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# The Merkel Era: A Review of Budgetary and Fiscal Policy

The budgetary and fiscal policy record of the Merkel era contains both light and shade. The greatest success is that the stability of Germany's public finances has suffered less during this period than in other countries, despite the fact that the economy had to weather the two deepest economic crises since the Second World War – the global financial crisis and the coronavirus pandemic. The most important weakness is a declining willingness over time to undertake far-sighted reforms and an increasing tendency to pursue short-term fiscal policies designed to appeal at election time.

The most visible indicator of the stability of Germany's public finances is the government debt ratio, i.e., the ratio of government debt to gross domestic product. It was 67 percent in 2005, when Angela Merkel became chancellor, rose to 82 percent during the global financial crisis in 2010, but fell back to 60 percent by 2019. The coronavirus crisis is expected to push the rate back above 70 percent this year. But this increase also makes sense in a deep crisis.

## Fiscal Stability

The finances of other European countries have fared much worse. France's government debt ratio was also 67 percent in 2005 and rose to 85 percent by 2010 in the wake of the global financial crisis. Unlike in Germany, however, it continued to rise thereafter, reaching 98 percent in 2019. Italy was already in a worse starting position in 2005, with government debt at 107 percent of economic output. The combination of the financial and euro crises set the country further back economically, and in 2019 the debt ratio there was 135 percent. As a result of the coronavirus crisis, the ratio is expected to rise to around 160 percent.

However, the high indebtedness of partner countries has meanwhile also had consequences for Germany. When the coronavirus crisis broke out, financial markets were close to repeating the loss of confidence that had brought Italy and other countries to the brink of national bankruptcy during the euro crisis. To avert this, the NextGenerationEU bailout fund was launched, an extensive fiscal transfer program in which Germany is a net payer. Preventing the problems of the euro crisis from returning was also in Germany's interest. Critics nevertheless complain that Germany's fiscal discipline leads only to the country having to pay transfers to countries that are less successful in keeping their finances under control.

## With Little Effort to Fiscal Surpluses

How great was Germany's fiscal effort and discipline really? The decline in the German debt ratio by 22 percentage points in the years between 2010 and 2019 is the result of substantial budget surpluses initiated under the "black zero" policy advocated by Federal Finance Minister Wolfgang Schäuble. However, German fiscal policy did not have to exert itself excessively to achieve this. Occasionally it is claimed that the population has been expected to accept "austerity" or that public investment has been neglected. In fact, there can be no question of austerity, at least as far as spending is concerned. Public spending excluding interest and investment was 41.6 percent of GDP in 2019, roughly the same as in 2005, at 42 percent. It should be borne in mind that there were about twice as many unemployed people to support in 2005 as in 2019. So there was no austerity in the form of declining government final consumption expenditure. Nor were there any cuts in investment; on the contrary, the share of public investment in GDP actually rose by one-quarter, from around 2 percent in 2005 to 2.5 percent in 2019. Certainly, more could have been done in this area, especially in the digitalization of the public sector. But what was lacking here was probably more agility and problem awareness than money.

The black zero was made possible by two other factors: the first is the decline in interest rates. In 2005, public interest expenditure was still 2.8 percent of GDP. In 2019, it was only 0.8 percent. The second factor is a rising tax burden: the tax ratio rose from 38.8 percent in 2005 to 41 percent in 2019.

So even if the black zero essentially fell into Angela Merkel's lap, it must be acknowledged that this policy has given Germany financial leeway. In the coronavirus crisis, Germany was able to provide massive support for the economy without having to fear that confidence in the country's financial solidity would suffer.

## Social Policy Flees from Reality

These successes in terms of stability policy are offset by a decline in the willingness to reform, above all in tax and social policy. In the early years of the Merkel era, things were still different. Corporate taxation was restructured in 2008, including a drop in the tax rate on corporate profits from 38 to 30 percent. This was followed by the introduction of the debt brake in 2009. Both reforms remain controversial to this day. But politicians acted to strengthen long-term growth and the stability of public finances.

In the years that followed, fiscal and budgetary policy instead tended to focus on handing out benefits. Election tactics appeared to be more important than the precise targeting of social policy. This applies above all to pension policy. Examples include making the pension available from age 63 onward, the maternal pension, and the basic pension. The accusation that this extension of benefits would jeopardize sustainability and intergenerational justice in view of the demographic situation was answered with the promise of a "double stop line." According to this policy, pensions should not fall below a certain level, but neither should contributions rise above a maximum level. This policy gives the impression that the money that will pay for future pensions is likely to fall from the sky. It refuses to give the perhaps unpopular but necessary answer to the question of how to fill the foreseeable financial gaps. There are similar problems in health and long-term care insurance.

### Flagging Forces for Reform

This flight from reality in social policy has been joined by a refusal to reform in tax policy. Other countries have cut taxes for companies over the past ten years in order to promote investment and employment. Germany has done nothing in this area since 2008 and therefore now has one of the highest tax burdens on companies by international standards. In terms of income tax, it is necessary to improve the employment incentives for second earners. There is an irrational proliferation of measures in the social transfer system, with the result that a willingness to take on more work in the low-income bracket is financially penalized to a degree. This prevents people from freeing themselves from dependence on the welfare state. Local government finances are also in need of reform. Their dependence on trade tax has once again caused damage in the current crisis. It would not be difficult to solve these problems. But nothing is happening.

Whether or not the flagging forces for reform have anything to do with Angela Merkel's long tenure in office is a matter of speculation. In any case, Germany's next federal government has the opportunity and the duty to clear this reform backlog with renewed vigor. After all, it can rely on public finances that are comparatively solid despite all the failures and future challenges.

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