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**Article**

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## FISCAL CONSOLIDATION IN GERMANY: GAIN WITHOUT PAIN?

CHRISTIAN BREUER\*

### The mystery of fiscal consolidation

10 years ago, when Angela Merkel came to power, Germany was seen as the ‘sick man of Europe’ (see Sinn 2007; Dustmann *et al.* 2014). In 2005, when other countries like Spain achieved fiscal surpluses and public debt in Spain stagnated at a level of 40 percent per GDP, Germany missed the Maastricht fiscal target to keep its deficit at a level of 3 percent of GDP for five consecutive years. Recently, with a large share of the Eurozone stuck in a fiscal crisis, Germany balanced its budget at the general government level for the third time since 2012 and in 2014 its government shows a structural surplus of approximately one percentage point of GDP (Figure 1). In 2014 the German finance minister Wolfgang Schäuble even reported the first balanced federal budget since 1969. The suddenly balanced German government budget in the midst of the European fiscal crisis was surprising from the point of view of other countries that are struggling with excessive deficits and debt levels. Other European countries have not been able to cut deficits even with harsh consolidation measures and in cases where they have attempted to do so, GDP has decreased, leading to a vicious circle of increasing debt to GDP ratios. How did Germany consolidate its public finance? Did Angela Merkel enact harsh consolidation measures?

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### Gain without pain

Recent contributions highlight the fact that public finances in Germany are currently benefiting from various extraordinary factors that are predominantly related to temporarily low expenditure and windfall profits. For instance, low interest expenditure on German government debt, the favourable labour market conditions during an extraordinary cyclical situation, low expenditure on government investment, as well as low expenditure on monetary transfers as a result of a temporarily supporting demographic situation (See also Breuer 2012; Boysen-Hogrefe 2013). It is possible to assess the quantitative effect of these arguments with a view to the general government budget in Germany.

Since 2002, the German government has reduced its deficit by approximately 5 percentage points as a ratio to GDP. This corresponds to a slow, but long-lasting consolidation of 0.4 percentage points per year. It is conceivable that this improvement is related to cyclical factors, however, the cyclically-adjusted budget balance also improved by 5 percentage points (Figure 1).<sup>1</sup>

<sup>1</sup> Standard methods to adjust for cyclical effects control for the effect of the output gap on the government budget, however, the output gap is estimated to be relatively low in 2002 as well as in 2014. In this article I use the strategy proposed by Girouard and André (2005) and Mourre *et al.* (2013) to adjust for cyclical effects. Estimations for potential output are obtained from BMWI/BMF (2015). Structural expenditures are corrected for one-offs in 1995, 2000, and 2010.

Figure 1

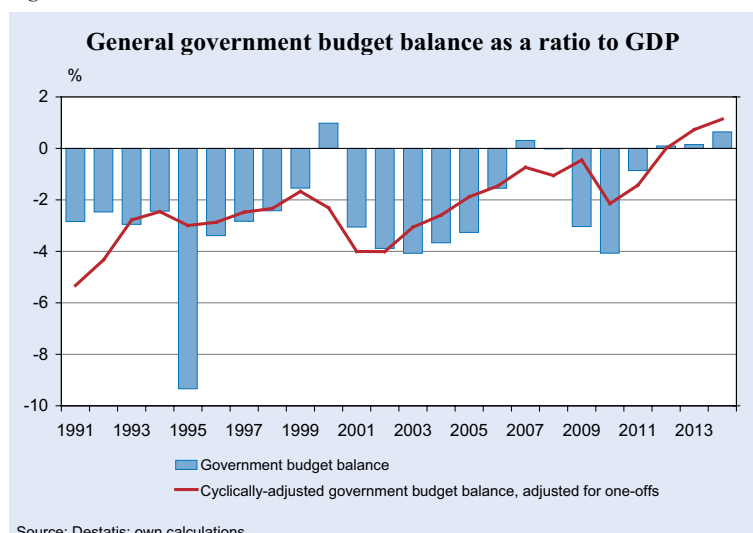
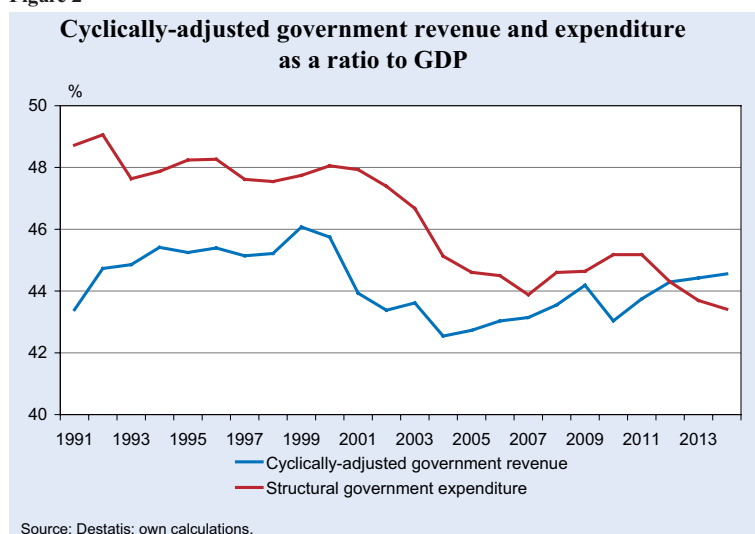


Figure 2



A number of studies suggest that the German government profited from the reduced expenditure on interest payments on its government debt. Interest expenditure on German government debt decreased from approximately 3 percentage points in 2002 to 1.8 percent in 2014, while debt per GDP increased from 59 to 75 percent of GDP. This bird's eye view suggests that – in comparison to the pre-crisis interest rates in 2002 – the government budget balance improved by approximately 1.5–2 percentage points of GDP or 45 to 60 billion euros. Nevertheless, interest rates are only one contributing factor and may explain only a share of the reduction in structural government deficits.<sup>2</sup>

### Reforms of the welfare system

The structural primary surplus, excluding interest expenditure and controlled for cyclical effects, has also improved by approximately 4 percentage points. It changed from a deficit of 1.1 percent of GDP in 2002 into a surplus of 2.9 percent in 2014. The predominant share of this structural consolidation is related to expenditure, rather than revenue (Figure 2). On the one hand, tax revenue increased slightly, particularly the ratio of direct taxes per GDP increased since 2010, however, the ratio of social insurance contributions per GDP decreased (Figure 3), so

<sup>2</sup> See also Boysen-Hogrefe (2012); and Breuer *et al.* (2012) on how decreasing interest rates affect federal interest expenditures in Germany.

that cyclically adjusted total government revenues have increased only slightly (by approximately 1 percent of GDP since 2002).

The predominant share of fiscal consolidation is related to decreasing government expenditure. Figure 4 shows the structural components of government expenditure as a ratio to potential GDP. Monetary transfers in particular decreased from a level of 18 percent of GDP in 2002 to 15.3 percent in 2014, which can be traced back to reforms of the welfare system made during the period

2001 and 2005. These reforms were constructed to reduce expenditure on long-term unemployment (over one year) and pension benefits.<sup>3</sup>

It is obvious that the reduction in social spending between 2002 and 2014 is influenced by these reforms. For example, the cuts in unemployment benefits for the long-term unemployed (above one year) lead to an immediate reduction in transfer payments and the subsequent reduction in unemployment decreased social expenditure once again.

The reforms made in the pension system have also been effective in the long-run.<sup>4</sup> After the reforms, the

<sup>3</sup> See Breuer, Gottschalk and Ivanova (2011) for a discussion of the fiscal consolidation program in 2003.

<sup>4</sup> A number of reforms were enacted during 2001 and 2007, see e.g. the introduction of a 'sustainability factor', the taxation of pension benefits, the introduction of the 'Riester factor', as well as the increase in the regular pension age.

Figure 3

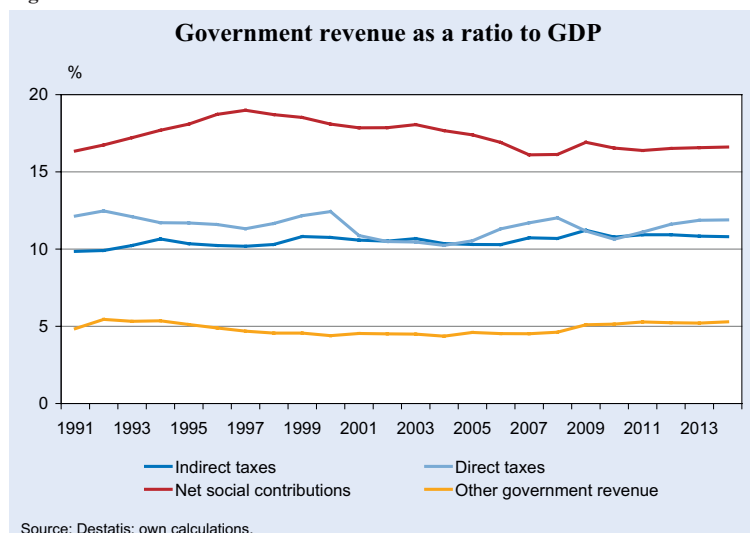


Figure 4

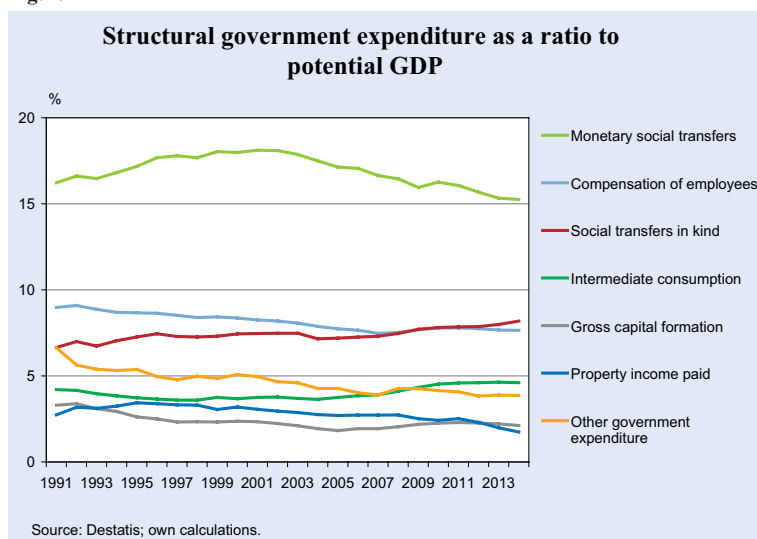


Figure 5

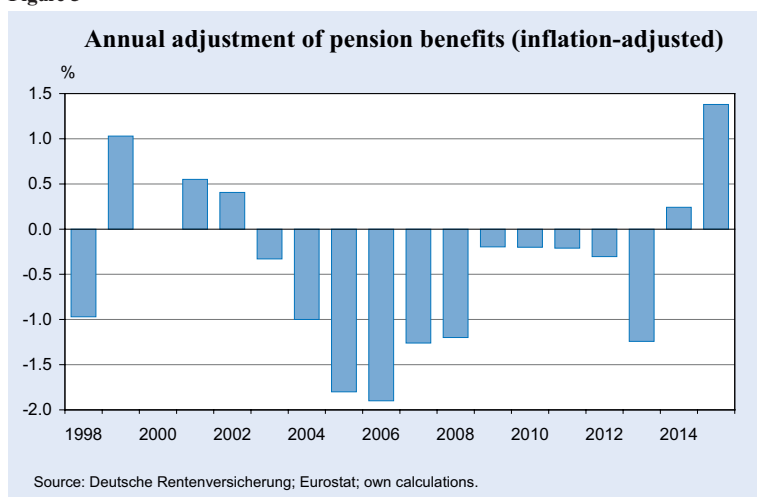
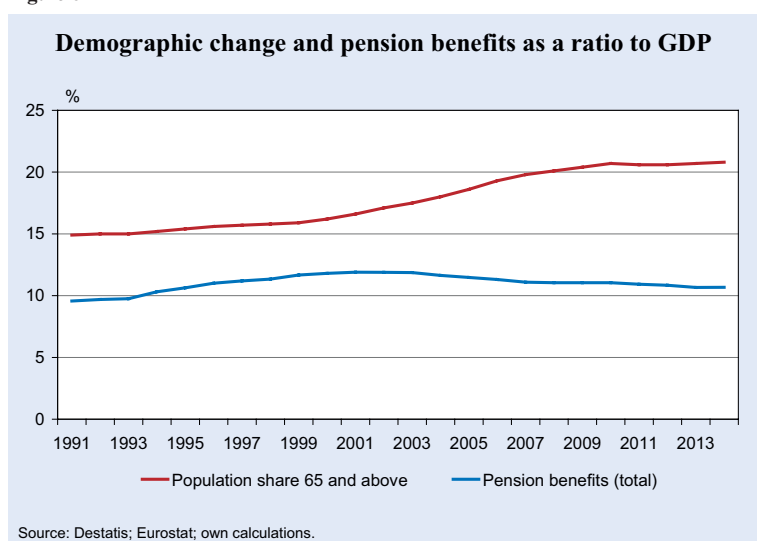


Figure 6



adjustments of nominal pension benefits did not exceed inflation rates for a long time, leading to a negative adjustment of real pension benefits for ten consecutive years (Figure 5).<sup>5</sup> Beyond these discretionary measures other factors might matter to the recent development of pension benefits, like, for example, the cyclical situation and the weak development of wages and salaries since – according to the German pension formula – the nominal adjustment of pensions is based on the development of wages and salaries during the preceding years. As a result, pension benefits decreased during 2002 and 2015 by 1.2 percentage points as a ratio to potential GDP, while the old-age dependency ratio as a natural proxy for pensions increased by 3½ percent (as a ratio to total population), pointing to a large scale cut in average pensions during this period (Figure 6).

### Concluding remarks

Different factors contributed to the recent favorable state of public finance in Germany. Firstly, low interest rates extensively contributed to the improvement in the German government budget. Property income paid by the German general government decreased by approximately 1½ to 2 percent of GDP or 45 to 60 billion euros per year. Secondly, beyond beneficial interest rates, a substantial share of recent fiscal consolidation in Germany is achieved by reductions in monetary social transfers that are related to reforms made in the period 2001 to 2005. Altogether, mone-

<sup>5</sup> The inflation-adjusted increase in pension benefits is the nominal increase in July of year  $t$  net of the annual inflation rate in the previous year  $t-1$ .

tary social transfers decreased by approximately 3 percentage points as a ratio to GDP or by 80 billion euros. It is inappropriate to assume that Germany did not enact reforms at all, even though, the reforms made in Germany were implemented a long time ago. These reforms have a few similarities with the recent consolidation episodes in Southern Europe. For example, the reforms were accompanied by a political crisis in which the governing social democratic party faced an inner-party conflict, a new left-wing party was established, and the prematurely arranged election in 2005 led to a deselection of the red-green cabinet of chancellor Schröder. Angela Merkel benefited from the loss of the social democrats and in 2005 she received a narrow majority in the new established grand coalition. In this sense Angela Merkel can be regarded as a product rather than an executer of austerity.

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