SIDE PAYMENTS OVER SOLIDARITY: FINANCING THE POOR COUSINS IN GERMANY AND THE EU

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American Consortium on European Union Studies (ACES)
EU Center of Excellence Washington, D.C.

ACES Cases, No. 2006.2

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Abstract

What happens when governments that have benefited from programs to redistribute money from richer to poorer states are faced with the prospect of being redefined as a "richer state" themselves? In recent years, such a situation has confronted the traditionally poorer states of Western Germany and the traditionally poorer nations of the European Union. Both have had to worry that systems of financial solidarity that benefited them in the past might change to benefit a new set of potential (and arguably needier) recipients. In the German case, reforms of the tax equalization system might channel funds to the new eastern Länder while in the EU case, reforms of the structural funds might channel funds to states in Central and Eastern Europe. It turns out that funding was generous in the East German case but decidedly not in the CEE case. Why? Neither partisanship nor feelings of solidarity towards these "poor cousins" seem to have much explanatory purchase. Rather, the strong institutional positions of the traditionally poorer states in both cases, meant that the key factors shaping the outcomes are the electoral exposure of the respective central governments and the presence or absence of hard budget constraints on that political center. The differences in process and outcomes have important implications for the study of federalism.

Thanks to Arthur Gunlicks, Craig Parsons, Stephen Silvia, Helga Welsh, Dirk Wentzel, and Daniel Ziblatt for comments on an earlier draft.

It is increasingly common to refer to the European Union as a political system that can be analyzed using the same tools of comparative politics that are widely used for individual states. This "governance" approach to the EU emphasizes features such as party politics, executive-legislative interaction, and judicial independence, that can be analyzed using the same theories and concepts that one would use to compare individual nation states.[1] Curiously, the governance approach generally has not used federalism as one of the core concepts to analyze the EU.[2] Likely, this is because while it is plain that while the EU institutions have federal aspects, they also have intergovernmental, supranational, confederal, and functional elements as well. And yet some recent theorists of the EU emphasize that it "increasingly resemble[s] an emergent federal polity."[3]

The purpose of this paper is to compare one system that is unarguably federal – the Federal Republic of Germany – with the quasi-federal EU. The comparison takes place along only one dimension and so is necessarily limited. But the dimension is both important and little-studied: the economic incorporation of new peoples into an existing federal (or, in the EU case, quasi-federal) political system. This situation is rare, but potentially of major importance, as it may upset crucial bargains struck over years and even decades. Many federal systems, including both Germany and the EU, have some provisions for what might be called "economic solidarity" across their constituent units. That is, many federal systems internally share some part of their wealth with one another.

But what happens when governments that have benefited from programs to redistribute money from richer to poorer states are faced with the prospect of being redefined as a "richer

[1] Hix 1999, 2005 has been among the foremost advocates of this approach.
[2] Indeed, federalism appears only once in the index to Hix 2005, which I take to be exemplary of the governance approach.
[3] For example, Burgess 2004: 26.

state" themselves? I look at two recent cases where this has happened: a system of payments to German states that undergirds fiscal federalism inside Germany and a system of payments to European regions -- the EU's Structural Funds. Both systems involved better-endowed political units making side payments to less well-endowed units in exchange for their participation in broader efforts to organize a national polity (case 1) and supranational markets (case 2). In both cases, even poorer claimants -- East German Länder and Eastern European countries -- have joined the redistribution systems. Thus both the traditional givers and takers have to deal with the arrival of the "poor cousins" from the East. In both cases, systems that were set up as payments to one set of beneficiaries essentially became redistribution mechanisms that needed to include new beneficiaries not party to the original bargain.

The first case centers on a set of poorer states in the old West Germany. These states – Schleswig-Holstein, Rhineland-Palatinate, Bremen, Lower Saxony, and the Saarland – had long received “tax equalization” payments from the richer West German states. The payments ensured that all states had roughly equal per capita tax revenues with which to work. Yet when five new Eastern German states appeared at the system’s doorstep, these “poorer” Western states were faced with the prospect of becoming givers in a system where they had previously been takers. How would they respond?

The second case centers on the poorer member states of the European Union. These states – Spain, Greece, Portugal, and Ireland – had long received “structural funds” from the EU meant to narrow economic differences within the Community. Specifically, any region of any EU country whose GDP per capita is less than 75% of the EU average is entitled to apply for the main fund. In the four countries named, a majority of the regions meet these categories, and these countries have been the largest recipients of EU structural funds over the past decade. Yet

with deliberations to enlarge the EU to include a number of countries – including ten poor ones mostly in Central and Eastern Europe (CEE) – these receivers have also been faced with the prospect of becoming givers in the very near future. As we will see, however, the poor cousins from East Germany fared considerably better than those from Eastern Europe. In fact, while Germany shoveled cash at its Eastern states right from the start, the EU had to create, in the last days of negotiations over membership, a "special payment facility" to benefit several CEE states in order to ensure that they would not become net payers into the EU right from the start of their membership in May 2004.

Despite the very different outcomes, four similarities give shape to the comparison: first, both programs involve substantial transfers. In the German case, until recent reforms, the states with the lowest tax revenues were guaranteed up to 99.5% of the average tax revenues of all German states. States that collected tax at rates far above the national average could retain only up to about 103% of that average and had to pass on the rest to poorer states. In the EU case, each year well over 30 billion Euros are passed along to poor regions. Second, both programs involve very extensive, bureaucratic criteria. The German system is so complex that it is often joked that there is only one person who understands the system – though he can't explain it – and one person who can explain the system – though she doesn't understand it.[4] In the EU case, the regulations are very precise, and regions often lose funding because of technical mistakes in their applications.[5] Third, both programs involve sub-regions of national states. In Germany, we deal with first eleven and then, after unification, sixteen federal states. In the EU, we deal with so-called NUTS II regions that meet EU standards for becoming recipients of structural funds.[6]

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[4] More seriously, the best recent English summary is Färber, 2003. In German, see Lintner, 2004; Seybold, 2005.
[5] European Information Service 2006.
[6] NUTS = la Nomenclature des Unites Territoriales Statistiques — EU defined regions for statistical and analytical purposes. These regions sometimes are and sometimes are not constitutional regions or states.

Finally, in each case, the old poor states held enough institutional high ground to avoid seeing their benefits be redirected to new recipients. If the poor cousins were to be helped, it would not come out of their hide.

Despite these similarities, many differences cannot be controlled for, not least that one case is almost purely domestic while the other has important elements of supranationalism. But then this is one of the points of the paper: such differences still matter greatly and must inform our judgments on the extent to which the EU is a system of "emergent" federalism. With this in mind, the rest of this paper makes three arguments aimed at establishing a plausible argument for the pattern of variation. First, it quickly excludes both fraternal sentiment and partisanship as plausible explanations for the difference in outcomes. Second, it shows that while arguments about fears of migration are plausible and likely played some role, they are not adequate to explain the observed pattern. Third, it argues that the best explanation flows from a combination of two factors, which, for shorthand, I label electoral exposure and budgetary discretion. The paper's conclusion links both of these factors to the difference that flows from being an established federal system.

The paper is premised on a fairly simple demand and supply model of politics. Essentially, I will quickly show that each set of poor cousins was eager to garner material benefits from their new political community and that the old poor were not enthusiastic about helping meet those claims. This claim is not controversial, and I do not dwell on it. But if the demand for relief was broadly consistent across cases, both the channels of expression for that demand, and the supply of relief varied.[7] More specifically, I argue that material relief was

[7] A caveat on the demand side is that German solidarity takes the form of tax revenues, which are highly fungible; once captured, state governments can use these revenues for any legal purpose. EU solidarity takes the form of co-financing of approved projects for public, private, or human capital formation. There are very strict rules governing the use of these funds, and many long time members cannot take advantage of some of the monies to which they are

supplied by the German federal state for three primary reasons: successive governments were a) exposed to the electoral force of East Germans' demands for relief as of October 1990 at the latest; b) institutionally constrained from forcing the older poor states to bear much of the new burden; and c) legally able to address the demands with debt financing. So the federal government paid the poor cousins in Eastern Germany. By contrast, the European Union gave less than in previous enlargements and less than was expected by CEE populations because a) it was protected from any electoral exposure until May 2004; b) also institutionally constrained from passing the new burdens onto its old poor states; but c) legally unable to address the new demands with debt financing. So the poor cousins in CEE were disappointed.

This explanation leaves out two variables that might have been expected to play some role. The first is partisanship. It is certainly thinkable that this might have mattered because of differences in how payments were distributed. In Germany, states are either payers *or* receivers. In the EU, however, individual nations both pay and receive from the funds (even wealthy EU countries receive some structural funds, though not those earmarked for the weakest regions). This difference simplifies political calculations for the German states because they are either payers or recipients, a position that seems to shape their views regardless of the shifting partisan makeup of their governing bodies, a point we see demonstrated below. In the EU, by contrast, the partisan composition of each member state government might plausibly have mattered more because different parties might read differently the complex basket of gains and losses that occur when the gains to "their" recipients of EU funding are pitted against the losses to "their" domestic taxpayers. But in the event, it did not work out this way. Rather, governments of both

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entitled because specific projects cannot meet these high standards. Thus, "winning" in Germany provides cash while winning in the EU provides assets contingent on subsequent political decisions. Nevertheless, it is clear that both sets of poor cousins were very eager to receive solidarity payments, which is why this paper stresses

right and left pursued the same policies in, for example, Spain, as both the Gonzalez and Zapatero (left) and Aznar (right) governments tenaciously defended entitlements for Spanish regions.[8]

A second potential explanation is that we would expect more solidarity in the case of a single national community, while we would expect in the EU case to see side payments carrying minimal payoffs depending more strictly on bargaining leverage.[9] It seems plausible to think that domestic interactions incorporate more identity and norm-legitimacy concerns than international ones; even those that see identity and legitimacy as generally important everywhere would probably expect empirically that intra-German ties and obligations should be stronger than those between, say, Spain and Poland. Yet surprisingly little evidence bears this out. In Germany, the pattern of funding does not track public opinion towards the East at all.[10] Significant resentment towards the "Ossis" had built up by the time when some key deals were cut to keep the system intact. West German attitudes were neither euphoric nor fraternal when it came to dealing with the East by the mid-1990s.[11] Rather than evidence of widespread warm, filial sentiments, the literature underscore West German concerns that these "other Germans" be brought up to western economic, political, social and cultural standards as quickly as possible. Meanwhile, Spanish public opinion was among the most supportive of Eastern enlargement in any of the old member states. We will see, however, that these public stances explain neither the substantial generosity of the West Germans, nor the striking obstructionism of the Spanish government, which caused more difficulty for the new EU members than any other state.

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differences in their ability to make their demands politically effective and differences in the political center's ability to respond.

[8] Spain, as the largest recipient of the structural funds, is treated here as exemplary of the attitudes of broader group of the old poor.

[9] See Moravcsik and Vachudova 2003.

[10] See the data in Glaeser, 2000: chapters 1 and 2.

[11] Boyer, 2005; Glaeser 2000.

A third possibility, less easily dismissed, is that the fear of migration explains the more generous West German policies. Such fears clearly did exist.[12] It is also true that the EU had available a tool that Germany did not: a ban on migration from the new member states for a period of up to seven years after full membership. But while this possibility is broadly consistent with the outcome, it leaves much unexplained. Specifically, if migration alone was driving West German public policy, why was it that this fear only affected the federal government and not the state governments? Most of the old poor states were located right on the boundary between East and West, and yet we have evidence below that they wouldn't pay for anti-migration programs if that meant giving up their entitlements. Their preference was to have Berlin pay, and because it did, it is hard to know if the old poor would have preferred lower benefits to higher migration. Similarly, we can't know if the EU's final offers on structural funds for CEE would have been more generous had they not already put in place the possibility of a seven-year wall against migration. But it is just as plausible to argue that one reason EU member states – Germany and Austria above all – demanded the barrier is because they knew just how little structural fund aid was designated to flow to CEE in the first years after their membership. Certainly, the indicators of a skimpy deal on the structural funds preceded, rather than followed, the preparations for the subsequent migration deal.[13]

Finally, a puzzle also emerges from the fact that one system is reformed and the other is not. In the German case, the poor cousins arrived at a time when the system was already under major stress and when there were fiscal, political, and judicial pressures for change. In the EU case, the poor cousins arrived in the wake of an apparently successful engagement with transitioning democracies in Iberia and with economic backwardness in Ireland. Yet it was in

[12] One economist actually published a paper entitled "Why does anybody live in Eastern Germany?"

Germany where the system was more or less retained intact and the EU level where wholesale changes were introduced (e.g. partial access). How do we explain this? Why would the richer German states, who had long complained about the tax equalization system, acquiesce as it was transferred to Eastern Germany? Why would Germany, which did more than any other EU member state to promote EU enlargement, be complicit in such stingy EU support for Eastern Europe?

The answers to these questions lend further credence to the idea that electoral dynamics and the room for maneuver of the political center – Berlin or Brussels – goes farther towards explaining the outcomes than do attitudes about solidarity or partisanship. Both systems had their critics. But in these cases, the demand for reform was much less important than the supply of reform. The broad argument of the paper is that only under conditions where one constituency was willing to pay to break the log-jam was reform possible. In the German case, that constituency was found in the federal government – once under CDU leadership in 1990-91 and again under SPD leadership in 2001. In the EU case, no such patron has been found. Absent a comprehensive reform, ad hoc policies must be negotiated, and the poor cousins – as one would expect – have very little leverage in these ad hoc agreements. Thus, in one case, the poor cousins from the east have been clothed and fed in a fairly generous manner; in the other, they must cope with the somewhat bitter realization that after long efforts to make themselves ready for EU membership, the benefits of that membership will not be what they originally anticipated.

The rest of this paper proceeds as follows. The second section describes the German system of tax equalization from its historical roots through the last major reform in 1969. The third section then traces and evaluates the efforts to reform and extend the system to Eastern

[13] If true, this would imply that as the barriers come down later this decade, we should expect the structural funds may grow more generous towards CEE member states.

Germany. The fourth section describes the EU structural funds system, and the fifth traces the contentious debates over its reform in light of efforts to enlarge the EU. In that debate, Spain has taken the lead in trying to assert the financial position of the traditional recipient nations/regions.

The German System of Tax Equalization: The Federal Government's Trojan Horse

Historically, Germany has had no settled pattern of taxation powers. Under the 1871 Reich Constitution, taxation authority lay broadly with the states, but the Weimar constitution of 1919 gave the central state the right to collect and allocate most taxes. To compensate, however, Weimar Germany developed a tax equalization system judged by one of its foremost students to be "very elastic and [to allow] flexible policy making."[14] Nevertheless, the states were pushed to the periphery of the taxation system in the Weimar period. If anything, the Nazis radically accelerated the trend toward central state control of taxation, as, after 1934, they controlled all relevant taxes.

Postwar Germany famously opted for a federal structure. Every federal system needs a fiscal architecture to make meaningful its rules and division of competencies. In the main, the story of tax financing in the Federal Republic is a story of the federal government attempting to divide and conquer the states. The FRG is an unusual case in that its states, while initially collecting most taxes, cannot set their own rates. Further, while state *executives*, through the upper house (Bundesrat), have significant influence in setting the uniform rates that prevail across the whole country, state *legislatures* generally have much less – a source of significant tension.[15] Another special situation is the system of tax equalization, called the *Länderfinanzausgleich* (LFA). The LFA makes an important difference in the amount of the

[14] Renzsch, 1991, p. 21.
[15] OECD, 1999, pp. 76-79.

money that each state has to spend. In 1951, for example, the weakest land, Schleswig-Holstein, would have had 112 DM per person in state spending. But because of the LFA (at that point informal and not yet codified), the state was able to spend 153 DM per capita in 1951, an increase of 36%.[16]

The LFA system is not in the German constitution, but rather emerged from the fact that the Länder are obliged by the constitution to perform a variety of different functions and to equalize "living conditions" in all parts of the country. For the poorest Länder, however, the money available often was not enough to meet these obligations. Absent the LFA, these states would have almost no discretionary spending and almost no political room for maneuver. As a consequence, prior to the creation of the LFA, the poor states were more or less obliged to call for federal help to meet their obligations. When they called for federal help, the richer states had to fear that the federal government would usurp state competencies (at least in the poorer states) in exchange for its financial support. Indeed, the federal state used weak states to carve out more influence throughout the 1950s and 1960s.[17] In other words, the bargain of national versus state responsibilities included a set of side payments that allowed poorer states to fulfill their obligations but at the cost of national involvement in their policymaking domains.

How exactly did the federal government use the weak states as its Trojan horse? Early in the post-war period, the federal CDU governments developed a pattern of offering direct "categorical grants" to the Prime Ministers of the financially weakest states.[18] The logic of this federal assistance was two-fold. First, it promoted the dependencies of individual weaker states on the federal government. Second, it undermined the solidarity of the states, and it opened up avenues for more federal intrusion into state policy making domains. In response, a second set

[16] Ibid., p. 14.
[17] Ibid., pp. 75-169.

of side payments emerged in with the richer states exercised "preemptive solidarity" to try to keep the federal state from intervening too deeply.[19] The result was a system of "horizontal" redistributions from richer to poorer states.

By the time of the first major codification and reform of the LFA system in 1955, the poor states were guaranteed at least 88.75% of the average per capita tax revenues.[20] In 1955, the states considered formalizing "vertical" payments from the federal government in Bonn but rejected the idea because the states calculated that Bonn would probably find some way to recapture those revenues from the tax resources it shared with the states.[21] As a consequence, strong states often tried to deny any legal basis for direct federal payments to weak states, and they did so to stop the erosion of state competencies.[22] Yet the richer states were never able to use the horizontal payments to completely end the connection between the federal government and the weaker states, though Bonn's vertical payments were generally ad hoc and sometimes lacked a secure legal basis. Horizontal tax equalization grew gradually, and by 1958, the weakest states were guaranteed at least 90% of the income and corporate tax receipts of the richer states.

LFA reform in 1969 made the system even more redistributive. In 1970, the first year in which the new system was put into place, available revenues ranged from 95.6% of the national average for the weakest states to a ceiling of 104.7% for the strongest states. Clearly, the gap was narrowing. The 1969 reform also ended the formal *bilateral* deals between the federal government and individual states. The new system thus strengthened the *group* of states, though

[18] Ibid., p. 99.
[19] Adelberger, 2000, pp. 61-2.
[20] In 1950, Schleswig-Holstein, the poorest state, was at 71.3% of average revenues after equalization, and Hamburg, the richest was at 122.3%. In 1959, the lowest was Lower Saxony, at 91% and Hamburg was again the highest at 117.8%. In 1970, the lowest was Bremen at 95%, and the highest again, Hamburg, at 104.7%. In 1983 it was 98% for Lower Saxony, and 105.2% in Hamburg. Renzsch, 1991, p. 282.
[21] Between the 1955 and 1969 reforms, the states received about 65% of the combined income and corporate taxes, while the federal government received around 35%.
[22] Renzch, 1991, p. 129.

individual states lost their ability to cut side deals with the federal government. And the federal government saw diminished the divide and conquer tactics that it had perfected over the past 25 years.[23] Yet at the same time, the reform carved out a new space for vertical redistribution in the form of "joint tasks" shared by the federal government and the state and "mixed financing" to underwrite such tasks. No longer did federal grants require states to provide matching funds. The rich states saw this new tool as a way to garner federal money of their own and thus to achieve some financial compensation for the inroads the federal government had made into their policy domains.

From Trojan Horse to Sacred Cow: Reforming the *Länderfinanzausgleich*

With the coming of German unification it became clear that the LFA system, fundamentally unreformed since 1969 and generating resentment on several fronts, would have to be reformed. Though some considered the system unreformable, if the five East German states had simply joined the LFA system under the existing rules, the amount of money redistributed would have had to rise from 3.5 billion DM per annum to about 20 billion DM in order deal with the financial inadequacies in Eastern Germany.[24] The focus of this section on the reform of the LFA is on the weak Western states, for they were the ones that most had to fear being shifted from receivers to payers.[25] Indeed, if the LFA were to remain unreformed, *every* West German state but Bremen would have become a net payer.

In response to this dilemma, Bonn – still the capital at this stage – and the Western states

[23] Renzch, 1991, pp. 258-259.

[24] For the argument that a "rationality trap" makes the system well-nigh unreformable, see Färber and Sauckel, p. 673 and passim.

[25] Ziblatt (2000, p. 20 and 35-6) shows how the richer Western states tried hard to cast the dispute about reform in terms of North versus South rather than as East versus West. For a time in 1998, it even appeared that the CDU-led Eastern states of Saxony and Thuringia might join with CDU and CSU-led Western states in supporting system

agreed to put off admitting the new states to the LFA until 1995.[26] Instead, they set up and financed more or less equally the Fund for German Unity. The Fund had the dual function of distributing the debt inherited from the GDR and also seeking to limit the West German states' liability for rebuilding Eastern Germany.[27] For example, the Western states used the Fund to argue that East Germany should have a separate turnover tax system that would distribute the turnover taxes raised *in their territory* on per capita basis, but not the turnover tax rates from the entire territory of the now larger FRG. Thus the weaker Western states helped undermine the intent of the 1969 law, which had had been using the turnover tax as a way of *increasing* the solidarity of the entire LFA system. The irony, of course, is that these states were precisely the ones that had argued for such a provision in 1969. This time, however, the weaker Western states had a ready partner in the stronger ones, and the Unity Treaty of August 31, 1990 set the East German access to the turnover tax at 55% for 1991 and proposed to raise it slowly to 70% by 1994.

Of course, the GDR government, which negotiated this treaty, showed little capacity to counter the disadvantages for the new states that would emerge on its territory. This first maneuver came before the collapse of the East German economy. As the first wave of layoffs came in the summer of 1991 and as the now-elected East German state prime ministers could represent their own interests in federal-state negotiations, it became clear that they had no realistic foundation for public finance. The old states relented and reversed the decision on turnover tax to allow all East German states full access on the same per capita basis that West German states had. Moreover, Bonn responded with a new program, *Aufschwung Ost*, which

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reform. Ziblatt shows that in the face of electoral challenges from the PDS, both states defected from this initial coalition (p. 35).

[26] Scholarship on post-unification reforms includes Färber, 2003; Renzsch, 1991, 1994; Burchardt, 1992; Hüther, 1993; and Hickel, 1992.

provided about 12 billion DM a year in 1991 and 1992 for new investment and employment in Eastern Germany.[28] Thus, the situation early in the reunification period was that the Eastern states had partial access to pieces of the old system plus a series of special programs to help with their special problems. Yet the entire FRG still looked ahead anxiously to 1995 when it would see the new states come into the real LFA system, whether reformed or not. Yet as we see in Table 1, which summarizes the three formal and one ad hoc stages of LFA, only minor changes – the addition of level three – in the overall structure of the system were enacted in 1995. At that time, the system was renewed until 2005. This raises the key question: who footed the bill for extending a staggeringly expensive LFA to the five new states?

Table 1: The Stages of the Burdensharing Scheme in the FRG

Stage	Mechanism	Measure of financial strength	Goal and 1999 transfer sums
One: horizontal	Redistribution among *Länder* of 25% of *Länder's* share of VAT.	Per capita tax income, Excludes: VAT income, local governments' income, city-state population weighting.	All *Länder* should reach 92% of average income. **Transfers:** DM 15.4 billion
Two: horizontal	Cash transfers from richer to poorer *Länder*	Per capita tax income, Includes: VAT income, 50% of local governments' income, and city-states' population weighted at 135%.	All *Länder* should reach 92% of average income. **Transfers:** DM 14.6 billion
Three: vertical (this step added in 1995)	Cash transfers from *Bund* to poorer or needier *Länder*	As in stage two.	All *Länder* should reach 99.5% of average income. **Transfers:** DM 6.5 billion
After the Equalization: vertical	Cash transfers from *Bund* to poorer or needier *Länder*	Ad hoc determination of need.	Varies. **Transfers:** DM 19.3 billion, with nearly 2/3 going to eastern *Länder,* the rest to poorer western

[27] Renzsch, p. 276.
[28] Sally and Weber, 1994.

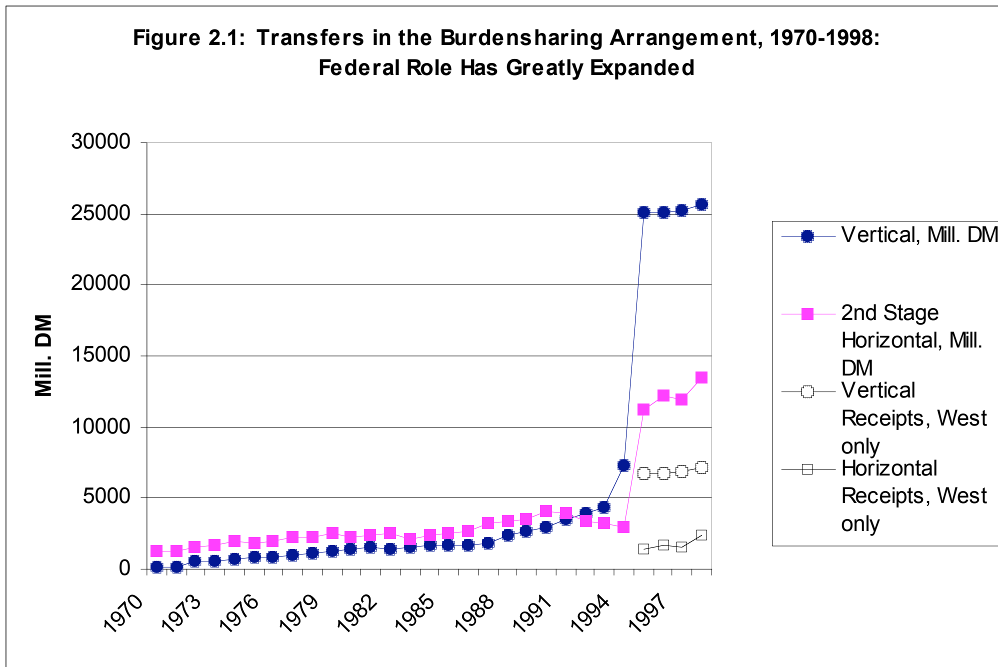
			Länder.

Source: Adelberger (2000, p. 68); Vesper (1996, tables 1-3); Margedant (2001, p. 21).

The answer, it turned out, was mostly the federal government. In order to make possible the inclusion of the five new states, the federal government agreed to pay the lion's share of the costs.[29] Indeed, most of the financially weaker Western states were guaranteed the extension or *even the improvement* of conditions under which they had access to LFA monies. There were some changes in the way richer states paid into the system, but on the side of the recipients, nothing significant in the formula changed. Thus, instead of using the financial crisis for fundamental reforms, virtually no reforms were undertaken. Instead, the federal government greatly increased its direct payments to states. Where prior to unification, the federal government's vertical payments had been about 60% of the land-governments' horizontal ones, by 1992 vertical transfers had already outstripped the horizontal transfers. Yet this jump was nothing compared to what was coming next: as we can see from table 2, vertical redistribution jumped almost 500% by 1995 (from less than 5 billion DM per year in the early 1990s to around 25 billion DM from 1995 on). The vast majority of the new vertical transfers went to East German states, although vertical transfers to West German states almost doubled during this period from around four billion DM to around seven billion DM. In subsequent years, federal

[29] I follow Renzsch and Adelberger in emphasizing federal payments, though it should be noted that Färber and Sauckel (2000) emphasize that the federal government used its agenda setting power and ability to disguise some taxes to get a better deal than is widely believed. For a discussion of the extensive new powers (and burdens) of the federal government in other policy areas, see Czada and Wollman, 2000 and Jacoby, 2005.

exposure has stayed high, and the most recent data (2004) showed it at just over 30 billion DM.[30] The old states didn't get off easy – their horizontal redistribution increased steeply as well (see Figure 2.1), though far less in absolute terms than did the federal government's exposure.



Source: Adelberger (2000, p. 71)

What political maneuverings produced this deal?[31] Essentially, the rich states feared that the poor states would form a coalition with the federal government – the old political constellation of the 1950s and 1960s. And once again, they tried to head off that possibility by offering the poor states a revenue-sharing deal as attractive as that the federal government's initial offer. Because the richer states proposed that the federal government absorb much of the cost, they were especially generous to the five East German states, offering them about 120% of average per capita taxes. And despite having complained all the way to the constitutional court

[30] 15.042 billion Euros. Bayerisches Staatsministerium der Finanzen, "Der Bundesstaatliche Finanzausgleich," February 2005, p. 20. See also Färber, op. cit., p. 60.

in the late 1980s, the rich states offered to retain most of the old privileges that the West German city states and the poor West German states had previously enjoyed in order to get their agreement to the 1995 reform. Given the veto positions of these states, it was difficult to get them on board unless they received much of what they had before.[32] Of the old poor states, only one (Schleswig-Holstein) moved from a net recipient to a net payer between 1995 and 1999 (and that only in the years 1995 and 1997). In the same period, Bremen and Lower Saxony's revenues were up slightly over 1994 (the last year of the old system) while those of Rhineland-Palatinate and Saarland were down slightly.[33]

Yet each layer of actors had their reasons for going along. Communities might struggle more against such buck-passing if they were seen as partially responsible for the taxation levels. But they are not, and indeed communities have not generally pushed harder for more authority over taxation.[34] Meanwhile, the poorer West German states accepted the inclusion of the Eastern states even when it did cost them some revenue from the LFA because they were able to get the federal government to make special-payments that softened this blow. Given that they had to make some contribution to financing German unity, the poorer Western states and the Eastern states agreed to resist the richer states' desires to reduce the amount of redistribution.[35] Finally, Kohl's government had made such a commitment to the Fund for German Unity that it couldn't easily accept the breakdown of the system that paid for it, so ultimately it felt compelled to go

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[31] Recent sources here include Adelberger, 2001; Renzsch, 1996, 1997, 2001; Schneider, 1999; Vesper, 1996, 1998; Gunlicks, 2000; Ziblatt, 2001; Färber 2003; and Färber and Sauckel, 2000.
[32] The one countertrend came when the federal state was able to push off some costs onto the old states (and their communities) by cutting programs for which they had previously paid. Yet because of the structure of German institutions, the federal government was only able to cut in areas where the existing states had no statutory requirement to spend because otherwise the Bundesrat could stop the government from making the cuts. In short, the FRG's institutional system encourages buck-passing in which the federal government passes onto the states what in the United States would be called unfunded mandates (Posner, 1998). The states, in turn, often pass those onto their own communities. The communities have the weakest institutional foundation to resist such mandates.
[33] Färber 2003, p. 59.
[34] Färber and Sauckel, 2000, pp. 685-86.
[35] Ibid., pp. 689-90.

along with the bulk of the rich states' proposal.

This pattern – minor concessions by current recipients coupled with increased federal payments – was repeated in negotiations in June 2001. Even though only six states now pay into the LFA (while ten are beneficiaries), the sides were able to reach an agreement to extend the LFA system from 2005 through 2019.[36] Two institutional factors pushed the states toward a deal: first, the Constitutional Court had ordered the parties to find a more just system in response to the suit brought by Bavaria, Baden-Württemberg, and Hesse. Second, if the state governments could not broker a unanimous deal, maneuvering would shift to the Bundestag, where all parties would be involved and a plurality would suffice. After regulating the system for four years (1991-95) and then ten more (1995-2005), the states moved to strike a long-term bargain. As one might expect given the implicit backing of the court, the richer states did do better. They achieved a new rule that allows them to keep the first 12% of revenues over the national average, and they also achieved a cap on their total contribution. Bavaria will gain an estimated 200 million DM per year from these new arrangements. Yet, the poorer states of Western and Eastern Germany did not lose the benefits they had formalized during the 1995 negotiations. Instead, when the negotiations seemed in trouble, the federal Chancellor stepped in with a package of 13 billion DM to compensate the poorer states for the funds the richer would be allowed to retain. This means that even a poor state such as Bremen will get an additional 70 million DM per year more than under the prior system. According to recent calculations of the Bavarian Ministry of Finance, new rules in 2005 will allow Bavaria to keep about 44 Euros out of every extra 100 Euros of tax revenues as compared to only 32 Euros under the system that prevailed up to 2004. North-Rhine Westphalia profits even more (it keeps 59 Euros rather than

[36] Details in this section are drawn from various German press sources and from interviews in Germany in May and June 2001.

44), while Baden-Württemberg (37 versus 30) and Hessen (32 versus 21) also benefit from the new system.[37]

This was an expensive accord for the federal government. The parties agreed to fund the *Aufbau Ost* program with 306 billion DM over the same period (the LFA, *Aufbau Ost*, and Fund for German Unity will all run until 2019 under this new deal). The same electoral calculations that pushed Schröder to guarantee the system's liquidity probably also helped moderate the position of at least one richer state. Bavaria's Prime Minister was then positioning for a run at the Chancellorship in 2002 and thus was not inclined to play hardball during these negotiations. He did, however, make clear that Bavaria wishes an end to the system of joint tasks and mixed financing regularized in the 1969 reforms. Instead, Stoiber argued that a clear division of competencies between federal, state, and European levels is required.[38] But whatever remains to be clarified in terms of *competencies*, the main responsibility to *pay* has clearly lain with the federal state, with the richer states seeing smaller increases in their exposure, and the poor West German states making very little contribution at all. The ultimate burden, of course, lies with the German taxpayers, East and West. Annual deficits have been rising (14 billion Euros in 1980 but 24 billion in 1990 and 32 billion in 2005) while total debt reached nearly 1.5 trillion Euro at the end of 2005, of which nearly 60% was federal. In comparison, total debt in 1990 was 536 billion Euros, of which only about 50% was federal.[39]

Importantly, while the fiscal system in Germany has few active defenders, it remains very difficult to envision a thoroughgoing reform. As noted, major elements of the architecture are entrenched in deals cut in the past decade. Notably, when in October 2003, the government

[37] Bayerisches Staatsministerium der Finanzen, 2005, p. 27.
[38] Bavaria has been joined in this argument by one other richer state, North-Rhine Westphalia (NRW). Bavaria and NRW are the only two states to progress from net recipients to net donors, but NRW had earlier refused to join the Bavarian suit in Karlsruhe.

established a special "Federalism Commission" to propose clearer division of responsibilities among the various levels of government, the Commission did not touch the LFA system. It was widely argued that an already contentious set of discussions would become unmanageable if it were included. The mayor of Bremen noted with satisfaction that the Commission "would not change one word" of the deal that runs until 2019.[40] Thus, an old side payment dating back to the 1950s ran from Bonn to the poor western states and was quickly followed by a second side payment from the strong states to the weak ones that was designed to minimize federal influence over state prerogatives. When unification came, both sets of side payments continued more or less intact even as the federal government in particular had to also come up with funds for a new set of recipients – the poor cousins from Eastern Germany.[41] So while the legitimacy of the current system may be low, its institutional anchoring is quite high. We turn now to the second case.

The EU Structural Funds: Solidarity and Side Payments

The EU provides structural funds to help co-finance (usually at the level of 50%) projects to promote regional economic priorities inside its member states. In recent years, the two central priorities of the EU's regional policy have been to reduce existing economic and social disparities between regions and to reduce unemployment in the EU's weakest regions.[42] The EU's structural and cohesion funds contribute financially to the regional policies of the member states as they try to create appropriate conditions for investment and job-creation. While the member states retain the responsibility for defining their development priorities, the co-financing role of

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[39] *Der Spiegel*, 19/2006: 23-30.
[40] Henning Scherf, as quoted in http://www.frankfurter-hefte.de/gespraech/gespraech/_04_1_2.html
[41] Note that by the definition used here, payments to the eastern Länder are the direct object of bargaining with the federal government and are not, therefore, side payments themselves.

the EU requires that individual projects take account of the European dimension of economic and social development. For the period 2000-06, the Commission set as priorities regional competitiveness, social cohesion and employment, and the development of urban and rural areas.[43]

EU spending on regional policy accounts for over a third of its total spending and trails only the Common Agricultural Policy in budgetary importance.[44] The total size of the four EU regional funds is currently capped at 0.46% of EU GDP, which translates into around 231 billion Euros between 2000-2006. Most of this – 182 billion Euros – is in the structural funds. This is set to increase to 308 billion Euros (247 billion in the structural funds) between 2007-2013. The structural funds have been around for nearly as along as the Community itself, but they grew significantly beginning in the middle of the 1980s as a result of pressure from Greece, Spain, and Portugal to help them develop at a time when the Commission was pushing the Single European Act.[45] Among other things, the funds are, therefore, a side payment to make countries capable of participating in a broader and wider single market. Of course, they are also a measure to boost consumption in poor areas, to redistribute income, to promote the participation of sub-national governments in EU policymaking, and to manage the levels and kinds of state support to domestic industry.

This paper focuses not on these functions per se, but looks primarily at the struggle over access to the funds themselves. The link to the first part of the paper is that in each case, a

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[42] On EU structural funds, see Hooghe, 1996 and Hooghe and Marks, 2001. On CEE states' efforts to join these funds, see Jacoby, 2004; Jacoby and ernoch, 2002. Hughes, Sasse, and Gordon, 2004.

[43] European Commission, 1999. Since 1988, the European Council has developed multi-year "financial perspectives" that set overall EU budget levels in ways that avoid annual budget showdowns. The current financial perspective expires in December 2006, and in April 2006, the EU agreed on a new financial perspective that will increase funding for both the structural and cohesion funds. See http://ec.europa.eu/financial_perspective/cohesion/index_en.htm.

[44] Declining to about 33% in 2006, given the 1999 absolute cap on structural funds spending.

[45] Mayhew, 1999, p. 283; Hooghe and Marks, 2001, pp. 106-07.

system that used side payments that increased financial solidarity and had a long-term and largely stable set of richer and poorer states has had to confront the reality that the arrival of poor cousins threatens to shift some states from being net recipients to becoming net payers. What does this do to the original side payments? In the EU case, the long-term recipients of structural funds have been Greece, Spain, Portugal, and Ireland. In all of these states, structural fund receipts were above 2% of GDP for most of the 1990s.[46] While all other EU members (including the wealthiest) have access to some structural fund monies, in none of them does the total magnitude come close to 2% (Italy is the next closest with 1.7%, concentrated mostly in the South). Also important in this context is the so-called cohesion fund, started in 1993 in the wake of Maastricht, and devoted to improving the environment and transportation only in the four poorest member states (Greece, Ireland, Portugal and Spain). Co-financing demands here are less – only 10% from the recipient side. The poorest regions in these states benefited further from the 1999 reforms that actually concentrated more spending on the weakest regions.[47] Thus, the poorest regions have, potentially, much to lose.

My focus here is on the so-called "objective 1 regions."[48] Objective 1 regions are those parts of member states where per capita GDP is less than 75% of the EU average. Of course, even poor states may have some regions that are not objective 1. For example, of Spain's 17 regions, 11 had objective 1 status during the 2000-2006 budget period. Objective 1 regions absorbed about 74% of total structural fund spending (including the cohesion funds) during the budget period ending in 1999, and they absorbed about 70% of structural funds during the 2000-

[46] In terms of percentage of GDP, Luxembourg actually receives the most EU funding, though relatively little of that comes from the structural funds. It is followed by Greece, Portugal, and the three Baltic States. In net terms (gross receipts minus contributions), Spain is the EU's largest recipient followed by Greece, Portugal, Ireland, and Poland (2004 data) (BBC September 22, 2005).
[47] Hooghe and Marks, 2001, p. 107. Hooghe and Marks (pp. 112-13) argue convincingly that an ideological conflict – between proponents of neoliberalism and regulated capitalism – overlays the territorial dispute I emphasize.
[48] The new member states have also been granted access to the cohesion funds.

2006 period.

It should not surprise us to learn that the structural funds long made up a significant portion of the four poorest member states' fixed capital formation and GDP. On average, in 1993, 6% of total investment in these states was financed by the structural funds.[49] By 1999, that figure had grown to 7.8% of all gross fixed capital formation. The percentage was highest in Greece, where by 1999 it reached almost 13%. In the other three countries, Spain, Ireland and Portugal, it ran from 7-8% in 1999. Similarly, the structural fund has grown important in GDP terms in all four countries. On average in 1989, structural fund spending equaled 1.6% of GDP in these four states. By 1993, it was 2.3% of GDP and by 1999, 2.9% of GDP. By contrast, in all other EU member states, the percentage of fixed capital investment coming from the structural funds was only 2.5%, and the percentage of GDP was 1.1%.[50] This is a significant prize to protect, and moreover, it was a prize provided originally as a way to help induce the participation of the poor countries in the increased competition of a single market. Spain has led the diplomatic fight to preserve structural fund spending for current recipients rather than be more generous towards the poor cousins. The final section of this paper thus looks at the diplomatic maneuvering that has made the poor cousins feel less than welcome.

Reforming the EU Structural Funds: Old Poor States versus New Poor Cousins

It is well known that the GDP levels of the ten new member states are far below those of the old EU-15. Using 2000 data, the EU-15 average GDP per capita at PPP was $23,133 (with the low in Portugal at $15,800) while in the new members the average was $8,440 (with a high in the

[49] Mayhew, 1999, p. 286.
[50] Ibid.

Czech Republic of $12,900).[51] Eurostat figures from the 2000-2002 period show that in the new members over 92% of the population lived in regions with a GDP per capita under 75% of the EU25 average. At that time, Within the old EU15, only 14% of the population still lived in regions below 75% of the EU average. In the new members, 61% of the population lived in regions below 50%; in the former EU15 countries, no region fell below this level.[52]

What would it mean to add these very poor countries to the existing system? The answer depended upon the rules the EU used to add the countries. Some rules seemed discredited from the start. For example, if one had simply extended the then-current per capita spending from the structural funds in existing objective 1 regions, then the ten new members would have been slated to receive a whopping 30 billion Euros per year.[53] This would then have represented about 85% of the total annual spending of the funds and would obviously have had to come out of the hide of existing recipients or of existing payers (who would have been obliged to pay even more). Even if the EU had dropped the level of per capita spending to the level received by the eastern German states -- 174 Euros per person, per year -- the new EU member states would have absorbed over 18 billion Euros annually. Instead of being 85% of the entire structural funds budget, that would have represented 51% of the structural funds budget in the 2000-2006 period.[54] Both options were thus politically unworkable.

Meanwhile, many experts also argued that these new members could not quickly "absorb" substantial funding and proposed various forms of caps on the percentage of GDP that

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[51] Central Intelligence Agency, 2001.
[52] EU Commission, "Latest European regional statistics confirm Commission's proposal on Structural Funds for 2007-2013." January 28, 2005. http://europa.eu.int/rapid/pressReleasesAction.do?reference=IP/05/107&format=HTML&aged=0&language=EN&guiLanguage=en.
[53] This is on the assumption of an ECU transfer per capita of 289 Euros per year, per person in objective 1 regions.
[54] Mayhew, 1999, pp. 289-91.

any one new member could receive in a given year.[55] The justification for such cap proposals – which drew much criticism from the prospective new members – were the significant administrative difficulties in starting up new structural fund programs, identifying projects, and providing the requisite co-financing. In addition, it was said that too much rapid investment might bring macroeconomic distortions.

Against this background, the EU-15 needed to negotiate a final deal with the accession countries, a deal that would allow the new members to join in time for the European Parliamentary elections scheduled for the summer of 2004. In the various negotiations that led up the final deal – and indeed in subsequent negotiations that continue up to the present moment – the old recipients of structural funds have been keen to protect their access to payments even as new payments flowed to the accession countries. No country has been more determined in this endeavor than has Spain. Spain quickly emerged as the leading diplomatic opponent of financing poorer CEE states out of the same pot that financed the poor member states.[56]

Spain has a rich recent history of raising to the level of high national drama the political bargains over the structural funds – a subject reserved for policy wonks in many other European countries. Felipe Gonzales, the socialist prime minister of Spain throughout the 1980s, is still remembered for having stared down past German attempts to cut structural funds to Spain. Such maneuvering seems common regardless of the partisan composition of the Madrid government. Both the Conservative Aznar governments and the current Socialist Zapatero government have shared two sets of tactics. First, they have sought to establish a new set of criteria that would

[55] Mayhew (1999, p. 291) makes this argument as did many of the people I have interviewed in the region in the past few years (Rozsa, Blažek, Černoch, Dupal, Červený).
[56] There is anecdotal evidence that Portugal and Greece were happy to see Spain take the lead in these deliberations, but I need to follow up on this claim in order to substantiate it. Ironically, Spain was a net contributor to the EU budget in the early years of its membership (before the structural funds grew so large).

keep many of their regions eligible[57], and second, they have threatened to blockade other EU policies.

In terms of new criteria, Spanish officials have emphasized, above all, the "statistical effect," in which the poor nations admitted to the EU have brought down the average per capita GDP, pushing old Objective 1 regions above the 75% threshold in the process. As Conservative Foreign Minister Josep Piqué stated in 2001, "If we don't come to a prior solution about the so-called 'statistical effect,' the expansion will push an artificial and automatic shift that would be gravely prejudicial to current beneficiaries of the Cohesion Funds." Diplomat Juan de Dios Izquierdo was even more blunt: "[The Spanish regions] will continue to be equally poor, although statistically it won't appear so….Either cohesion today for everybody and fulfillment of the pact, or political war."[58]

Despite the fact that only two Spanish regions (Asturias and Murcia), were affected in this particular way, Spanish diplomats have consistently framed this as a major dilemma. To address it, Spain put forward several solutions. One idea was to broaden eligibility from regions with less than 75% of the average GDP to those with less than 90% of the average.[59] Another was to use unemployment as the measuring stick for deciding when a region gets structural funds (Spanish unemployment remains high). Yet a third proposal was to raise the overall ceiling on aid available from the 2000-2006 limit of .45% of EU GDP to perhaps .66%, which could have meant an extra 20 billion Euros per year.

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[57] They do so in the context of Madrid's longstanding struggle to keep its own regions from participating in negotiations about the Structural Funds support framework. This dimension of the complex politics of Spanish regionalism is outside the scope of this paper.
[58] Both quotations in this paragraph are from Yárnoz, 2001b.
[59] "Europe: What's Ours is Ours." *The Economist.* May 26, 2001. Volume 359: 47-48.

The key problem has been that the Germans – the EU's largest net payer – have liked none of these options.[60] In part, German anger is understandable when one considers how few Spanish regions are really hurt by the statistical effect. The population of the two regions so affected is just over two million or about 5.4% of total Spanish population.[61] The German SPD has, in fact, proposed returning regional policy largely to national control, and aides to then-Foreign Minister Joschka Fischer were furious about last-minute Spanish demands during the all-night bargaining during the last day of the Nice summit.[62] For their part, Spain blames Germany for wanting to take away their funds. For example, Izquierdo maintains that the most developed nations of the EU benefit most from the union, and notes that Spain imports about 1 billion pesetas worth of automobiles from Germany each year. In addition, much of the Spanish infrastructure improved through the cohesion funds ultimately benefits the German industries from which they buy machinery and technology.[63] This argument leads directly to a second one, already familiar from the first part of this paper: the German federal government should foot a large part of any bill for expanding the current system.

The second tactic involved policy blockades. Most notably, in 2001, Aznar's Foreign Ministry announced that Spain was only willing to compromise on the structural funds issue if Germany would compromise on the issue of immigration controls within the EU.[64] At that time, Chancellor Schröder was trying to broker a seven-year moratorium on free movement of labor from accession countries because many German voters, especially in border regions of Eastern Germany

[60] In 2000, Germany's net contribution to the EU was 9.3 billion Euros. The other net contributors had far smaller balances: Britain (3.8 billion), Netherlands (1.7 billion), France (1.4 billion), Sweden (1.2 billion), and Austria, Belgium and Luxembourg all with less than one billion Euros.
[61] Schmidt-Seiwert, 2004.
[62] Interviews in the German Foreign Ministry. Until I can clear these, I'm not using direct quotations or names.
[63] Yárnoz, 2001b.
[64] Indeed, Germany's *Wirtschaftswoche* (November 29, 2001, p. 47) claimed that the price for Spanish agreement to Germany's plan for immigration controls was that Germany guarantee that Spain suffer no loss of structural funds during enlargement. Rumors of a similar deal surfaced in *Der Spiegel* just after Nice.

and Bavaria feared being swamped with immigrants. Spanish leaders understand that this issue was only politically significant in Germany and Austria and skillfully used it to block other reforms, including those of the structural and cohesion funds.[65] Despite German efforts to move toward agreement on reforming the funds, Spanish officials insisted that the two issues were inseparable, and any negotiation on one front must produce satisfaction on the other. Conservative Minister of Economics Rodrigo Rato argued, "If there are countries that bring up concerns about the process of expansion, like those that are worried about the circulation of people, there can also be others that have justified problems with respect to the statistic effect produced by the expansion." Piqué noted that "Spain can be flexible in its negotiations if other nations are flexible."[66] For German Finance Minister Hans Eichel, Spain crossed the line between blockade and blackmail.[67]

In the end, these 2002 negotiations brought many disappointments for CEE states. In particular, the EU-15's determination to stay within the bounds of the 2000-2006 financial perspective meant that for the period 2004-2006, only very limited funds would flow to the new members. Moreover, when the EU-15 took this decision in 1999, it was widely assumed that only six states would qualify for membership during this period. When it was decided in 2002 to admit ten, this meant that the same amount of money had to cover four more countries.[68] The 21.6 billion Euros in structural and cohesion funds allocated to all of CEE for the 2004-06 period is roughly similar to what Portugal alone received in the 2000-2006 period, a time during which Spain received about 55 billion Euros. In short, the final deal on the structural funds was not generous. Indeed, as noted earlier, the combined agricultural and structural funds receipts for some CEE new

[65] Yárnoz, 2001a.
[66] Yárnoz, 2001c.
[67] "Europe: What's Ours is Ours." *The Economist.* May 26, 2001. Volume 359: 47-48.
[68] "Enlargement: Playing for Real." Europe Information Service, *European Report*, February 2, 2000.

members were so low that the EU created a special "payment facility" to add new monies so that no new member state would immediately be a net contributor to the EU budget.

CEE complaints about the side of the structural funds package were heard immediately. In November 2002, the finance ministers of 13 candidate countries released a statement expressing their concern that the EU's final offer included funding that the candidates would be unlikely to be able to use given the EU's complex rules. The ministers worried that these monies would then be redirected away the CEE states.[69] As it happened, the new members have been able to contract projects covering virtually 100% of their allotted funds for 2004, though it is important to note that some projects may not be realized in ways that would allow Brussels to transfer the allotted monies.[70]

Meanwhile, Spain continued to press its own case, which occasionally brought it into direct conflict with the new members. For example, Spanish diplomats overcame the strong objections of Polish, Czech, Slovakian, and Hungarian officials to remove key language from a joint EU document prepared for the budget summit in December 2004. The deleted language had emphasized solidarity as an important principle for the distribution of cohesion funds during the 2007-2013 budget period and called explicitly for efforts to help the new members reach average EU levels of economic development.[71]

In confronting these conflicts, some additional money has been proposed by the Commission, specifically an increase in structural and cohesion funds for 2007-2013 to 336 billion Euros. However, this is just a request, and the European Council is widely expected to approve a smaller figure when and if it approves a new financial perspective. Still, it seems like the new

[69] Mihaela Gherghisan, "Candadiates Consider Financial Package Unrealistic." *EUObservor.com*, November 5, 2002; CTK, "Czechs Displeased at EP Majority 'Ignoring New Members' Needs,'" in *CTK National News Wire*, July 6, 2005.
[70] Polish News Company, "New Members Make the Most of EU Funds," *Polish News Bulletin*, January 19, 2005.

members will see an increase over the truly modest annual allocations they will receive in the first two yeas of membership. That said, the Commission has also called for regions hit by the statistical effect to be "phased out" of the funds, rather than dropped altogether. The terms proposed are 85% funding for the first two years followed by 5% annual drops throughout the rest of the budget period to 2013. In all, the EU Commission has proposed spending about 22 billion Euros on the "statistically ejected" regions (not just Spanish) between 2007-2013.[72]

Meanwhile, CEE states have continued to worry about the cap on structural funds as a percentage of GDP. The EU set this cap at 4%, which the CEE states have now grudgingly accepted, but they continue to insist that the formula used to calculate their GDP understates the real size of their economy and thus diminished the size of funds for which they are eligible.[73] The flexibility and phase out issues came together when the Luxembourg presidency drafted a "compromise" plan for the EU budget, which guaranteed the phase-out desired by Spain but rejected calls by the new member states for "flexibility" in interpreting the cap rules. The Czech representative spoke for many others when he publicly denounced the proposal as a "giant step backwards."[74] A short time later, the European Parliament followed the Commission on the flexibility issue. Czech MEP Jan Brezina called the EP majority's decision "a move of arrogance and also a huge political mistake."[75]

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[71] Polish News Company, "Visegrad Group Struggles with Spain over Structural Funds," *Polish News Bulletin*, December 13, 2004.
[72] European Information Service, "Regional Policy: Michel Barnier Confirms Broad Outlines of Future Cohesion," in *European Report*, February 14, 2005.
[73] European Information Service, "EU Budget: Commissioner Eases Stance on Cohesion Policy," in *European Report*, February 2, 2005.
[74] European Information Service, "Budget: Beneficiaries Give Hostile reaction to New Draft Compromise," in *European Report*, April 27, 2005.
[75] Quoted in CTK, "Czechs Displeased at EP Majority 'Ignoring New Members' Needs,'" in *CTK National News Wire*, July 6, 2005.

Conclusions: Side Payments, Not Solidarity

In terms of financial solidarity, there remains a significant difference between being a federal system and a quasi-federal one. Institutions, not affection, seem to have driven the policy choices above. In turn, a central finding of this paper is that these are systems of side payments more than of solidarity. The Eastern Länder did not get a generous deal because their compatriots were strongly inclined toward solidarity; instead their actions and rhetoric look quite a bit like the moves of the EU "old poor" in trying to preserve their Structural Fund monies. In both cases, the old weak recipients did well. The old poor German states continued to receive most of the prior benefits they had enjoyed, while the old poor EU states have not, so far, paid much of a price for enlargement. Both sets of states used their insider location and the corresponding veto positions they enjoyed to shape the terms under which new states would enter the two systems of financial solidarity. In both cases, old sets of side payments were largely continued. In the German case, they were formally reaffirmed until 2019, while in the EU case, they are insulated until 2013.[76]

If the old poor states largely kept what they'd had, then the two sets of poor cousins could only benefit if someone else paid. The key in both cases was whether the political center of the respective systems had the fiscal flexibility to engage in deficit financing. In the German case, the strong states and the old poor ones ganged up on the center (the federal government). The poor cousins in Eastern Germany profited as a result. The center found it impossible to resist, in no small part because the electoral dynamic in Eastern Germany made voters there crucial to both major parties in three successive elections.[77] In Germany, the addition of the new Eastern

[76] One difference is that while all the Eastern German states are "all the way in" the LFA system, some Spanish (and indeed in other states) have grown wealthy enough to partially graduate out of the structural fund system, though under the announced guidelines for 2007-2013, they still receive substantial transitional help.
[77] Eastern voters remained important in the September 2005 elections, but by then the federal financial architecture was no longer a central issue.

units was made at the central political level, so the inclusion of these poor cousins was, with the signing of the Unity Treaty, inevitable. The old units could shape the conditions of entry, but realistically they could not say "no." This deal strengthened the hand of the poor cousins from Eastern Germany.

In the EU case, by contrast, both the old wealthy and the old poor states ganged up on the poor cousins. The center – the EU Commission, which is the primary EU institution tasked with pushing national interests to the periphery – could not help them; it lacked both the authority and resources to do so without the member states, who controlled the broad contours of the enlargement process and had a firm cap on the budgetary process that was valid until the end of 2006. Unlike in Germany, the addition of new units required the consent of the old units – a consent that was not given until 2004 and that allowed the old units to put strict conditions on entry and limit their exposure to any revenue losses. In short, two features mattered a great deal: electoral ties across levels of government and the taxation/borrowing limits on federal actors. The German federal government had the capacity to step in to bridge a funding gap when the German old poor were not forthcoming, and Bonn/Berlin also had the motivation to do so because the respective governments wanted to build their political support for national-level elections. In the EU, "federal actors" like the Commission had neither the capacity for funding nor little motivation to provide it if it had to come from existing resources.

The 2007-2013 period should treat the CEE states somewhat better. Total spending for the structural funds is, as noted, now set to increase, as is the percentage of those funds that will go to the poorest recipients (from around 70% of total spending to nearly 80%). Since the new members fall almost entirely into this poorer category, they will benefit disproportionately from such a shift. But the disparities have been stark: In 2004, 93.5% of EU spending went to the old

EU15, with only 6.5% going to the new members despite the fact that their population was 16.3% of the EU. Spain remains, by some distance, the leading recipient of EU funds with almost 16.5 billion Euros (17.8% of the budget), followed by France, Germany, and Italy (with 14, 13, and 11% respectively). The largest recipient in the new member states was, of course, Poland, but it received only 3% of EU funds. By comparison, Ireland, which received slightly more gross funding, has a population of 4 million compared to 38 million in Poland. And though Poland has virtually the same amount of agricultural area as France, French farmers receive roughly 30 times as much CAP support as Polish ones.[78]

One might respond that it is early, and in due time, the poor cousins will find access to more EU monies. At one level, this seems likely, as noted by the 2007-2013 figures. But if things could get better, they could also get worse. For example, it is less than certain that the current Structural Fund programs will be durable. Where the rich German states cannot easily escape the solidarity system – and so had to make some contribution to extending the LFA – the British case shows that richer EU states *can* make a credible threat to diminish or even dismantle the structural funds system. Where the Spanish have fought tenaciously to defend the current system, the British seem to accept that relatively few of their regions would receive much continued funding – only Cornwall – and thus seek to shrink the program.[79] If they do – and the Germans, Swedes, and Dutch have made favorable comments about variants of the "renationalization" plans for the structural funds – then this would be another blow to the financial aspirations of the poor cousins.

Sympathy and solidarity seem to play little role in these debates. Spain is a country

[78] "The Bulk of EU Money Goes to EU15," *Euractiv.com*, September 29, 2005.
[79] Three other UK regions are likely to leave Objective 1 status in the next budget period (Merseyside, South Yorkshire, West Wales and Valleys).

without a single important anti-EU political party and where Euro-skepticism has been small, disorganized, and ad hoc.[80] Nevertheless, Spain has maneuvered to hang on to structural fund allocations that might otherwise go to even poorer CEE states. Taken together with the earlier evidence from the politics of LFA reform in Germany, there can be little doubt that recipient states have fought to maintain existing benefits, even in the face of clear evidence that other states are much worse off. This pattern apparently holds true even when the funds are explicitly to promote solidarity by compensating for the inequalities of market outcomes.

Of course, it can hardly surprise anyone that politicians who must run for reelection struggle to protect resources for their constituencies. A more intriguing picture emerges, however, when we return to the claim that the "solidarity fund" in both the inner-German and inner-European cases is really more a system of side-payments than of solidarity per se. These tax and development policies are embedded in a larger logic of state and market making that spans several decades and highlights the struggle for resources and control among various levels of government, perhaps more levels than the dominant state-building literature has heretofore emphasized. Indeed, we have seen in this paper that policy reforms are fought out between community, state, national, and European levels.

In Germany, the stronger states tried to help the weaker states in order to ward off the central state's influence on them. They found, to their consternation, that the weaker states took help from both sides, and so, as a second step, the strong states proposed areas of joint decision making and federal-state cofinancing. In so doing, they acknowledged the inroads the federal state had made into certain policy areas, but they tried to control those inroads, and at the same time found an avenue for securing some funding from the central state in their own right. Both sets of side payments ultimately made the system impervious to major reforms, but it also made

[80] Goetz and Hix, 2000, p. 34.

the system unworkable in Eastern Germany unless one actor stepped forward to pay for it. The electoral weight of the Eastern voters in 1990, 1995, and 2001 has been sufficient for the federal state to make this very expensive investment. It has done so, moreover, under both center-right and center-left coalitions, suggesting that ideological factors are not the key explanatory variable. Rather, the key was a shift in the bargaining strategy of the richer states in about 1995 when they moved from open hostility to net recipients in both the West and the East to propose a settlement generous to all the states because it was substantially paid for with Berlin's money. By framing a new possibility for a cross-state coalition, the richer states foiled the predictions of experts who argued that subsequent reforms were likely to see burdens shift from Berlin to the richer states.[81] Indeed, the big question is whether "subsequent reform" will even happen at all. With the financial basis for this costly set of side payments now set until 2019, one wonders just how much disaffection would be required to push through some kind of reform.

The side-payments in the EU case resulted from the decision of the Commission, backed by important member states, to accelerate the market-building aspect of the Community in the mid-1980's.[82] In order to allay fears in the less developed member states, the EC significantly expanded the funds available for regional development. These monies raised confidence that even if the market's greater scope benefited some Europeans in a disproportional way, some of those benefits would be made available to the Community's poorest regions. Even though the redistribution targets never came anywhere near the 99% achieved in the LFA system, they were significant in their impact on both investment and consumption. And they have proved just as hard to reform.

That said, there is more evidence here than in the LFA case that the side payments may

[81] Renzsch, 2001.
[82] On the SEA more generally, see Moravcsik, 1998.

be vulnerable. In particular, as the eastern German states and several UK regions have outgrown the 75% threshold for Objective 1 regions, these important net contributors to the EU budget have each raised the specter of a renationalization of regional policy. Each has been careful to note that some funds should continue to flow to the new members, and as we saw, the current UK proposal actually calls for the new members to have almost exclusive access to EU structural and cohesion funds. Such a scenario might be superficially appealing to CEE leaders, but one would have to wonder about the political durability of a system of funds that brought little direct benefit to the major underwriters of the EU budget.

In part, the EU has been unable to do what the federal government in Germany has done – strike a long term deal – because it has no independent powers of taxation. In each crisis of fiscal equalization in Germany, the federal state has been able to draw upon general tax revenues to purchase the compliance of the recalcitrant states. For decades, pareto optimal deals have been unavailable in German federalism, and side payments have been crucial in holding the system together. The EU has no analogous general revenues from which to draw to overcome political blockades. In this sense, the EU is more similar to the fiscal system of the original German Reich of 1870 than to the current German government.[83] Indeed, it is possible that the price for extending (largely unreformed) the German LFA system has diminished the long term sustainability of the EU structural funds. Obviously, Germany – as the EU's largest net payer – has to bear a large part of the burden of the structural funds. But the German government, having ponied up most of the money to extend one system of solidarity, feels it is in no position to do it again. Absent a voice in the national elections of existing member states, the poor cousins of Eastern Europe have found significantly less solidarity than the poor cousins of Eastern Germany. Now that they are in the system, it will be fascinating to see how, if at all, their

fortunes change.

[83] Hefeker 2000 develops this comparison.

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