ECO FLASH

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Germany: Adopting a fiscal expansionary stance

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- **In March, after an unprecedented six months of talks, Chancellor Angela Merkel succeeded in prolonging the grand coalition between CDU/CSU and SPD.**
- **Even though the economy is operating close to potential, fiscal policy will be very expansionary in the coming years.**
- **The positive elements in the programme are the investment in digital infrastructure and education.**
- **However, new pension promises risk compromising the government budget's stability in the longer term.**
- **On the eurozone, the grand coalition pleads for a return to the old concepts as best recipe for stability.**
- **Even though Chancellor Merkel subscribes to the need of strengthening the eurozone, the policies to achieve this remain rather vague or fall back on old concepts. No major changes are expected in this area.**

Over the past decade, Germany has been transformed to one of Europe's most successful economies. In the period 2013-2017, the economy grew by almost 2% per annum on average, the unemployment declined by 1.4 points to 3.8% of the labour force, and government finances returned to a solid footing. An important factor in the turnaround of the economy was the implementation of a structural reform programme "Agenda 2010" by Chancellor Schröder (SPD, social democrats) a decade earlier.

Despite the robust recovery, the grand coalition between CDU/CSU (conservatives) and SPD that governed between 2013 and 2017 became increasingly unpopular. In the first place, not everybody shared in the economic successes.[1] Income inequality has increased, although this is largely related to the successful integration of low skilled workers in

[1] *Raymond Van der Putten, 2017, "Germany: building a fairer society", Conjoncture, June, BNP Paribas.*

Government programme 2018-2021

billion euros

	Total	Federal State	Social security
Total fiscal impulse	**88.6**	**66.0**	**22.6**
% GDP	2.7	2.0	0.7
Extra spending	**50.7**	**48.3**	**2.4**
of which			
Education	6.0	6.0	
Families	12.0	12.0	
Construction	4.0	4.0	
Regional policy	4.0	4.0	
Continuation refugee programme	0.0	8.0	-8.0
Defense and development aid	2.0	2.0	
Mother pensions	10.7	3.2	7.5
EU budget after Brexit	7.8	7.8	
Health insurance	4.2	1.3	2.9
Tax reductions	**40.9**	**19.0**	**21.9**
of which			
Phasing-out of re-unification tax	10.0	10.0	
Bracket creep	21.0	9.0	12.0
Unemployment insurance	9.9		9.9
Tax increases (-)	**3.0**	**1.3**	**1.7**
Withholdding tax	3.0	1.3	1.7
PM Broadband, Digital compact for schools financed by 5G licence auctions	14.5	14.5	

Table 1 Source: Institut der deutschen Wirtschaft.

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the economy. The SPD even campaigned on a platform for building a fairer society and reversing some of the Agenda 2010 reforms. Second, as in other European countries, concern about immigration policies increased. In 2015-2016, Germany received 1.2 million asylum seekers.

At the general election in September 2017, the coalition parties received a severe drubbing. The CDU/CSU fell back from 41.5% to 32.9% of the vote. The SPD only obtained 20.5% of the vote, a loss of 5.2 percentage points. Moreover, an extreme right party succeeded for the first time in passing the 5% election threshold. The AfD gained 12.6% of the vote, making it the third largest political formation.

The forming of the new coalition was a long process. As the largest group in the Bundestag, the CDU/CSU headed by Chancellor Angela Merkel took the lead in forming a new government. The options were limited as the SPD preferred spending the new parliamentary term in the opposition benches and participation of far right and left wing parties was excluded. The only viable option seemed to be the so-called Jamaica coalition, between CDU/CSU, the Greens (die Grüne) and the liberals (FDP). After negotiations between these parties failed, the Chancellor turned again to the SPD.

In exchange for its participation, the SPD succeeded in obtaining some heavy-weight posts, such as the finance, social and foreign affairs ministries. Moreover, a substantial part of the SPD programme was included in the coalition agreement such as the increase in pensions, the support for integration of the long-term unemployed and restrictions on short-term labour contracts. The family support measures came mainly from the CDU/CSU side. Both parties agreed on boosting investment, in particular in infrastructure and education.

The Government Programme

An expansionary fiscal policy

According to the coalition agreement, net federal spending will be increased by EUR 46 billion, of which EUR 10 billion in tax reductions, during the period 2018-2021. However, the list is far from complete, as it only contains priority spending. In addition, some spending items are hard to estimate such as higher EU contribution after Brexit, which will be determined during negotiations with the remaining EU members.

The research institute IW (Institut der deutschen Wirtschaft) estimates that the net increase in government spending, including social security, could amount to almost EUR 90 bn over 4 years or almost 0.7% of GDP per annum on average, of which EUR66 bn for the federal government (Table 1). Even this is likely to underestimate the spending boost as the costs of many programmes are difficult to quantify.

The increased spending is partly to boost the digital infrastructure, financed by the auctioning of 5G licenses. However, most of the plans are directed at supporting purchasing power, rather than for structural improvements. This is in particular the case for the increase in child benefits, and pensions, income tax measures (abolition of re-unification tax for medium income earners and measures against bracket creep) and the lowering of the unemployment contribution. These measures on themselves already account for about EUR 65 bn.

Additional federal spending 2018-2022

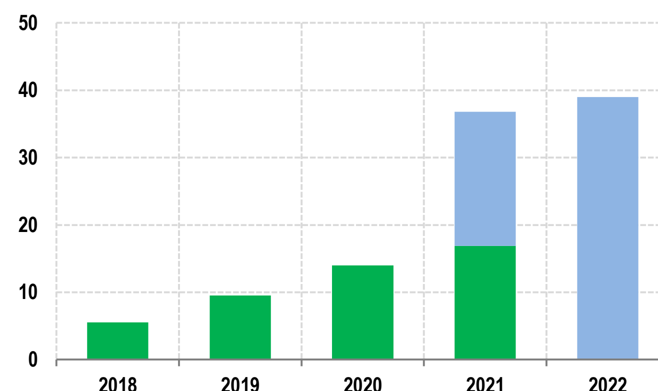

Chart 1 Source: Institut der deutschen Wirtschaft

The implementation of an expansionary budget is a late response to various demands from international organisation such as the European Commission, the OECD and the IMF for more growth supporting macroeconomic policies.[2] However, the economy being at the top of the cycle, the additional support arrives somewhat untimely.

Moreover, it could raise questions concerning the future soundness of public finances. Most of the federal spending increases will take place in the period 2020-2021, EUR 51 bn of a total package of EUR 66 bn. According to IW, the government has to issue about EUR 20 bn in new debt to cover expenditure in 2021 (chart 1). The problem will be even greater for the next government. It will be confronted with an uncovered increase in the level of expenditure of around EUR 40 billion in 2022. Against this backdrop, it will be very hard for Finance Minister Scholz to maintain the “schwarze Nulle” (zero deficit or surplus), in particular if growth were to disappoint.

European policy: Scaled down ambitions?

The coalition agreement opens with a chapter on Europe, at the insistence of the SPD leader Martin Schulz, member of the European Parliament from 1994 to 2017 and even its president from 2012 to 2017. As Mr. Schulz stepped down as SPD leader after the coalition negotiations, Europe has lost one of its fiercest supporters in government.

In close cooperation with France, the coalition will aim at strengthening the European Union and its institutions. A major objective is to make the eurozone more crisis-resilient. However, Germany’s policy is unlikely to change much, as the two main policy principles stay in place. First, the Growth and Stability Pact remains the compass. The second principle is the rule that member states should bear the full consequences of their own fiscal decisions.

The coalition partners wanted to send a positive signal to the reforms proposed by French President Emmanuel Macron. Nevertheless, the agreement is rather vague on which

[2] For example, ECB President Mario Draghi declared in September 2016, “countries that have fiscal space should use it. Germany has fiscal space”.

reforms should be implemented. It is in favour of transforming the European Stability Mechanism into a European Monetary Fund. However, the role of the national parliaments should not be affected by such reforms. Recently, during a meeting with the CDU/CSU parliamentary group, Chancellor Merkel emphasised that the new Monetary Fund requires a change in the treaty. Given the length of such procedure, it could effectively kill off the project. On the banking union, the government is likely to maintain its current position by insisting that European banks, where necessary, have to reduce risks on their books before the creation of a European wide bank deposit guarantee scheme.

Germany is prepared to increase its EU contribution, once the United Kingdom, which is a major creditor, has left the union. In the European multi-annual financial framework, means should be set aside for economic stabilisation, social convergence, and structural reforms. These could be a starting point for a European investment fund. However, no funds have been earmarked for this purpose in the financial plan of the agreement.

The coalition is in favour of taxing internet firms at EU level, the introduction of a European wide minimum wage, measures against tax dumping, and the introduction of a tax on financial transactions, the so-called Tobin tax. However, it is unlikely that much progress will be made in this area, as unanimity is required on social and tax issues at the European level.

Labour market

One of the main objectives of the government is to reduce long-term unemployment. At the moment, around 1.5% of the labour force is unemployed for longer than one year. The aim is to spend EUR 4 billion for the re-integration of 150 000 of the 650 000 long-term unemployed.

Moreover, against the wishes of the employers' organisations, the coalition partners have agreed on further restricting the use of fixed-term contracts. The duration of short-term contracts without material reasons should be limited to 18 months instead of 24 months. Moreover, the number of such contracts will depend on the size of the company. Firms with more than 75 employees can only have 2.5% of such contracts. According to the labour market research institute IAB, about 400 000 jobs could be affected.

The measure is likely to affect particularly the people that have the weakest link with the labour market such as long-term unemployed or refugees with residence status. In that respect it seems contrary to the government's objective to improve labour market access for these groups.

For entreprises with more than 45 employees, workers have the legal right to work temporarily part-time and return to a full-time position afterwards.

Digital network

The development of a nationwide fibre network for very fast internet is among the government's top priorities. This should be achieved by 2025. Moreover, free internet will be introduced in all federal buildings and trains and the administration will be digitalised. From 2022, it should be possible to contact all civil servants on internet. The investment will be financed from the receipts of the auction of 5G licenses.

Education and research

The government will invest more than EUR 10 bn in Education and Research. The investment in computer equipment will also be financed out the 5G auction. The government will invest EUR 2 bn in all-day primary schools. This will make it easier for parents to take up a full-time job. For this purpose, the constitutional ban on cooperation between the federal government and the states in the field of education will be relaxed. From 2025, parents get a legal right to send their children to an all-day school. Moreover, the federal government will invest EUR 3.5 bn in nurseries. In order to remain one of the leaders in innovation, the federal government and the states together will stimulate R&D spending, to take it to 3.5% of GDP by 2025, compared with around 3% at the moment.

Family

The coalition agreement is very favourable for households. They benefit from the abolition of the re-unification tax for 90% of income earners in 2021, the correction of the brackets in the income tax for inflation, and the lower unemployment contribution. Households with children profit most because of the increase in family allowances (*Kindergeld* and *Kinderzuschlag*), for which EUR 3.5 billion has been set aside.

To make housing for families with children better affordable, the government will re-introduce a subsidy for home purchases (*Baukindergeld*). Each family earning less than EUR 75 000 plus EUR 15 000 for each child can receive EUR 1 200 per child and year over a ten-year period. Without a substantial increase in housing construction, the measure is likely to push up house prices even more, and making it more difficult for people without children to gain access to the property market. As the subsidy will be paid over a 10-year period, most of the cost of this programme will come after the end of the current parliamentary term.

At the same time, the coalition has promised to step up the construction programme to 1.5 million homes during the coalition period, partly through the increased building of homes for social rent. This looks very ambitious, as between 2013-2016 housing building permits amounted to just over 1 million housing.

Pensions

The coalition agreement is very generous for pensioners. To reduce poverty among pensioners, the minimum pension (*Grundsicherung*) will be increased by 10% for pensioners with at least 35 contribution years. The double stop line will be introduced: The income replacement ratio will not be lowered below 48% up to 2025[3]. According to the original plans, the replacement rate would reach 48% in 2022 and 47.5% in 2025. The second stop line is the capping of the contribution rate at 20%. The contribution rate is currently 19.5% of the gross salary, equally between employee and employer of gross pay. The contribution rate would have reached 20% by 2026. However, these projections are called into question because of other give-aways, such as the increase in pensions for people who have cared for children during their active life (*Mütterrente*). For the latter, the government has set aside EUR 10.7 bn in the current term. The new pension

[3] For a standard pensioner with 45 contribution years.

liabilities will weigh heavily on the government budget in the years to come.

Energy and climate

The coalition agreement is not very favourable for the environment. It is already clear that the self-imposed emission objectives in the Climate Action Plan for 2020 will not be achieved. Moreover, no time table is set for a phase-out of coal. A commission will be installed to advice the government on this issue. It should bring out its report in early 2019. The government has already set aside EUR 1.5 billion for accompanying the closure of the coal mines. However, this might not be sufficient. The coalition promises to respect the 2030 objectives, but that is well beyond the end of its term. The non-respect of the 2020 Climate Action Plan sets a bad example for future governments.

Limited macroeconomic consequences

The coalition programme is a patchwork of the wish list of the participating parties, but lacks an overall coherent long-term vision. As the economy is already operating close to potential, the macroeconomic impact in the short-term is likely to be limited. In particular, the spending stimulus in the construction sector is likely to be ineffective. The sector is already reporting labour shortages. The additional demand will be probably translated into higher wages, which can also spread to other firms, and an additional boost to house prices. The impact on consumer price inflation should remain limited. We estimate that GDP growth may be boosted by 0.3 percentage point both in 2018 and 2019, which will prolong the upswing a little bit longer. In recent months, indicators such as IFO and orders have been pointing to a slowing of the cycle.

In the longer term, the programme has some good elements such as the nationwide deployment of fast-speed internet, investment in digital equipment in schools and the improvement in childcare facilities (all-day schools, nurseries).

However, many of the problems are not addressed or passed on to a next government. The most obvious is the long-term sustainability of the public pension system. During the current legislature, several programmes will be introduced, for which the main financial consequences will fall after 2021, such as *Baukindergeld*, the partial abolition of the re-unification tax, and changes to the pension system such and the increase in the *Mütterrente* and the double-stop line. The ageing of the population will further add to the pressure on the pension system.

IW estimates that the next federal government might be confronted by a EUR 39 billion shortfall in 2022. This does not take into account shortages in social security and at the community and state level. The next government might not have another choice than fiscal tightening in order to respect the debt brake, a constitutional requirement for a structurally close-to-balance or balanced budget.

Also the non-respect of the self-imposed environmental objectives, such as emission standards, sets a bad example. Instead of taking a firm stance, the coalition is postponing the need of taking a decision by appointing an expert commission.

The text on Europe remains rather vague. It is a repeat of well-known positions such as the strict adherence to the Stability and Growth Pact. During the euro crisis, these concepts have proved not to function. Moreover, the coalition has made it clear that the eurozone should not become a transfer union with Germany as paymaster. Nevertheless, there is still good reason for optimism. Chancellor Merkel has always shown a good dose of realism. During the awarding of the Charlemagne Prize in Aachen to the then Polish prime minister Donald Tusk in May 2010, Mrs Merkel made a dramatic appeal for European unity and addressing the euro crisis by warning that “if the euro collapses, so will the idea of European unity”.[4] The ultimate guiding principle for the Chancellor’s European policy is clear.

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[4] *“Scheitert der Euro, dann scheitert nicht nur das Geld. Dann scheitert mehr. Dann scheitert Europa, dann scheitert die Idee der europäischen Einigung.”*

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