

**REGIONAL DEVELOPMENT,  
DEVOLUTION AND FEDERALISM**

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# **REGIONAL DEVELOPMENT, DEVOLUTION AND FEDERALISM**

## **Abstract**

The following paper is the text of a lecture given by Dr Paul Klemmer as Visiting Professor to the European Policies Research Centre at EPRC on 7 December 1998. The lecture provided an overview of new developments in regional economic research, including the growing importance of region-specific characteristics underpinning the creation, dissemination and adaptation knowledge for innovation and new firm formation. Against this background, it considered the ability of devolved systems of governance to respond to new regional challenges, with a critical assessment of the system of 'co-operative federalism' in Germany and the current debate over financial equalisation

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Ladies and Gentlemen,

I last had the opportunity of lecturing here as a Visiting Professor about two years ago. The interest that was shown and the generous hospitality that was extended to me remain a very pleasant memory. I wanted to come back - not only because of the duties connected with the professorship but also because of the agreeable atmosphere. Unfortunately the lecture that was envisaged for last year fell through owing to unforeseen problems with my schedule. I am all the more delighted that things have worked out this time and would like to thank the representatives of the University and the EPRC for their patience.

I hope that the topic we have selected this time will be of interest to you all. During the preliminary discussions held in preparation for my visit today we took the view that the lecture should be on an area relating to our common research interests while at the same time providing information on specifically German experience. This would particularly concern experience of practical politics and therefore, in my case, of German politics.

Unquestionably, our common field of interests includes regional development research. In the EPRC here in Glasgow you have a renowned research institute whose reputation extends far beyond Great Britain. I especially admire the dynamic role played by the EPRC in the preparation of expert opinions throughout the world. We can all learn a great deal from this. In some areas the EPRC and RWI have already collaborated successfully. I hope that we will be able to intensify this cooperation in the future, regional development research being something that is experiencing a resurgence of interest in Germany. On the one hand, this has to do with the regional policy problems connected with the new eastern German states and, on the other, there is the possibility that some recent research may bring about a change in German regional policy, reorienting it towards innovation. Accordingly, I would like to say something about the results of this recent research, concentrating more on recommendations for action than on theory.

I have also been told that topics relating to devolution and federalism are currently receiving great attention in Great Britain. In Scotland, at least, debate on this issue seems to have great prominence. In view of the long tradition of federalism in Germany, this gives me an opportunity of talking about selected aspects of the German experience of federalism. It should be made clear that the current discussion in Germany is primarily concerned with

wrong turnings that have been taken. That does not mean that we question the merit of federalism. What we are attempting to do is adapt it so as to avoid such adverse developments, to learn by our mistakes. Once again, I want to address practical experience and ideas for reforms rather than theoretical models.

Let me begin with regional development research. This has a long tradition in Germany. Since its inception it has been concerned not only with explaining particular companies' choice of location or the development of particular kinds of settlement structures - for example, agglomerations or a hierarchical system of central locations - but rather, and especially, with regional growth processes. In this context the question has repeatedly arisen as to whether the regions of an overall economy are converging or diverging. Regional development research is to a great extent research into convergence and practical regional policy is a policy of convergence. Accordingly, one of the major goals of both German and European regional policy to date has been an attempt to reduce undesirable geographical disparities by means of selective measures. In their attempts to accomplish this politicians are constantly faced with the need to draw on the results of regional development research.

In the past attention has mostly been focused on the so-called "hard" location factors when an attempt has been made to explain divergent regional development processes. These factors are termed "hard" because they can be directly measured (eg. prices, population, transport costs, distances, travelling time) or are at least measurable in physical or performance related terms (number of places for trainees in industry, capacities of sewage treatment plants). Largely identical or similar production functions were assumed in all areas and the geographical disparities explained as resulting from a divergent availability of resources or specific local factors such as location and transport costs. This approach addressed determining factors such as availability of natural resources (eg. coal), infrastructure, locations, available labour force, available sites for industry and population density. Added to this there were often differences in the prices of important resources like energy and labour. The basic assumption was always that convergence was possible. Recent convergence research, however, has emphasised that this requires a great deal of time. For instance, it is anticipated that parity between the eastern and western German regions will take more than 25 years to attain.

In the past infrastructure policy has been especially prominent as a strategic variable in regional policy. Basically, it can be said that regional policy is to a large extent infrastructure policy. In addressing this issue we have learned to distinguish between local or regionally oriented infrastructure and network infrastructure. The former (regionally oriented installations) comprises high capital expenditure installations which usually serve the needs of a town or region: water mains, sewers, sewage treatment plants, schools and hospitals. Deficits in these fields may result in development bottlenecks and can be remedied by 'bottleneck oriented' regional policy. Such policy ought to be planned and implemented as far as possible at the regional level itself, the notion of a region being one of intermeshing areas. The interrelationship of town and surrounding area points up the geographical effect of local investment. When local or regional authorities are responsible for building infrastructure installations of this kind they can be assisted financially by regional policy making bodies at a higher level (European, federal or state level) but these should not interfere in matters relating to the actual content of the projects.

Network infrastructure, on the other hand, comprises installations whose effect on development becomes apparent within the context of a comprehensive network. A road or railway network, for instance, is defined by the accessibility of destinations: what is the average travelling time from particular locations - say, the Ruhrgebiet - to any other location in Germany or Europe? The destinations can also be weighted with population or value creation figures so as to express their significance more clearly.

Recently the practice has grown up of analysing the accessibility of destinations on the basis of a large, digitised network of lines of communication which simulates these (ie. roads, railways etc.) in sections that are as small as possible (about one or two kilometres) and as true to life as possible (ie. with bend radii, gradients, number of lanes or tracks, surface characteristics etc.). This shows up the small-scale hindrances to traffic and enables the time required to cover the various individual sections to be deduced. Maps of this kind with very detailed information on the accessibility of destinations are available for Germany and, to an extent, for Europe as a whole. They can also be combined with information on the latest traffic situation and the risk of being caught in tail-backs estimated. You can use them to look into how the improvement of a particular section will affect the accessibility of destinations in the network as a whole and it becomes clear how the construction of a new motorway or high-speed railway track not only benefits the places directly on the route but also the

reachability of destinations in the network as a whole. It turns out, for example, that a motorway development in western Germany can have a favourable effect on the quality of locations in the new eastern German states. This applies especially when the interrelationships of trade with western Europe are taken into account. This has to be emphasised with a view to a planned European system of communications. The removal of bottlenecks on major transit routes is often more important than improving traffic in peripheral regions. In view of the supra-regional network effects the planning of such a system of communications with regard to trunk roads and railways should be as centralised as possible.

For a long time, the above-mentioned hard location factors were able usefully to explain regional development processes and were, accordingly, suitable points of departure for regional economic policy. West Germany after the Second World War, for instance, had a well-trained labour force, the demand for consumer and capital goods was enormous after the period of enforced privation and almost all production was profitable. All that really had to be done was to restore the infrastructure that had been partially destroyed in the war and to invest. Everything else followed almost automatically. Economic growth was, of course, initially concentrated on the areas with relatively intact production plant and high population. Because energy and steel were the major requirements in the initial stage of reconstruction, not only the old big cities and conurbations expanded but also the regions where coal could be mined and steel produced. A prime example was the *Ruhrgebiet* (Ruhr District) with a population at that time of around five million people. Tax revenue rose steeply, especially in states which had both conurbations and coal and steel – North-Rhine Westphalia, for instance. These states got rich very fast. They improved their own infrastructure and soon began to assist regions which, by the average standard of the states as a whole, were “underdeveloped”. Finally, by the end of the 1960s, North-Rhine Westphalia was assisting adjoining regions in the neighbouring state of Lower Saxony - a state with a more rural character - which, by the standards of Lower Saxony, were in fact already highly developed. The rich states of the Federal Republic were getting richer all the time and were able to do more and more for their regions.

At this point I must digress for a moment from the subject of regional development research and my description of the initial regional development policy of the states of the Federal Republic in order to briefly say something about our federal system itself. In 1949 when the

founding fathers of the German Constitution were formulating their notions of a federal polity they strongly emphasised the so-called “system of separability” and the principle of regional liability. In order to understand this better, we must distinguish between four rights or, indeed, duties: the right of planning, the right - or, in this context more precisely - the duty of funding, the right of execution and the right of supervision. The first right concerns the opportunity, and also the duty, to plan locations: for example, how the infrastructure is to be built up, property development and zoning, the implementation of education policy. The second right and, of course, duty requires the problem of funding to be solved independently (for instance, within the state itself). The third right authorises the execution of measures that have been decided on. The fourth right regulates the accountability of the planners and/or investors to the authorities (for example, the regional parliament). Stressing the principle of subsidiarity, the founding fathers of the Constitution aimed at bundling these powers at levels below the federal level and particularly had in mind the levels of the federal states and the local authorities. At these levels elected representatives were to make the political decisions and there was to be accountability to regional parliaments.

The intention was not only to align political decisions with the preferences of local people but also to keep the decision making process as efficient and inexpensive as possible. Powers at state level were strengthened in particular. Structural policy became largely a matter for the individual federal states. The only problem that was not so well solved was that of the format of the states; the issue of the regional level, ie. the level between state and local authority was neglected. And it is precisely here that the principle of fiscal equity, ie. having the area that pays for a particular measure such as an infrastructure project also largely benefit from it, could have been realised. The result would have been to bring policy more closely in line with the wishes of local citizens and to strengthen the principle of liability.

In order to motivate the political decision makers, the founding fathers of our Constitution granted the states and local authorities a certain fiscal autonomy. This meant that the states and, to a lesser extent, the local authorities were entitled to harvest the fruits of their development efforts by way of local trade tax. As can be seen from the generally successful post-war developments, this incentive system worked.

Another important aspect of our federal system is the principle of tax revenue transfer. This is intended to ensure that the rich states and local authorities do not get richer and richer while

the poor states and local authorities get steadily poorer. A complicated system ensures that the gap between regional funding needs and regional tax revenue does not become too wide. This is accomplished by means of compensatory financial allocations within the framework of a horizontal and vertical tax revenue transfer funded by all. The horizontal transfer takes place mainly between the states and the vertical transfer between federal level and state level and state and local authority level.

By the end of the 1960s, this system was no longer considered adequate by many states of the Federal Republic. They complained that the transfer was insufficiently balanced. Poor states applied to the wealthy federal government for financial support. This was granted. We might say that the federal level “bought into” the lower levels. A similar thing happened in the 1980s with the European Commission. And those who pay the piper generally want to call the tune, at least to an extent. Federal government was, however, prohibited from doing this by the Constitution. So the Constitution was amended and the system of so-called “joint task responsibility” was introduced at the end of the 1960s for the major projects of improvement of regional economic structure, improvement of agricultural structure and expansion of higher education. This involved joint planning and joint funding. In other words, the states relinquished some of their independent planning rights in exchange for money. The result was collective planning and mixed funding. A planning committee comprising representatives of federal and state government decides what regions are to be assisted and what is to be assisted in these regions. No resolution can be passed against a majority of the states - but, then again, not against federal government either. A high degree of consensus is always required.

Initially the basic idea was to boost investment in regions where untapped reserves of labour were supposed to exist or - as later proved increasingly the case - where income was lagging behind the average or unemployment was apparent. These regions were selected jointly. The leverage applied was usually financial assistance for local authority infrastructure projects and for investment by companies producing for the supra-regional market.

In this way the poorer states also hoped to put the brakes on the richer ones - there was talk of preventing ruinous competition. Accordingly, side by side with the general tax revenue transfer a special tax revenue transfer came about with regard to regional assistance. Nowadays the scope of this joint regional policy is considerably restricted, as regional aid grants are only permissible in areas considered worthy of assistance by the European

Commission and the Commission is becoming more and more restrictive about this. An erosion of German regional policy has been the observable result.

To return now to regional policy and regional development research. It has become apparent that this erosion of regional policy has a further cause. In the late 'seventies the time of the great successes of regional policy seemed to be coming to an end. The hard location factors were losing importance as means of explaining regional growth processes. This is also confirmed by regional development research. There have, for example, been various attempts to analyse the influence of these hard location factors on regional development statistically. In doing this the quality of network infrastructure has been pointed up in terms of the accessibility of destinations in a large-scale network. Regressive analyses indicating the connections between parameters such as the development of employment or income on the one hand and hard location factors on the other are proving less and less able to explain regional development processes. Taking so-called major intermeshed areas (big cities with a large surrounding area), for example, only about 40–45 percent of the variation in development processes can be accounted for. This is unsatisfactory. All it indicates is that special attention should be paid to the accessibility of destinations and the population density; otherwise an increasingly large part seems to be played by other factors.

Clearly it is very difficult to make recommendations for action to be taken in regional policy on the basis of these research results. Infrastructure policy in itself together with financial support for companies investing in weakly developed areas seems to be no longer enough to induce genuine development processes.

Recent regional development research is accordingly addressing the unknown factors, attempting to connect agglomeration research and innovation research with one another. Taking recent growth theory as a basis, it perceives that the principal concern of developed nations must be to stimulate innovation and the production of knowledge. The burning questions are: Where does new knowledge arise? How is knowledge disseminated? Where is there resistance to the adaptation of knowledge? Or the questions are asked: Where are innovation processes to be observed? Where are new businesses being established? Where are new product life cycles arising? Where is the restructuring of large industrial concerns most successful?

What becomes apparent is that we must distinguish between different categories of region. At the price of a certain simplification we can divide regions into three main categories. The first group is in a sort of world or European league, the second in the national league and the third in a regional league. The world or European league players are the regions whose research institutions and organisations put them among the major “islands of knowledge production” at a global level. Corporate headquarters are located there, they have attractive residential environments, they are fully equipped with all the requisite infrastructure and their population numbers alone make them interesting from a sales point of view. Even more important, however, is that they frequently boast a particular kind of lifestyle and a good economic climate and that they are interconnected with one another in a close mesh of trade and information relationships. There is talk nowadays of a “milieu” favourable to economic development or of an “innovation culture”. Not only are the world and European league regions able to keep themselves at the top of the first division by virtue of their own strength, they are also - and this is important - a source of innovative processes which are communicated to larger regional complexes (eg. states or the nation as a whole) and accordingly also to other regions. This lends them an important function. New product life cycles can emanate from them which determine the growth processes of an entire national economy. The growth of a national economy is always the growth of regions. The two are not independent of one another. Some of them - the members of the top league - act as motors and this is a function which should be promoted.

The globalisation and internationalisation process, the shortening of product life cycles and the process of tertiarisation have raised the requirements applicable to these top regions and the result may well be that some parts of them will be relegated from the world or European league.

If the regions around national capitals are discounted for a moment, the top regions in Europe include, for example, the greater Milan, Barcelona and Zurich areas and, in Germany, the greater Frankfurt and Munich areas. Whether or not the *Ruhrgebiet* still belongs in this category is by no means certain. Where the greater Glasgow area comes in this ranking is certainly an interesting question which local experts are in a far better position to answer than I am. All that is important is that these regions should be a nucleus for the formation of large-scale networks. If such power houses are lacking a large state or even an entire nation will drop to second class economic status.

Side by side with this world or European league there are the national and regional leagues. The national league comprises regions that can be designated major central intermeshing areas. The big cities in such regions serve a large surrounding area and are the clear nucleus of a region. Effects on the overall national economy or the function of a driving force for large regional complexes are mostly not so pronounced. The regional league also includes complementary regions which can only survive in dependency on neighbouring big cities.

Nowadays there is consensus that the ability of a region, a state or a nation to produce innovations and successfully integrate them in the market is crucial to its future economic development. By innovation, in this context, we mean applications of new knowledge which are successful on the market. Ideas for products must in the final analysis become business ideas that show a profit. To achieve this, demand must be mobilised. New knowledge may, in addition to new products and production processes, also include new forms of organisation (eg. sales and distribution organisation), strategic concepts (eg. advertising concepts), new rules or even new values (eg. documentation of the environmental awareness and responsibility of industrial concerns).

These innovations do not always involve fundamental changes to traditional products or processes. In fact, marginal changes along particular lines of engineering and technology are what generally happens and this is where small and medium sized businesses and first-time ventures play an especially significant part. Recognition of these marginal changes in statistics is often difficult, with the result that they are mostly underestimated.

When attempting to explain regionally divergent innovation patterns it is useful to distinguish between the origin, spread and adaptation of new knowledge. As a rule, new knowledge originates from pure research conducted with no specific application in mind, ie. it comes from State system or private universities, independent research institutes or research departments in industry. Research and development activities in private sector industry usually depend on the size of the company concerned. As I have already mentioned, we often speak in this context of “islands of knowledge production” and expect this kind of new knowledge to be generated particularly in the large conurbations.

In Germany’s federal system the various states of the Federal Republic have undertaken great efforts to create the structural conditions for such conurbations to arise. The infrastructure in

these areas is usually very good and a lot of money has been invested. This is one reason why Germany has a great many big and medium-sized cities. To this extent federalism with its encouragement of the various different states to promote their own interests has brought about a very evenly balanced settlement structure by comparison with centralised nations like France. Recent research, however, has shown that the quantitative concentration of infrastructure, housing and socio-economic activities within a limited area is not enough to generate what regional development researchers call “conurbation benefits”.

What this requires is two things. Firstly, the existence of a specific milieu or culture and, secondly, a specific capability. In this context the notion of culture or milieu is termed “collective subjectivity” by the social scientists. This refers to common values, standards and attitudes that can result in a specific regional identity which attracts supra-regional attention and recognition. The term “milieu” must at the outset be defined very neutrally: it may stand for a variety of mental constructs.

Take the *Ruhrgebiet*, for example. For a long time, the predominant mentality and therefore the milieu - I will not say “culture” because that term usually has a positive connotation - was determined by large-scale heavy industry. What was rewarded was not mobility, adaptability or unorthodox thinking but rather loyalty to the firm, conformity, physical strength and vigour. At Krupp’s you were looked after from the cradle to the grave. Employees who had put in their 20 or 30 years were awarded a gold badge for loyalty. As the major industrial concerns were to a great extent dependent on public contracts and, owing to their central importance to the economy, could expect State subsidies in the event of crises, there was a widespread inclination to inertia. In regions like this, perpetuation of the status quo is paramount, and the will to undertake restructuring is weak. Graft becomes widespread - management, unions and local politicians collude to preserve their own interests. The threat of 10,000 redundancies is used as leverage to extort more and more subsidies.

You often come across a similar mentality in regions with large-scale agricultural operations. Anyone who gives up his farm is not just changing his occupation, he is guilty of disloyalty. Regions like this are not exactly likely to foster innovation.

A contrast to this is provided by the greater Milan area in Italy. This region with its 5 million or so inhabitants is a source of fascination to many regional development researchers. On the

one hand, it has a great many environmental problems; on the other, it is heterogeneous, dynamic and its structure is characterised by small businesses. In terms of population it is as big as the *Ruhrgebiet* but inwardly it is the exact opposite. There is a capability of constant reorientation and modernisation there. Italian regional development researchers speak of a “cultura del fare”, a “getting things done” spirit generated by entrepreneurs who respond intuitively to changing circumstances from day to day - “*giorno dopo giorno*”. Hans Magnus Enzensberger, a modern German poet, put it this way:

*Even if they wanted to, Germans, Englishmen or Finns wouldn't be able to emulate the Italians. They're not clever or cynical or talented enough; they're too stolid, too set in their ways, too unprofessional, too inhibited. They've invested too much in their well ordered systems and delegated too many resources, responsibilities and hopes to the State. They've lost the habit of taking up the challenge of going it alone when the chips are down and saying, “Me and mine are going to get by and to hell with everybody else!”. They still believe in the illusion of security and cling to an order that has perhaps already become an anachronism.*

*Don't worry, we're not going to get like that. Or let's say, not yet. The Italian model is not something that has been rationally planned. It's an unpredictable, productive, fantastic tumult. We shall continue to observe it with mixed feelings, with anxiety and admiration, terror and envy.*

That the notion of “milieu” or “culture” is also applicable to other fields can be briefly illustrated by reference to the dual system of vocational training in Germany. Our young people receive training at work and in colleges of education at the same time. The important thing is that they get early experience of the everyday working world. That can mould patterns of behaviour. Apprentices who know what it's like to have the foreman breathing down their neck are going to get used to the idea of producing solid quality. And this is the basis for a solid culture. This was and is an attitude that made the label “Made in Germany” something to command respect and produced craftsmen and technicians who possessed not only specialised skills but also an inner relationship with the notion of solidity.

The notion of culture can also stand for a culture of self-employment or entrepreneurship. In this case it relates to an important determinant of regional development that we normally refer to as “human enterprise resources”. It has become increasingly evident that the regions that survive are the ones with people who are prepared to take risks and think independently and creatively. This can but need not find expression in the establishment of first-time business ventures. The same attitude can be of crucial importance to structural change within existing companies. This is a cultural component that is more than acquisitiveness. It is an attitude of mind that induces a genuine pioneering spirit and bears witness to a readiness for innovation.

In the view of many economic historians Prussia, for example, owed its economic development partly to the persecution of the Huguenots in France. As a result of the religious persecution businessmen, often Calvinists, were compelled to seek a new home. The kings of Prussia were tolerant in this respect and afforded protection. Successful businesses were established in Prussia and are frequently still under French names today. Or, to take another example, many Germans lost their businesses when the eastern territories were lost. It is a matter of demonstrable fact that the economic boom in Baden-Württemberg was largely attributable to businesses founded by the refugees.

This spirit of enterprise already referred to in connection with the Milan region is accordingly of crucial importance. It stands for a culture of self-reliance. To this extent we are entitled to speak of “human enterprise resources”. There are still elements of this in many of Germany’s neighbouring countries to the east and the result has been economic development in Poland, Hungary and the Czech Republic. In Russia, on the other hand, there is scarcely any such tradition of enterprise. The Chinese have it in plenty. All the regions of Asia where there is a Chinese population exhibit a very positive economic development. This can, of course, sometimes lead to racial conflict, as in Indonesia recently.

When we look for institutions which are the sources of such attitudes and are accordingly the original driving force behind the foundation of new businesses we usually come up against established families in, for the most part, medium-scale trade and industry. Families of this kind foster a culture of self-reliance. Another source is represented by large-scale industrial concerns which are highly diversified and rapidly expanding. These mostly have a stratum of middle managers who are impatient to carve out a career for themselves. They have contacts among customers and access to product ideas, all of which makes it easier for them to start up

for themselves. Nowadays big companies not only tolerate that but even encourage it. If the new venture turns out to be a flop it's hard luck on the fledgling entrepreneur. If it's a success the company might well be interested in buying him out. A third source of new business ventures is to be found at the universities. It must be said, however, that this is the exception rather than the rule in Germany.

Before turning to the conclusions to be drawn from milieu research and the role of the universities, taking account also of the relevance of federalism, I must first briefly deal with what I have previously referred to as "capability". I have said that conurbations which evince a culture of self-reliance or human enterprise resources are successful if they can provide a specific capability in addition to a milieu which is favourable for development. What I mean by "capability" is specific skills, qualifications or knowledge of particular product qualities. Let me give an example. In recent years, Cologne has developed into a significant centre for the media. The reason for this is that, almost coincidentally, the semi-public broadcasting corporation WDR and the commercial channel RTL moved there. As a result, new firms shot out of the ground to supply them with production material and advertising spots. A specialised capability for this gradually grew up in the region and similar stories are to be found in Hamburg, Munich and, to an extent, in Berlin. We are talking about people with specific skills and information and relevant networks - comparable with, say, the diamond cutters of Amsterdam or, possibly, the whisky distillers of Glasgow. These are unmistakably distinctive products and qualifications.

In Germany the states of the Federal Republic are currently attempting to launch a regional policy that forms milieus and creates capability, enlisting the aid of the universities. At first this effort lacked organisation. Support was given for special lectures and enterprise conventions at universities, enterprise grants were awarded and there was a motley of individual initiatives aimed at promoting an enterprise culture. This has proved inadequate. It has become clear that motivation must be brought to bear on the universities, that businessmen are best qualified to do this and that there is a need for academics who are willing to help. It is the success stories of business venturers who have made the grade that will encourage students and employees to try their own hand. For this reason efforts must be made to find and support businessmen, preferably from the immediate region, and universities willing to cooperate in such projects on a long-term basis. This is also linked with the notion of capability communication, ie. so-called "capability fora" must be built up in

fields which have a tradition in regional production and which are the subject of research at the local universities.

Such fields may be medical technology, the development of new materials, genetic engineering or new services. The important thing is to take up a regional tradition of production and assure a long-term exchange of ideas. Businessmen could well have product ideas they have no time to look at more closely at present developed by work groups in the universities to the point where they evolve into business propositions. Students and academics could submit their research results to businessmen to have them tested for commercial viability and receive suggestions for further research. This kind of collaboration and the dialogue it entails will result in the benefits that regional development researchers subsume under the heading of conurbation advantages. Specialist capability can be developed in this way and independent “capability centres” established. Work in such capability centres must be interdisciplinary and open to other faculties. It is not infrequently lawyers, sociologists and economists who turn new ideas for products into business propositions. In this way people who are paid to have ideas can be brought together with people who put them into practice to earn money.

The capability centres should be complemented by a course of study appealing to all faculties and featuring businessmen in a teaching role. The influence of businessmen must permeate universities and make the traditional German university into a school of enterprise. It is only the success stories of businessmen, the opportunity to visit companies and the confrontation of ideas that will produce an impulse towards self-reliance and commercial risk. In the final analysis it is a question of creating a specific milieu which fosters at one and the same time capability clusters and the spirit of enterprise.

It is in this context that a new federalism discussion unfolds which addresses the overall question of funding in Germany. Current developments in public finance are regarded as unsustainable for several reasons.

- There has been no attempt to halt the trend towards increasing the financial burden on future generations as a result of rising national debt and payment obligations that will be hard to correct (eg. pensions). Political short sightedness will result in a conflict of interests regarding the division of wealth between the generations.

- The development of government expenditure exhibits a restructuring towards a rise in the proportion accounted for by consumption which primarily favours the present generation and accordingly towards a vitiation of the significance of expenditure (infrastructure, human resources, research) that could assure a wider scope for action on the part of the regions or future generations.
- Generally speaking, not only the system of revenue and spending but also the revenue transfer system is overburdened by the problem of distribution and this will be difficult to correct in the future.
- The predominance of short-term distribution imperatives, the increase of mixed funding, the trend towards indiscriminately levied taxation or the increased merging of the important planning and funding rights of the various individual levels of the Federal Republic have inevitably led to a centralisation that was not politically intended.
- In particular, there has been an erosion of the principle of fiscal equity (who pays, benefits) and accordingly to an erosion of the principle of liability.
- The interlocking mesh of authority and funding favours a perversion of the behaviour of the regional and local corporations (moral hazard problem). Decision making and funding are not clearly separated, which results not only in the creation of unnecessary debt but also in exploitation of the relationship of solidarity between federal and state and state and local authority government. Given the levelling effect - many would say that this has gone too far - of a federalism based on balance and compensation, it is not surprising that incentives aimed at closer touch with the man in the street, long-term responsibility and effectiveness have largely been dissipated. Any notion that the principle of financial equity has been put into practice can no longer be taken seriously. On the contrary, analysis indicates that the distribution of funding obeys no clear rules and is only roughly aligned with need.
- The consequence of these adverse developments (collectivisation of the liability principle, diffuse and short sighted distribution policy, centralisation etc.) is a diminishment of the efficacy of government intervention.

As has recently been demonstrated by the federal level decision to alter the DM 620 rule [low flat-rate taxation and exemption from social security payments for trivial jobs] without consulting the states, the fiscal independence of the states is open to question.

There have recently been several proposals regarding a reform of finance in Germany. These are mainly aimed at reform of the inter-state tax revenue transfer system but also touch on the powers of federal, state and local government. For instance, there have been proposals to improve incentives by taking around 65 percent rather than in some cases more than 90 percent of income tax revenue under the inter-state tax revenue transfer system. There are also recommendations to grant the states and local authorities more autonomy in matters of taxation and to devolve the federal/state and state/local authority powers.

This would encourage the states to take steps to mobilise their regional growth potential once again. They quite simply have to be allowed to reap the benefits of their own efforts.

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Ladies and Gentlemen,

I hope I have succeeded in providing you with an impression of the results of recent regional development research and regional policy projects. At the same time I have deliberately revealed the weaknesses of our financial mechanisms. These have weakened our federal system and impaired our political efficiency. I urge you to exploit the advantages of federalism while taking care to avoid the pitfalls.

Thank you for your attention.

Professor Dr Paul Klemmer

Glasgow

December 1998