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Demystifying a 'shining example': German public finances under the debt break

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DEMYSTIFYING A 'SHINING EXAMPLE': GERMAN PUBLIC FINANCES UNDER THE DEBT BRAKE

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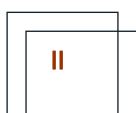
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ABSTRACT

German fiscal policy is nowadays often presented as a shining example due to successful budget consolidation after the Great Recession. However, the idea that the German success is the result of a well-thought-out economic strategy that could therefore serve as a role model for other countries does not stand up to closer scrutiny. First of all, Germany's fiscal policy escaped from an absolutely bleak outlook just three years ago only due to extraordinarily good luck. A completely unexpected soaring economic upturn in 2010 and 2011 led to the substantial easing of the burden on Germany's public budgets. Second, if the economy nosedived, public budgets would again be faced with severe cyclical constraints. Third, below the surface of the balanced government budget severe structural deficiencies of German tax and fiscal policies are hidden: excessive tax cuts in the past have led to continuing structural shortfalls in the budget that in turn caused a serious neglect of undisputedly necessary essential investments in the future of education, research and infrastructure. As long as the debt brake is in place, in order to overcome these deficiencies socially just tax increases should be used to finance the spending needs. It turns out, that to date a real policy shift in this direction is still lacking.



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1. INTRODUCTION

German fiscal policy is nowadays often presented as a shining example: The fiscal exit after the recession in 2009 was quick and apparently smooth: the 2010 budget deficit of 4.2 per cent of GDP was turned into a small surplus of 0.1 per cent of GDP by 2012. At the same time the German economy recovered very strongly from the crisis with comparatively very low and soon even decreasing unemployment. According to conventional wisdom one major reason behind the German public finance success story is the fact that Germany had already incorporated a debt brake into its Constitution back in the summer of 2009, just before the onset of the Euro crisis. According to the brake, from 2020 onwards the structural general government deficit must not be higher than 0.35 per cent of GDP. When most EU governments pledged in the Fiscal Compact at the end of 2011 to introduce stricter limits on public debts and deficits, where possible incorporating them into the Constitutions, this resulted primarily from an acute sense of panic in the face of the continuing escalation of the euro crisis. But the fact that they resorted to the German approach of constitutionally fixed debt brakes certainly also had something to do with the allegedly easily demonstrable success of the German example.

However, the idea that the German success in terms of budget consolidation is the result of a well-thought-out economic strategy that could therefore serve as a role model for other countries does not stand up to closer scrutiny. First of all, in fact, just three years ago, Germany's fiscal policy seemed to have reached a complete impasse (cf. Truger 2010 and 2011). The economic crisis and the measures brought in, partly to overcome that crisis, quickly had led to high overall government budget deficits. In that situation the debt brake called for consolidation within the foreseeable future without reference to the economic outlook, which was bleak even in the medium term – a situation that was strikingly similar to that in which many of the European crisis countries still find themselves trapped in. There was therefore reason to be seriously worried about the future of the German economy and its public finances. However, due to extraordinarily good luck things took a positive turn: a soaring economic upturn in 2010 and 2011, the extent and duration of which had been wholly unexpected, led to a clear-cut easing of the burden on Germany's public budgets and tangible progress on budget consolidation. All of this without, to date, any need for extremely painful additional cuts.¹ Second, this noticeable improvement does by no means guarantee that all of Germany's public finance problems have been solved. If, given the still smouldering euro crisis (cf. IMK/OFCE/WIFO 2013), the economy nosedived or entered quite a long period of weakness, public budgets would again be faced with severe cyclical constraints. Third, below the surface of the balanced government budget severe structural deficiencies of German tax and fiscal policies are hidden: excessive tax cuts in the past have led to continuing structural shortfalls in the budget that in turn caused a serious neglect of

¹ Truger (2010: 21) had already correctly anticipated that, in the case of an unexpectedly strong upturn, the debt brake would be much less intimidating.

undisputedly necessary essential investments in the future of education, research and infrastructure. It turns out then, that to date, the unexpected upturn has simply prevented an even worse situation, giving policy-makers a breathing space whereas a real policy shift – quite different from the one prescribed by the debt brake and by the fiscal compact on the European level – is still lacking.

In order to show this, the current paper takes a more detailed look at German tax and fiscal policy. Section 2 takes a brief look back at the gloomy initial situation in the first half of 2010 and describes the main features and shortcomings of the debt brake. Against this backdrop, Section 3 describes the noticeable improvement since then, mainly thanks to unexpected “economic luck”. Section 4 relates how, despite this, public budgets in Germany are still having to contend with a structural revenue gap caused mainly by tax cuts. Section 5 demonstrates, against the background of the extremely moderate spending policies over the past almost one and a half decades, that the need for essential future-oriented investment is still very great. Section 6 argues that socially just tax increases are the only reliable strategy for safeguarding the State’s scope for action and future-oriented central investment under the debt brake. Section 7 shows that there are no convincing economic arguments against such tax increases and that therefore the real obstacles to such a strategy are political and not economic ones. Section 8 is an attempt to foresee whether it will be possible in the future to overcome the political obstacles.

2. THE INTRODUCTION OF THE DEBT BRAKE AND THE GLOOMY OUTLOOK IN 2009/2010²

The debt brake incorporated into the constitution in 2009 essentially consists of a structural component, which permits structural budget deficits only within very narrow limits (less than 0.35 per cent of Gross Domestic Product (GDP) at the federal level and zero per cent in each of the 16 federal states) and a cyclical component which, depending on the economic situation, provides either more or less leeway for deficits than the structural component does. In addition, a waiver clause permits the deficit limits to be exceeded if, and only if, a situation of exceptional emergency arises. The federal level also has a compensatory account, which is intended to ensure that the debt brake is applied not only to the formulation of the budget but also to its implementation. The federal authorities were granted a transition period running up to 2016 within which to comply with the structural deficit limits, while the states were given until 2020. Five states (Berlin, Bremen, Saarland, Sachsen-Anhalt und Schleswig-Holstein) are also receiving consolidation assistance payments, which are tied to strict conditions. The requirements imposed by the debt brake actually overfulfil the medium-term overall national budget targets for Germany within the Stability and Growth Pact

² This section closely follows Truger/Will (2013: Section 1).

and the Fiscal Compact on the European level, which permits Germany to run a structural deficit of 0.5 per cent of GDP.³

There is absolutely no reason to praise German fiscal policy before the introduction of the debt brake. Indeed, it has been pro-cyclically oriented for more than 30 years now. And from the turn of the century till the crisis of 2009, that policy's dangerous combination of constant tax cuts with a strict determination to consolidate budgets did great damage to growth and employment, considerably aggravated the disparities in the income distribution and markedly weakened the government's fiscal space (cf. Truger 2004, 2009 and 2010; Truger et al. 2010; Truger/Teichmann 2011). So there was reason enough to change course. But the new institutional arrangement that was actually chosen, namely the debt brake, can be criticized on at least five basic counts.

First, even the constitutionally enshrined target of holding new net structural deficits to a maximum of 0.35 per cent of GDP at the federal level, together with the ban on new net structural indebtedness by the states, is completely arbitrary from an economic point of view. It implies that, if the average annual growth in nominal GDP is 3 per cent, the overall government debt ratio will in the long term be 11.7 per cent. Nobody disputes that an upper limit on the debt ratio may be useful. However, the more recent empirical literature puts at 80 or 90 per cent the critical levels at which public debt might start to have growth-damaging effects.⁴ Rather, the fear must be that, due to the debt brake and the push to reduce the volume of what has so far been the most secure form of investment, the capital markets will be largely deprived of an important stabilizing force and a key point of reference. What forms of placement will be used in future for the German private sector's traditionally high surplus funds, and in which countries, is unclear.⁵ Among other things, this concerns private pension provisions. The fear must be that all this will make the financial markets significantly less stable in the long term.

Secondly, the debt brake means that fiscal policy has turned its back on the most important and broadly accepted economic yardstick for the level of government deficits, namely the Golden Rule. By so doing, it is ignoring 60 years of theoretical common sense. The Golden Rule, or the pay-as-you-go principle, constitutes a growth-oriented rule for new borrowing that permits new structural budget deficits, beyond the cycle, up to the level of public (net) investment. The idea behind this is to involve several generations in the financing of the public capital stock, as future generations will also benefit, in the form of rising prosperity, from productive public investments that are made today (cf. Musgrave 1959 and SVR

³ See Hein and Truger (2014: section 4.2) for a discussion of the differences between the German debt brake and the Fiscal Compact.

⁴ See Reinhart and Rogoff (2010) as the most prominent of the studies. However, as Nersisyan and Wray (2010) have convincingly demonstrated, such studies suffer from serious methodological shortcomings and should, therefore, not be taken as a guideline for economic policy. The doubts as to the original contribution by Reinhart and Rogoff have been reinforced very much by the discovery by Herndon et al. (2013) of major flaws in the underlying calculations.

⁵ See Hein and Truger (2014) for a closer investigation of the implications of German sectoral and trade imbalances in the European economic context.

2007). Certainly, the old debt rules for the federal and state levels did present the weakness of not distinguishing between gross and net investment, and also of not covering all economically relevant investments. Instead of seeking out a suitable definition or estimate of depreciation, the necessary discussion was never had – just as in the cases of the Maastricht Criteria and the Stability and Growth Pact. Moreover, the recommendation of the German Council of Economic Experts (SVR 2007) was ignored – a Council, be it said, that is not exactly known for its advocacy of limitless State spending.

Thirdly, the effects of the debt brake are critically dependent on the precise technical set-up, i.e. the choice of the underlying cyclical adjustment process and the budget sensitivities used. In fact, the German federal level has already opted for the process used by the EU Commission for budgetary supervision. In the final analysis, however, the precise technical implementation is a matter for the Ministry of the Economy and Finance to decide. The process is therefore extremely opaque and malleable (cf. Truger/Will 2013). Meanwhile, not all the different German states have so far come up with concrete implementation plans (cf. Deutsche Bundesbank 2011 and 2012). As the provisions in Art. 109 of the constitution leave them considerable leeway, Germany could well find itself with 17 different debt brakes in 2020: one at the federal level and 16 across the individual states, each with highly divergent forms and effects.

Fourthly, due to the mechanics of the most commonly used cyclical adjustment method, the debt brake has a pro-cyclical effect, so that it will cause an unnecessary destabilization of economic developments. On the downswing, too much consolidation will be demanded – and on the upswing, conversely, too little (cf. Truger/Will 2013).

Fifthly, however, the most serious problem faced by the debt brake when it was introduced was that it came at a time when public budgets were, from a structural point of view, substantially underfunded. For many years, public budgets had repeatedly come under big pressure from tax cuts. Then the lasting tax reductions adopted in response to the serious global financial and economic crisis and later on the so-called Growth Acceleration Law resulted in a further revenue decrease of more than €30bn (1.2 per cent of GDP) per year.⁶ If, in such a situation, a structurally (almost) balanced budget is unconditionally demanded by a set date, without previously or simultaneously bridging the existing revenue gap, then public budgets will of necessity have to follow a strict spending cuts policy for years on end. Macroeconomically, this is an extremely risky course to take, with potentially negative consequences for growth and employment during the adjustment process – especially in view of the economic situation in Germany, which was still looking precarious up to 2010. It is also quite indisputably associated with substantial declines in the provision of public goods, services and social security to the population. The decision taken jointly by the two chambers of the Federal Parliament to apply the debt brake and almost simultaneously to bring in lasting tax cuts – for instance, by reversing the

⁶ For details, see Section 4.

withdrawal of lump sum tax deductibility for the first 20 kilometres of work journeys and implementing a two-stage reduction of income tax rates, while bringing in the Citizen Relief Law and later the Growth Acceleration Law (cf. Truger 2010) – was therefore more than negligent, both economically and politically. For these reasons alone, it would have been wise, from the macroeconomic but ultimately also from the budgetary point of view, to have refrained from building a debt brake into the constitution.

However, the lawmakers opted to enshrine the debt brake in the constitution. So, for better or worse, the public budgets just had to learn to live with it. Due to the previously described fudges, leeway and opacities, it is difficult to establish the precise structural consolidation requirements placed on German public finances. Based on the spring 2010 forecast of an overall government deficit of roughly 4 per cent of GDP in 2010, a consolidation to the tune of 3.65 per cent of GDP (about €85bn) would have been necessary by 2020. As all the usual cyclical adjustment methods were still showing a negative output gap for 2010, the structural consolidation actually required must have been considerably lower. A figure somewhere between €50bn and €60bn would be plausible (2 to 2.4 per cent of GDP).

This consolidation would have had to be gradually achieved despite an extremely gloomy economic outlook, thus placing the German economic recovery process in very grave peril. Indeed, all the economic forecasts made during or just after the global financial and economic crisis painted a very dark picture. Right in the midst of the crisis, in early 2009, the Gemeinschaftsdiagnose project group, that is doing a twice-yearly forecast on behalf of the federal government, was still assuming that the German economy would shrink by 6 per cent during 2009 and a further 0.5 per cent in 2010 (Projektgruppe Gemeinschaftsdiagnose 2009). Forecasts were that unemployment would rise from just under 3.3m in 2008 to almost 4.7m. Over the next one and a half years, the predictions brightened up a little. The assumption in 2010 was that real GDP had shrunk by 5.0 per cent in 2009. This was almost correct. The actual figure was 5.1 per cent (European Commission 2013). For 2010 and 2011, growth rates of 1.5 and 1.4 per cent, respectively, were anticipated – still only a hesitant recovery, although with much better employment trends than previously thought (Projektgruppe Gemeinschaftsdiagnose 2010).

3. THE UNEXPECTED BRIGHTENING DUE TO THE STRONG ECONOMIC UPTURN 2010/2011

In the spring of 2010, nobody would have dared to dream that by 2011, the German economy would actually be soaring away from the crisis. Real GDP rose by 4.0 per cent in 2010 and a further 3.3 per cent the year after (cf. Table 1). On the labour market, all that the crisis had left behind was a small dip in 2009. By 2011, with unemployment at an annual average of just under 3 million, it had clearly already dropped below its pre-crisis level (IMK/OFCE/WIFO 2013). In

retrospect, Germany's rapid shift away from economic collapse seems to have been due, first of all, to the counter-cyclical course taken by fiscal policy. The Economic Stimulus Package II, adopted in January 2009, launched €50bn worth of measures, mainly targeted at 2009 and 2010. At least temporarily, this represented a break with the course steered by economic policy over the previous three decades. Until the world economic crisis, a counter-cyclically oriented fiscal policy had been seen as outdated. Just before that, during the long stagnation period of 2001-2005, German fiscal policy had taken a pro-cyclically restrictive line (cf. Hein/Truger 2007 and Eicker-Wolf et al. 2009). Secondly, the economy and employment were stabilized by a strong temporary reduction of working hours and labour hoarding by firms (cf. Herzog-Stein/Seifert 2010). Shorter working hours were achieved through various instruments, such as adjustable use of flexitime, short-time working and the application of collective agreement provisions on work time reductions. Labour "hoarding" was practised by many firms, in order to avoid dismissals during the downturn that could have faced them with labour shortages in the longer term.

Between the turn of the millennium and the onset of the world economic crisis, economic growth in Germany was mainly stimulated by foreign demand, while domestic demand growth – particularly in private and government consumption – was modest, notably in comparison with other European countries (cf. Eicker-Wolf et al. 2009: 21ff.). In the course of the global financial and economic crisis, this picture changed noticeably (cf. Table 1). In 2010 and 2011, domestic demand contributed more to growth than did foreign demand, and in 2012 the figures for the two were not particularly divergent. Unlike before the world economic crisis, in the following years private consumption stabilized economic growth, apparently due to a stronger development of employment and, correspondingly, wage incomes (cf. Arbeitskreis Konjunktur 2012).

Table 1: Real GDP growth and the growth contribution of demand aggregates in Germany 2008-2012

Year	2008	2009	2010	2011	2012
GDP	1.1	-5.1	4.0	3.3	0.7
domestic demand	1.1	-2.2	2.3	2.6	-0.3
<i>of which</i>					
private consumption	0.4	0.1	0.6	1.3	0.4
public consumption	0.6	0.6	0.3	0.2	0.2
gross investment	0.2	-2.2	1.0	1.2	-0.4
net exports	0.0	-3.0	1.7	0.7	1.0

Source: European Commission (2013).

However, the positive turn taken by the German economy in the years after 2009 was also significant for another reason: the much-heralded collapse of foreign demand never happened. As its labour and unit labour cost trends had, by international comparison, been very weak since 2000, Germany had achieved very high and rising net export surpluses with the EU and the euro area, while the euro crisis countries were tending towards rising and in some cases very high

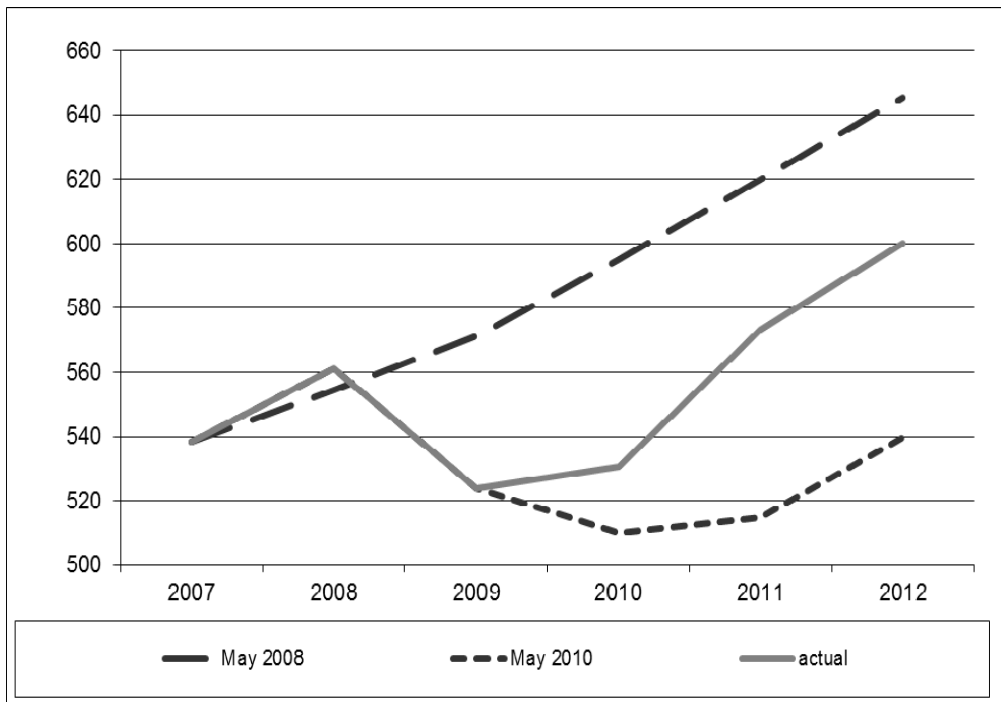
foreign trade deficits. At heart in fact, the euro crisis is attributable to current account imbalances due to increasingly divergent competitiveness levels within the euro area.⁷ As about 40 per cent of German export demand in 2011 came from the euro area (and about 60 per cent from the EU as a whole), it might be expected that the euro crisis would have strong knock-on effects on the German economy. And indeed, exports to the euro area, and in particular to the southern European crisis countries, did fall by 2.2 per cent during the first three quarters of 2012 as compared to the same period in 2011. However, dynamic export demand from the US, Japan and the South and East Asian emerging economies more than compensated for this (cf. Arbeitskreis Wirtschaftspolitik 2013: 4f.).

The unexpectedly powerful recovery of the German economy after 2009 undoubtedly had very positive effects on public budgets in Germany. Lower unemployment meant fewer benefits pay-outs and higher social insurance contributions. But the strongest sign of an upswing came from the tax take (cf. Fig. 1). Tax revenue forecasts, and the actual revenue figures, were successively corrected upwards from those given in the most pessimistic tax estimates of May 2010. In 2012, the total revenue for all levels of government was €600.0bn, which was 60.1bn more than the figure anticipated in May 2010 – but nonetheless still way below the figure anticipated in 2008.

Overall, the easing of burdens on public budgets, due to the economic situation, and the unexpectedly low interest rates, due to the euro crisis, together with the complex cyclical adjustment calculations conducted by the EU Commission, means that the 2012 structural budget deficit estimated for the German government as a whole by the EU Commission in the November 2013 autumn forecast has already completely disappeared and been turned into a small surplus of 0.2 per cent of GDP. In other words, as things stand now, the €50 to €60bn consolidation requirement cited in Section 2 has, in comparison with the initial situation in 2010, already been substantially achieved – without any need for additional consolidation efforts. Due to the good economic situation, all that was required was the expiry of the cyclical programmes and the application of the relatively moderate retrenchments that were already foreseeable in 2010.

⁷ For labour and unit labour cost trends, cf. Herzog-Stein et al. 2013. On the origins of the euro crisis, cf. for example Horn et al. 2012.

Figure 1: General government tax revenue 2007-2012: Comparison of revenue estimates in May 2008, May 2010 and actual revenue (in €bn.)



Source: Federal Finance Ministry

4. THE REMAINING SUBSTANTIAL STRUCTURAL REVENUE GAP⁸

As was only to be expected in Germany (cf. Truger 2010), the developments described above – undeniably positive though they are, particularly as regards the tax take – have already brought the tax cut supporters out in force. For some time now, superlatives have been the hallmark of media reporting on tax revenue and tax estimate trends. For instance, a report from the German press agency dpa, much relayed by the media, describes the outcome of the 140th meeting of the “Tax Estimates Working Group” in May 2012 as follows: “Record tax take is piling on top of record tax take, setting the State cash registers a-ringing. Already this year, the federal government, the states and local authorities can count on the highest revenue in history.” (Stahl 2012, translation: Ian Graham). News items of this kind create the impression that the revenue fountains are now spouting so freely that there is more than enough money around for “tax giveaways”. While the statements in the report quoted do not really contain any factual inaccuracies, the extent to which they have been spread around does suggest a

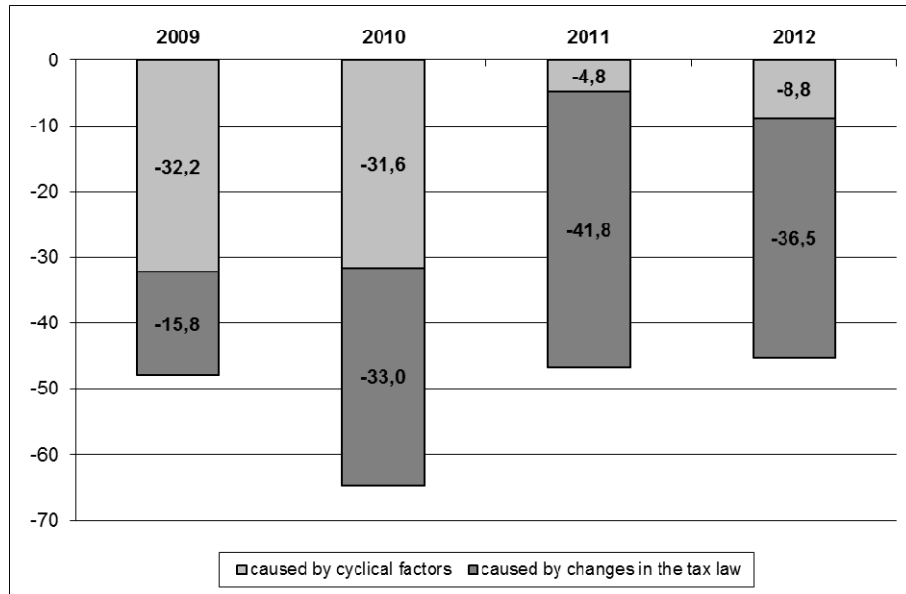
⁸ In places, this section draws strongly on Rietzler et al. 2012: 8-11. However, the figures have been updated.

lack of economic understanding. Overall tax revenues are strongly dependent on GDP trends. With a few exceptions, developments in annual tax revenue from 1950 to 2012 were more or less proportional to nominal GDP. The years with heavy downward deviations were mainly those that saw big tax cuts. In 57 of the 62 years, the rate of growth of tax revenues, compared with the previous year, was positive – in most cases strongly so. In only 5 years, which as mentioned were marked by big tax cuts and economic slumps (1996, 1997, 2001, 2002, 2009), was less tax revenue garnered than in the previous year. Moreover, 53 years showed record revenues compared with the previous years. Each time, this was the highest tax revenue in history. So clearly, in a (nominally) growing economy with a modern tax system, record revenues each year are completely normal.

As may be seen in Fig. 1, the tax revenue in 2012 was €60.1bn up on the estimate made in spring 2010. However, the tax estimate in May 2010 was the most pessimistic forecast in recent years, due to the shock of the major recession caused by the financial crisis. That the estimates should be much more encouraging after the unexpectedly rapid recovery of the economy than when it was at a low is scarcely surprising. A more adequate consideration should therefore be based on the tax estimate that was made just before the deep recession. Therefore, Fig. 1 also includes the result of the tax estimate in May 2008. This shows just how hard the tax revenues were hit by the crisis – and that in 2012, they were still very strongly affected by that crisis. For instance, the value for 2012 is, despite all the upward revisions, still some €45.3bn less than the estimate for 2012 produced by the Tax Estimates Working Group in May 2008.

Fig. 2 shows how actual tax revenues deviate from the takes predicted in the spring of 2008, shortly before the global financial and economic crisis. In all, the crisis resulted in national, regional and local government losses of €48bn (2009), €64.6bn (2010), €46.6bn (2011) and €45.3bn (2012). The revenue losses can be subdivided into those caused by tax law changes (the darker column blocks; Federal Finance Ministry estimates) and those due to cyclical influences (lighter blocks). It is noticeable that the cyclical influences predominated in 2009 and 2010 but had a minimal impact in 2011 and 2012, due to the rapid recovery. In the latter years, the effects of tax law changes (particularly from the economic stimulus packages as well as the Citizen Relief Law and the Growth Acceleration Law) carried significantly more weight. In 2012, there was still a structural revenue gap of €36.5bn in comparison with the May 2008 estimate. This is attributable to tax cuts. So it should be noted that, even in 2012, tax revenues had still by no means recovered from the deep recession, and that the tax-cutting policies at the time played a major role in this.

Figure 2: Actual revenue in comparison with Tax Estimates Working Group's forecast in May 2008: revenue reductions from 2009 to 2012 in €bn

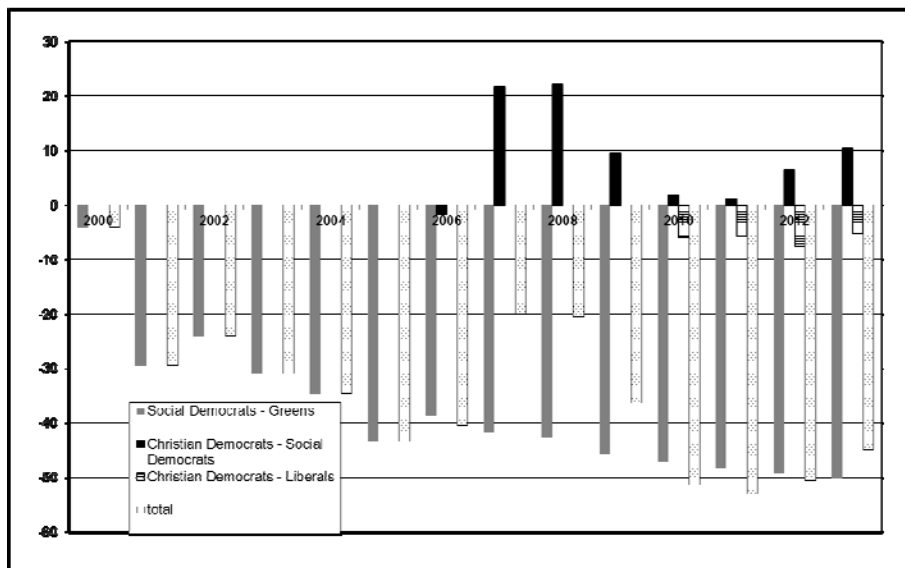


Sources: Federal Finance Ministry, authors' own calculations.

Moreover, above and beyond the tax cuts decided in the short term since 2008 in the context of the economic stimulus packages, government budgets had already, from 2001 to 2005, been weakened by drastic, permanent tax cuts – particularly in the personal as well as the corporate income taxes (Truger 2004 and 2009; Truger/Teichmann 2010 as well as Truger/Teichmann 2011: 8-12).

Fig. 3 shows the net fiscal effects in 2000-2013 of the changes made to tax law since 1998, and assigns them to the particular federal government in office at each date. The effects were calculated by adding up and projecting the data from the finance table published by the Federal Finance Ministry (cf. Truger et al. 2007). These are indeed net effects – i.e. tax increases introduced in the meantime are taken into account and are offset against the quantitatively much larger tax cuts.

Figure 3: Impact of tax law changes by the various coalition governments since 1998 (2000 to 2013) in €bn



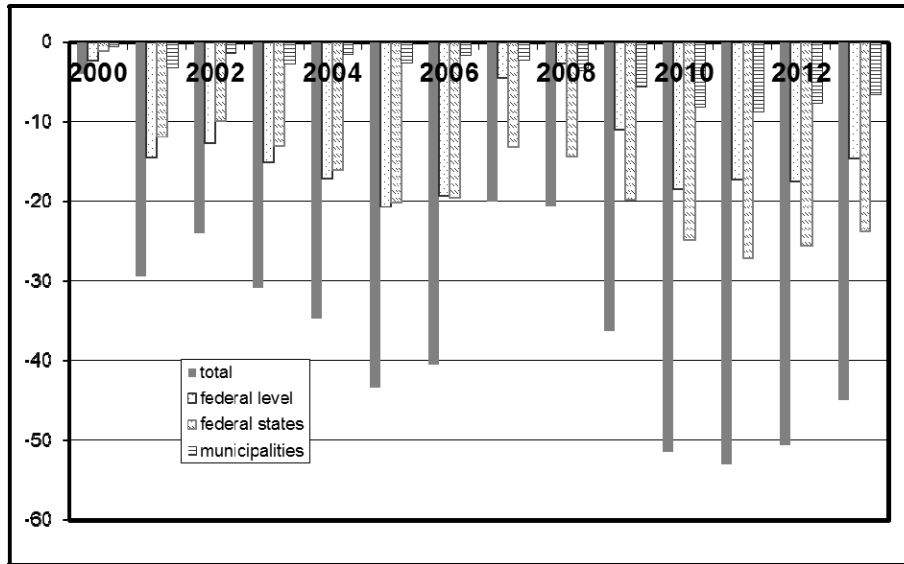
Sources: Federal Finance Ministry, authors' own calculations.

After drastic tax cuts by the Social Democratic-Green federal government, especially as part of the so-called tax reform in the year 2000, there were compensatory increased revenues from 2006 onwards, starting with the Great Coalition's consolidation drive and primarily attributable to the increase in the value added tax by three percentage points from 16 to 19 per cent. If there had been no further changes, the revenue losses would have stabilized at about half the figure brought about by the Social Democratic-Green reforms. However, within the framework of the economic packages, further tax cuts were then adopted, so that by 2009, the revenue increases from the measures brought in by the Great Coalition had almost all been eaten away again. Nevertheless, the Christian Democrat – Liberal Democrat coalition, which had taken office in the autumn of 2009, opted for further tax cuts via the so-called Growth Acceleration Law. Overall, the revenue loss to all levels of government from 1998 onwards, due to past tax-cutting policies, is currently running at about €45bn (1.7 per cent of GDP).

Fig. 4 shows the distribution of tax revenue losses across federal, state and municipal government. In fact, the federal-level situation from 2007 onwards was worse than indicated. Although federal government did see a substantial revenue increase from 2007 onwards, due to the rise in VAT, one percentage point of that was passed on to the unemployment insurance budget to fund a cut in contribution rates. It should also be borne in mind that the municipalities were and are being hit harder than the graphs imply, as under the local government finance equalization scheme (KFA), a substantial share of the losses incurred by the states (varying from one state to another, but averaging just under 20 per

cent) is passed on to the municipalities. Correspondingly, the burden on the states is reduced once the KFA has been applied.

Figure 4: Impact of tax law changes since 1998 on the different levels of government (2000 to 2013) in €bn

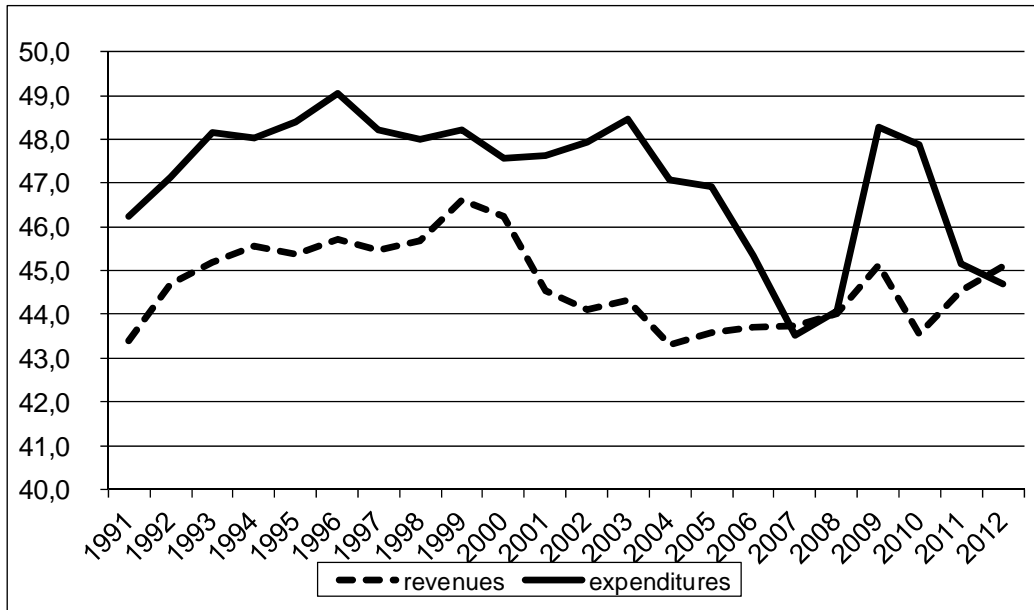


Sources: Federal Finance Ministry, authors' own calculations.

5. MAJOR SPENDING REQUIREMENTS TO SAFEGUARD THE GOVERNMENT'S CAPACITY FOR ACTION AND FUND FUTURE-ORIENTED INVESTMENT

Alongside transitory, cyclically induced declines in revenue, the drastic tax cuts described in the previous section are also the main cause of the budget deficits that have arisen over the past twelve years. However, there is a widespread belief in Germany that the government is "living beyond its means". This is generally blamed on an overly expansionary development of government spending. Hence the well-known demand for a balanced budget, to be achieved notably through reduced benefits and spending. As Fig. 5 shows, this thesis of an expansionary government spending policy is completely unfounded in the case of Germany.

Figure 5: Overall government revenues and expenditures* in relation to GDP, in per cent. 1991-2012



* Expenditure in 1995 excluding debt assumption by the Treuhandanstalt (privatization agency for Eastern Germany) and by the housing sector of the former GDR (totalling €119.6bn) and in 2000 excluding the proceeds from the auctioning of UMTS licences (€50.8bn)

Source: Federal Statistical Office.

Clearly, the overall government revenue ratio has dropped dramatically since 2001 (due mainly, as has been seen, to tax-cutting policies), and this led to a rise in the overall government budget deficit. Hence an even steeper drop in the expenditure rate from 2003 onwards, i.e. in order to consolidate the budget, the State – except during the brief economic package phase in 2009 and 2010 – made a lasting reduction of some three percentage points in its claims on GDP, from around 48 per cent in the early 1990s to only about 45 per cent since 2005. The thesis of irresponsible spending by the German government becomes wholly absurd if an international comparison is made. In fact, the evolution of government spending over the ten years before the global financial and economic crisis was extremely cautious (cf. Table 2, columns 1 and 2): the average annual rate of growth in overall government spending from 1999 to 2008 was nominally around 1.5 per cent in Germany. In real terms, i.e. excluding inflation, German government spending actually fell by an average of 0.2 per cent per year. The average for the “old” EU countries is almost three times as high, at (a nominal) 4.3 per cent. Over this period, no other developed economy except Japan showed a lower growth in government spending than did Germany. True, German public spending in 2009 and 2010 did present a slightly greater rise in comparison to that of other countries, but this was due to the economic stimulus packages in Germany as well as the austerity policies imposed mainly on Southern Europe (cf. Truger 2013a). But even taking those two years into account, German spending

policy does, in the longer view, remain unusually restrictive by international comparison.

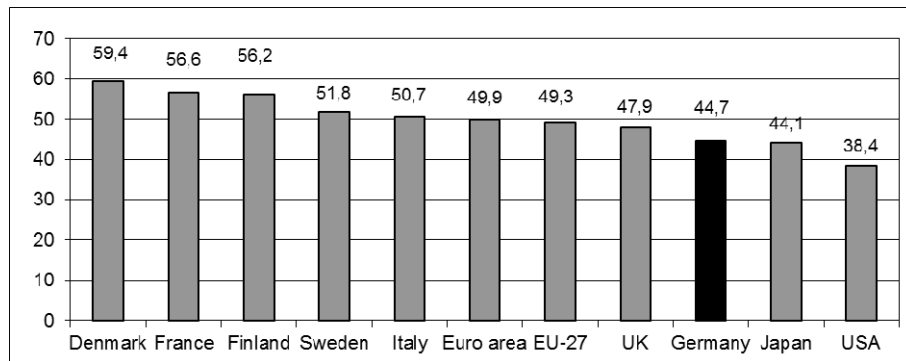
Table 2: Evolution of government spending (average annual growth rate) since 1999

Country	1999-2008		1999-2011	
	nominal	real*	nominal	real*
EU-27	4.3	1.5	3.7	1.1
EU-15	4.0	1.8	3.5	1.4
EMU-17	3.8	1.6	3.5	1.4
EMU-12	3.8	1.6	3.4	1.4
Belgium	4.1	1.8	4.2	2.0
Bulgaria	11.7	4.6	8.9	2.9
Czech Republic	6.0	3.2	4.9	2.5
Denmark	3.3	1.1	3.6	1.5
Germany	1.5	-0.2	1.7	0.1
Estonia	12.6	7.6	9.1	4.7
Ireland	10.9	7.3	8.2	5.7
Greece	8.4	5.0	5.7	2.4
Spain	7.4	4.0	6.1	3.2
France	4.0	2.0	3.7	1.9
Italy	3.6	1.2	3.0	0.7
Cyprus	8.9	6.0	7.9	5.2
Latvia	14.7	8.6	10.0	4.9
Lithuania	8.7	5.8	6.3	3.3
Luxembourg	7.4	4.4	7.3	4.5
Hungary	9.5	2.7	7.7	1.5
Malta	5.6	3.0	4.9	2.4
Netherlands	5.0	2.5	4.5	2.3
Austria	3.1	1.2	3.0	1.1
Poland	7.5	3.5	7.3	3.4
Portugal	5.4	2.4	4.8	2.2
Romania	31.3	9.9	24.1	6.8
Slovenia	9.2	3.6	7.9	3.2
Slovak Republic	6.9	0.7	6.3	1.0
Finland	4.0	2.2	4.1	2.1
Sweden	3.4	1.6	3.2	1.5
UK	7.1	5.2	6.0	3.8
Iceland	13.4	8.6	9.3	3.6
Norway	6.2	4.2	6.1	4.1
Switzerland	2.4	-	2.5	-
USA	6.3	3.3	5.7	3.1
Japan	-1.5	-1.3	-0.8	-0.5

* deflated with the (harmonised) index of consumer prices.
Source: Eurostat; authors' own calculations.

As explained, the situation set out here is also reflected in the evolution of the German government spending ratio. This fell from about 48 per cent at the end of the 1990s to just below 44 per cent in 2008, and it is currently around 45 per cent – a relatively low figure in international terms (cf. Fig. 6).

Figure 6: Selected government spending ratios in 2012 – international comparison*



Source: European Commission (2013).

Of particular interest in connection with public spending activity are the growth-relevant areas of public investment as well as education and training. It is generally recognized that the public budget has to spend part of its income on investment, in order to provide sufficient public infrastructure in the form of roads, educational institutions, water supplies, sewers etc. both for private households and for enterprises. State provision of public infrastructure is an important precondition for economic activity. From the firms' point of view, public infrastructure has a preparatory or complementary function. It raises firms' production potential and lowers production costs. If government investment is too small, this will have a negative effect in the long term on economic growth within the economic area concerned. Indeed, education is one of the fields in which too little public investment can have negative effects. If children's learning environment – chiefly schools but also daycare centres – is in a bad state, this will have consequences for the students' performance and the effectiveness of teaching. Examples would be classroom sizes, noise levels, lighting and acoustics.

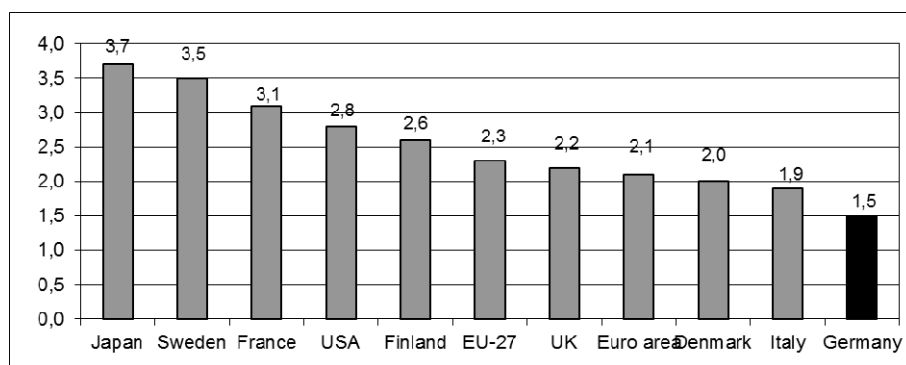
It should also be borne in mind that a lack of investment can lead to serious environmental problems, and hence to costs. One instance of this is sewerage systems, where leaky piping can cause groundwater pollution. What must be remembered in relation to public investment activity is that an interim suspension of replacement investment – such as when damage to roads is not repaired promptly – will lead to progressive cost increases over time (cf. Reidenbach et al, 76ff.).

In Germany since the early 1970s, public investment has been declining relative to GDP. In fact, this is a general international trend, but in comparison with other major industrial nations, the decline in Germany has been markedly stronger. In 2012, the German government investment ratio was very low, at just 1.5 per cent

of GDP (Fig. 7), whereas the euro area average, including Germany, was 2.1 per cent of GDP. And the Swedish ratio was 3.5 per cent.

One major reason for this decline and the internationally sub-average investment in the public budgets is the efforts to consolidate: cutting public investment is often the authorities' preferred means of restricting expenditure. If, as a yardstick for the investment gap, one simply took the euro area average without Germany, the result would be a difference of $(2.3 - 1.5 = 0.8)$ per cent of GDP or €21bn for classic public investments in buildings and infrastructure. And if Sweden were taken, as a particularly positive example, the gap would be much greater still. It would then come to $(3.5 - 1.5 = 2.0)$ per cent of GDP or €52bn.

Figure 7: Government investment as percentage of GDP in 2012 in selected countries

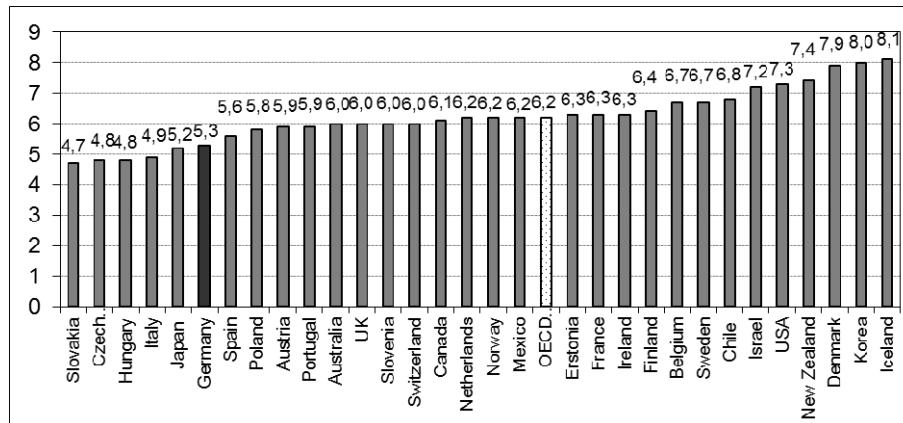


Source: European Commission (2013)

Public spending on education, which in Germany is to a very great extent the responsibility of the individual federal states as far as schools and higher education are concerned, is another field in which Germany looks none too good in comparison with other OECD countries (cf. Fig. 8). The relatively high private spending on this, within the dual system, does partly compensate for the low public expenditure, but even when public and private spending are taken together, they are still quite clearly below the OECD average and are far removed from those countries that devote seven per cent or more of their GDP to education (cf. Fig. 8). In 2009, the German figure was some 5.3 per cent – about one percentage point lower than for the OECD as a whole. Whereas six countries devote between seven and a good eight per cent of their national GDP to education, only five out of 28 OECD countries spend less money on this than Germany does. To bring German spending on education up to the OECD average would take an extra expenditure of €25bn. And for German expenditure on education to reach the level of front runners Denmark, Korea and Iceland, it would have to go up by about €70bn.⁹

⁹ Piltz (2011), on the basis of very detailed calculations, concludes that additional current expenditure of around €55bn would be needed in order to equip the German education system properly. On top of that, there is an investment bottleneck that Piltz puts at €45bn.

Figure 8: Private and public spending on education as a percentage of GDP – international comparison (2009)



Source: OECD (2012a)

To sum up, it can be concluded, even without a comprehensive analysis, that the need for additional public investments (in the broadest sense) is great. Here, we are looking at something in the order of €51bn to €117bn a year, or 1.9 to 4.5 per cent of GDP.

And of course, above and beyond the need for investment, there are other potential financing requirements. For instance, public administrations have undergone a massive downsizing process over the past two decades, and the wages and salaries of public service workers are lagging far behind the already weak wage developments in the economy as a whole. Correcting these aberrations would certainly require significant spending of another ten billion or more. If, in addition, there were a quite justifiable wish to boost social benefits, further tens of billions could easily be needed. So the total funding requirement could amount to some €60bn to €150bn (2.3 to 5.7 per cent of GDP).

6. SOCIALLY JUST TAX INCREASES AS THE ONLY RELIABLE WAY OUT

How can this funding need, which the previous section plausibly put at around €60bn to €150bn (2.3 to 5.7 per cent of GDP), be met? Although the underlying expenditure requirements are mostly investments, in the economic sense, the German debt brake means that, in defiance of standard economic textbook knowledge, they could not be covered by net public borrowing. This state of affairs breaches the principle of intergenerational justice (cf. Truger/Will 2012: 81f.) and is all the more regrettable because a short-term increase in net borrowing in order to finance these extremely growth-friendly public investments would probably not even entail any serious medium-term rise in the deficit ratio, thanks to major self-financing effects. Funding through any

significant spending cuts is also a non-starter, due to the already observable State downsizing trends of the past.

Another possibility, in principle, would be to count on a further surprisingly strong and long-lasting economic upturn in Germany. Similarly to the soaring upturn in 2010 and 2011, as described in Sections 3 and 4, a growth boost of this kind would, due to the pro-cyclical tendencies built into the usual cyclical adjustment calculations, certainly hold the potential for a durable “structural” financial reinforcement of public budgets. This could serve to at least partially fund the spending requirements. And as in 2010, such an upturn may be improbable but is not unthinkable. However, a responsible fiscal policy with the declared aim of significantly strengthening future-oriented investment must not be a hostage to the vicissitudes of global economic developments.

That is why a structural, durable strengthening of the revenue side is vital. There are many options for implementing this in a socially just way (cf. Schäfer/Truger back in 2005). The main ones are an income tax rise for those on high incomes, stronger taxation of capital income, an increased inheritance tax, the reintroduction of the wealth tax along constitutionally correct lines, a tax on financial transactions, and the withdrawal of the most recent tax privileges for enterprises, together with an expansion of corporate taxation – notably through the reinforcement and perpetuation of the trade tax. The implicit increase in the fiscal burden on higher incomes and wealth would not only redress, in a socially desirable way, the imbalance that has strongly grown over recent years in the distribution of income and wealth in Germany. It would also very probably, by adjusting that skew, make a more comprehensive contribution to improving society’s quality of life (Wilkinson/Pickett 2010). Moreover, it would help to reduce international macroeconomic imbalances (cf. Truger 2013b).

The revenue potential of the measures listed above is quite considerable. Overall, it could certainly generate an additional €20bn to €120bn, depending on how it was implemented and the degree of political courage shown. Higher income tax on upper income groups could bring in an extra €2bn to €20bn. Other income tax measures (abolition of the withholding tax, a reform of spousal income splitting, less privileged treatment of income from rent and leases, and a reform of “mini-jobs”) could add a further €5bn to €20bn. An inheritance tax reform could be worth up to €8bn more, a constitutionally compatible reintroduction of the wealth tax has the potential to deliver €10bn to €20bn, and €3bn to €20bn could be expected from a financial transaction tax. Meanwhile, company tax measures (including a municipal finance reform) could certainly achieve an extra €2bn to €20bn. And there is the potential for garnering up to €12bn more by resolutely improving tax enforcement. Additional revenues on this scale would quite certainly be enough to cover the bulk of the investment needs described. And if the massive increase in public investment led to increased production and employment, despite being completely financed by tax increases in line with the *balanced budget multiplier* concept, then even more revenue would be

generated, and this might in turn be used for further investment – without breaching the debt brake rules.¹⁰

Moreover, even within the debt brake framework, a certain amount of leeway still exists – if necessary even without tax increases. This is particularly the case for the individual states within Germany during the transition period up to 2020. This legroom could possibly be used to fund public investment, or at least to avoid too hard a consolidation course (cf. Truger 2012). Be that as it may, the debt brake must certainly be implemented in such a way at the federal and state levels that it will not lead to a pro-cyclically restrictive cutback policy in the case of an economic downturn (for a detailed treatment of this problem, cf. Truger/Will 2013), thus frustrating the strategy recommended here for strengthening the government's capacity to act as well as future-oriented investment.

7. ECONOMIC LIMITS TO TAX INCREASES – NOT VERY PLAUSIBLE¹¹

It may be asked whether the revenue ratio increase that is needed for the reasons set out above, and which would probably amount to a few percentage points, would be economically tolerable. According to many representatives of the German economic mainstream, it would not. They explicitly or implicitly assume that a higher government revenue ratio quickly comes up against economic limits. The arguments usually advanced for this are, for the most part, negative incentive effects, demographic change or international tax competition. However, none of these arguments runs very deep.

As regards the incentive effects, these have long been a topic in the (textbook) literature of public finance. This provides a detailed analysis of the effects of taxation on economically important decisions by private households and enterprises (for example, cf. Rosen/Gayer 2008: 375 ff.). For households, the main items are decisions about labour supply and savings. However, even within the mainstream, no convincing theoretical or empirical indications can be found of strong negative incentive effects from taxation and hence from tax increases (cf. detailed treatment in Corneo 2005; Truger 1999). Even in the simplest textbook model, it is theoretically unclear whether tax increases have positive or negative effects on the labour supply. On average, empirical findings point to only small negative reactions. A generally weak reaction can, on average, also be found in savings formation. Moreover, even clear decreases in labour supply and savings would actually be a good thing in a situation of major cyclical underutilization, as they would, at least in the short term, reduce unemployment and increase consumption, due to the rising consumption ratio. Finally, the finding of an, at

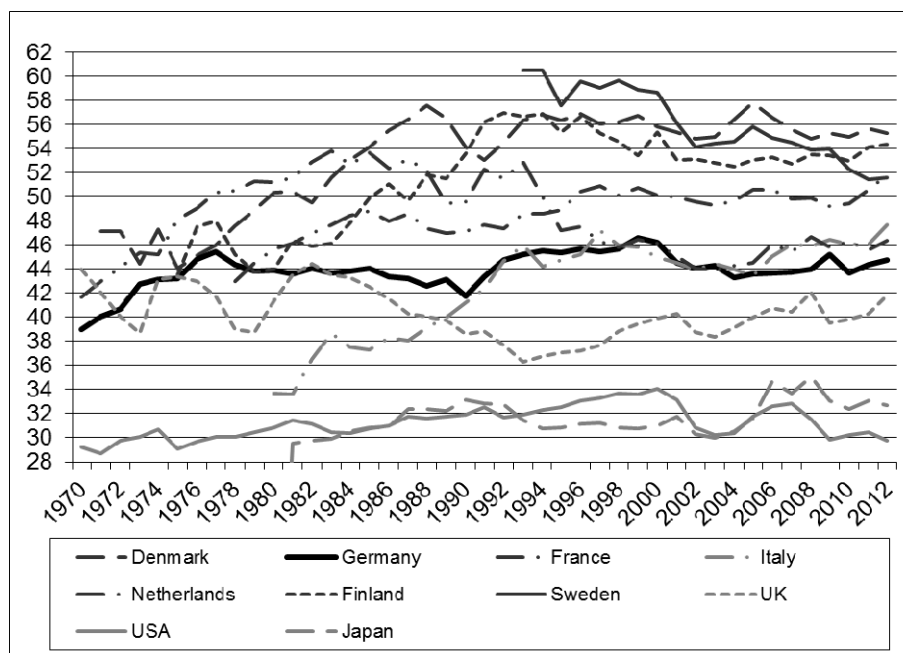
¹⁰ For the issue of consolidation via the *balanced budget multiplier*, see for instance Horn/Truger (2005) and for a concrete example, Truger et al. (2010: 80ff.).

¹¹ For a more extensive and recent treatment of taxation trends and the debate on incentives, tax competition and tax evasion see Godar/Truger (2014a and 2014b).

most, moderate and perhaps non-existent negative impact of taxation is also transferable to the business sphere (Corneo 2005). All in all, the incentive issues do not appear particularly serious (cf. Atkinson 1993 and 1999).

The implausibility of the government revenue ratio's having a serious impact on economic growth can also be demonstrated by means of a simple international comparison of State revenue ratios (Fig. 9). The revenue ratios are between 30 and 60 per cent of GDP, and have no particularly noticeable connection to the economic performance of the various countries.

Figure 9: Government total revenue as a percentage of GDP for selected countries 1970-2012



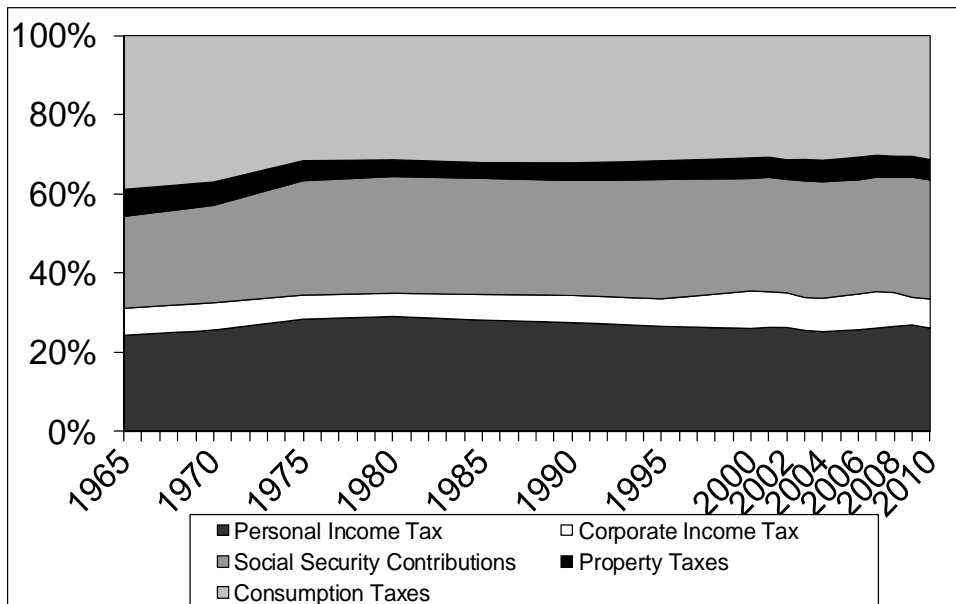
Source: European Commission (2013)

Demography, despite its prominence in the public debate, is not really a separate argument in its own right. If a growing share of GDP has to be devoted to taking care of people who are no longer in work (i.e. for social transfers), then obviously the trend in the State expenditure ratio will be upwards and, given the continued existence of the debt brake, the government revenue ratio will have to go up too. But this means that the demographic issue comes down to the same thing as the incentive issue described above: is it possible to increase the revenue ratio by a few percentage points without triggering substantially negative impacts on growth and employment? As explained, the incentive issue is not a particularly serious one, so a fairly relaxed attitude can also be taken to the demographic issue.

International tax competition, with its downward trend in tax rates, was long a problem that certainly needed to be taken seriously. However, this may be about to change, as many States are turning to tax increases as a way of reducing their

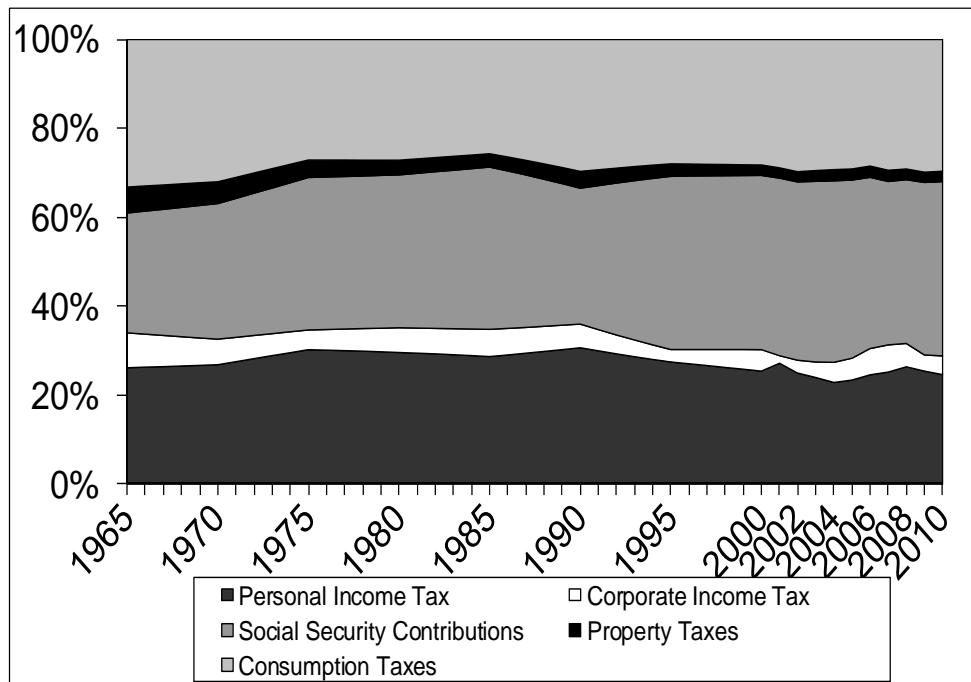
budget deficits. But even if the problem remains, it has not so far become a serious issue for the funding of the welfare state (cf. also Hines 2006). First, it is mainly concentrated in the field of capital income and company taxation, and thus in a relatively narrowly defined area of taxation and contributions, whereas other types of central taxation, such as taxes on wages and indirect taxes, but also wealth-related taxes, are scarcely affected. To that extent, this is more an issue of justice in taxation or distribution than of general State financing. Secondly, the current evolution of the tax structure, over time, in the EU-15 has so far not shown any decline in the importance of personal income tax or of the taxes paid on profits by corporations (Fig. 10). Both these tax categories together contributed scarcely any less, in percentage terms, to overall revenue from tax and contributions in 2010 than in the previous three decades – despite the downturn provoked by the crisis. It would appear that the decreasing tax rates were compensated by a broadening of the assessment basis, but also by a disproportionate rise in profits and capital income, due to distribution shifts. This does not mean that these taxes might not decline in importance in future, thus posing finance problems for the State as a whole. But it is remarkable that tax competition, which has been under intensive discussion for at least 20 years now, has thus far left so few visible marks on the revenue structure. Also, it may be assumed that, in the course of the worldwide consolidation efforts, the tax-cutting spiral will come to a halt in the foreseeable future, or will at least slow down. There may even be a trend towards higher rates. Certainly, a comparison of Fig. 11 with Fig. 10 suggests that the erosion of personal income tax and corporate profit taxes that can be seen over time in Germany is a specifically German phenomenon rather than an inevitable, universal one.

Figure 10: Tax and contribution structure as a percentage of total revenue, EU-15 (1965-2010)



Sources: OECD (2012b); authors' own calculations

Figure 11: Tax and contribution structure as a percentage of total revenue, Germany (1965-2010)



Sources: OECD (2012b); authors' own calculations

But even if there were the prospect of a noticeable decline in the importance of taxes on capital income and on corporations in future, it would not necessarily pose any serious threat to the public finances. First of all, there would probably be a growing awareness of the problem and hence also increasing international action to harmonize taxes.¹² Also, the problem might in any case be less significant in the case of Germany, as this country's revenue from "endangered" types of tax is, by international comparison, below average, but also because the wealth-related taxes still have great potential for generating more revenue. In Germany, the personal income tax together with the tax on corporate profits accounted for just 28.7 per cent of tax and contribution revenues in 2010. The unweighted median for the EU-15 was 32.6 per cent, although the overall tax and contribution level in Germany, at 36.1 per cent of GDP, was markedly below the unweighted EU-15 average of 38.4 per cent (OECD 2012). Wealth-related taxes (e.g. inheritance tax, wealth tax as such, and real estate taxes) also only contributed 2.3 per cent of the revenue in Germany, but more than twice as much in the EU-15, at 5.0 per cent (OECD 2012b).

¹² See Godar/Truger (2014c) for a discussion of recent policy proposals and alternatives.

All in all, then, as outlined in Section 6, the conditions for a distributionally just increase in Germany's State revenue ratio may also be regarded as favourable.

8. OUTLOOK: GERMAN FISCAL POLICY AT A CROSSROADS

Safeguarding the State's ability to act and financing future-oriented central public investment are, for the reasons cited, essentially a political rather than an economic issue – even in the era of the debt brake. For those who wish to see an effective social and investment State, it is theoretically possible to achieve one. The central question here is whether, contrary to the experience of the past 15 years, political consent can be secured in the near future for the higher taxes that would be needed. It has not been obtained up to now because German fiscal policy seemed to be caught in a vicious circle: cuts to, and a decline in, State services decreased the willingness to pay taxes; State financial resources dwindled due to tax cuts; hence public services were cut back more and more, and the public authorities lost the capacity and the consent for action. It would be desirable to shift from this pessimistic scenario to an optimistic one and build up a "virtuous circle": a high level of public services, together with a State funding structure that is felt to be just, strengthens the willingness to contribute to the funding of public services through taxation, and this in turn enables a high level of services. Essential future-oriented investments and a State that has the capacity to act, the twin themes of the present paper, are in the most basic interests of the great majority of the population, which definitely includes the so-called New Centre. Higher spending in the various fields of State responsibility cited could strongly improve the living conditions of the broad majority of the population. And to fund it, recourse should be had to those who have been profiteering from the extremely strong redistribution – also by international comparison – in Germany over recent years (OECD 2008).

After all, German tax and fiscal policy is at a crossroads. If, over the coming years, the structural underfunding can be successfully resolved through socially just increases in taxes and contributions, and the debt brake can be made crisis-proof, then the State's capacity to act and the realization of central future-oriented investments are within reach. Unfortunately, opportunities to make the policy changes outlined here have been missed time and again in recent years. And although the fiscal policy plans of the opposition parties' programmes for the recent federal election in September 2013 did provide substantial hope of a real change of course, the election results are truly sobering: The draft of the coalition agreement for the probable Grand Coalition government does hardly include any of the tax measures proposed in this paper. Instead, it relies on a continuation of the country's great "economic luck" to use some of the expected additional revenues to fund small proportions of the spending requirements identified in this paper. If there is no such luck, then the long-standing policy of State

downsizing is set to continue – with all the ensuing economic and social consequences.

It seems that German fiscal policy is just about to take the wrong turn at the crossroads, once again.

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