision-makers not to confuse financial equalisation with reducing regional disparities. The comparison with Germany has been instructive, because the FRG has to be regarded as the ‘home’ of co-operative federalism\(^1\) - and the Cohesion Fund, for which legislative and executive powers are separated between the EC and the Member States, can be seen to epitomise the principles of co-operative federalism, and thus serve as a testament to the fact that if not the entire EU so at least the ECs also belong to this branch of federalism.\(^2\)

Within this framework of co-operative federalism, and in the context of the wider environment of conflicting goals and aims found in any union of states, the Cohesion Fund must therefore be seen as the best out of the three choices discussed in this thesis, and

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\(^1\) In contrast to ‘dual’ federalism, where the layers of government exist strictly separate from one another, ‘cooperative’ federalism describes the entanglement between the vertical levels of government, both in terms of the decision-making processes, and the way in which legislative and executive powers are split between them. See Section 1.1.

\(^2\) As has been discussed in Chapter One.
therefore a guide, for a way in which the European Union could realistically be able to tackle its regional disparities in the future.
LIST OF ABBREVIATIONS

BEZ : Bundesergänzungszuweisungen (Federal Complemental Grants)
BGBl. : Bundesgesetzblatt
BRD : Bundesrepublik Deutschland (Federal Republic of Germany)
CAP : Common Agricultural Policy
CDU : Christian Democratic Union
CEECs : Central and Eastern European Countries
CFI : Cohesion Financial Instrument
CFSP : Common Foreign and Security Policy
CoA : European Court of Auditors
CoJ : European Court of Justice
CSF : Community Support Framework
CSU : Christian Social Union
DÖV : Die Öffentliche Verwaltung
EAGGF : European Agricultural Guidance and Guarantee Fund
EC : European Community (formerly: European Economic Community)
ECs : European Communities
ECSC : European Coal and Steel Community
ECT : Treaty Establishing the European Community (EC Treaty)
ECU : European Currency Unit
EDC : European Defence Community
EEC : European Economic Community (now European Community)
EECT : Treaty Establishing the European Economic Community
EIB : European Investment Bank
EMS : European Monetary System
EMSU : Economic, Monetary and Social Union
EMU : Economic and Monetary Union
EP : European Parliament
ERDF : European Regional Development Fund
ERM : Exchange Rate Mechanism (of the EMS)
ESF : European Social Fund
EU : European Union
Euratom : European Atomic Energy Community
F.A.Z. : Frankfurter Allgemeine Zeitung
F.D.P. : Free Democratic Party of Germany
FIFG : Financial Instrument for Fisheries Guidance
FRG : Federal Republic of Germany
GDP : Gross Domestic Product
GDR : German Democratic Republic
GG : Grundgesetz (Basic Law)
GNP : Gross National Product
IGC : Intergovernmental Conference
IMPs : Integrated Mediterranean Programmes
JHA : Co-operation in Justice and Home Affairs
MEPs : Members of the European Parliament
MPs : Members of Parliament
NATO : North Atlantic Treaty Organisation
O.J. : Official Journal of the European Communities
OPEC : Organisation of Petroleum Exporting Countries
SEA : Single European Act
SEM : Single European Market
SME : Small and Medium-Sized Enterprise
SPD : Social Democratic Party of Germany
SZ : Süddeutsche Zeitung
TEU : Treaty on European Union (Maastricht Treaty)
UK : United Kingdom of Great Britain and Northern Ireland
US : United States of America
VAT : Value-Added Tax
WEU : West European Union
ZParl : Zeitschrift für Parlamentsfragen
**GLOSSARY**

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<thead>
<tr>
<th>Term</th>
<th>Definition</th>
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<tr>
<td>Acquis Communautaire</td>
<td>The Body of ECs Primary and Secondary Law</td>
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<tr>
<td>Bizone</td>
<td>Unified Economic Area (in post-War Germany)</td>
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<td>Bund</td>
<td>Federation</td>
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<td>Bundesbank</td>
<td>Federal Central Bank</td>
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<td>Bundesergänzungszuweisungen</td>
<td>Federal Complemental Grants</td>
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<td>Bundesrat</td>
<td>Federal Council</td>
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<td>Bundestag</td>
<td>Federal Diet</td>
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<td>Bundestreue</td>
<td>Federal Loyalty</td>
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<td>Bundesverfassungsgericht</td>
<td>Federal Constitutional Court</td>
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<tr>
<td>Bürger</td>
<td>Citizen/Burgher</td>
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<tr>
<td>Deutscher Bund</td>
<td>German Confederation (1815-1866)</td>
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<td>Deutscher Zollverein</td>
<td>German Customs Union (1834-1871)</td>
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<td>Einheitlichkeit</td>
<td>Uniformity</td>
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<td>Finanzausgleich</td>
<td>Financial Equalisation</td>
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<tr>
<td>Gemeinschaftstreue</td>
<td>Communal Loyalty</td>
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<tr>
<td>Gleichwertigkeit</td>
<td>Equivalence in Value</td>
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<td>Grundgesetz</td>
<td>(German) Basic Law</td>
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<td>Horizontaler Finanzausgleich</td>
<td>Financial Equalisation among the Länder</td>
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<td>Land/Länder</td>
<td>German (Federal) State/States</td>
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<tr>
<td>Strukturhilfegesetz</td>
<td>Structural Aid Act</td>
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<td>Vermittlungsausschuss</td>
<td>Conciliation Committee of Bundestag and Bundesrat</td>
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<td>Vertikaler Finanzausgleich</td>
<td>Distribution of Revenues between Bund and Länder</td>
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<td>Zollverein</td>
<td>see: Deutscher Zollverein</td>
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