

# Country focus — Germany

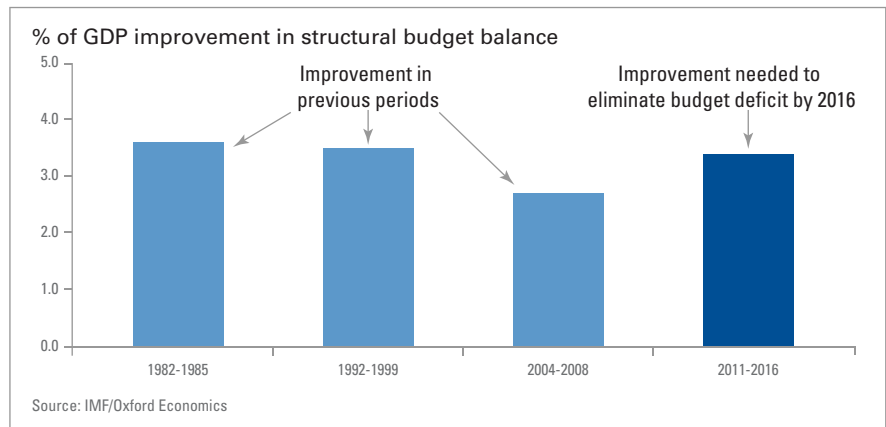
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Germany is confronting a fiscal challenge that is less daunting than that facing some of the other major industrialized countries, but is nevertheless considerable. Germany suffered one of the biggest contractions in output among the major economies during the global recession, with a peak-to-trough drop in GDP of around seven percent. This sapped government revenues, and the budget was further strained by a relatively large fiscal stimulus package adopted to try to counter the recession. In 2009 and 2010, fiscal stimulus measures exceeded two percent of GDP.<sup>1</sup>

As a result, the German headline fiscal deficit is forecast at around five percent of GDP for 2010, with the structural deficit at around 3.2 percent of GDP. The debt/GDP ratio will approach 80 percent of GDP this year.<sup>2</sup> Eliminating this deficit will be a substantial undertaking, comparable in scale to major adjustment efforts in the past such as in the mid-1980s and second half of the 1990s (see chart 1).

**Chart 1: Germany's fiscal challenge**



Source: IMF: Germany Staff Report for the 2010 Article IV Consultation March 10 2010

**The fiscal challenge for Germany is also complicated by a number of factors.**

Firstly, as part of the Eurozone, Germany does not have the option of using currency depreciation to cushion the effects of fiscal cutbacks on growth in the way many previously successful adjusting countries have done. Secondly, Germany is a complex Federal state in which fiscal responsibilities are divided between different levels of government – getting all levels of government to work effectively together to achieve deficit recovery may be difficult. Finally, as well as a substantial public debt, Germany also faces large off-balance sheet liabilities related to the government’s future health and pension commitments. According to one estimate, these exceed 300 percent of GDP.<sup>3</sup>

In the wake of the fiscal crises in some of the peripheral Eurozone economies, the German authorities have already made a start on elaborating a deficit recovery strategy – in the opinion of *one senior German public official*, “Erring on the side of caution is better.” Tax cuts planned for next year, which would have cost one percent of GDP, have been scrapped. And a program of savings worth €80 billion during 2011–2014 has been announced.<sup>4</sup>

The savings program includes a range of spending cuts and tax increases:

- Around 10,000 public sector jobs are set to go
- Public sector pay will be reduced by canceling Christmas bonuses
- And, new taxes on air travel, nuclear power and the banking sector are planned.

In addition, the government plans to reduce social security and unemployment benefits.<sup>5</sup>

**As well as reining in social security spending, Germany has considerable scope to reduce the deficit by removing or reducing subsidies and tax breaks.** In 2010, some €6.8 billion is expected to be spent on subsidies to sectors such as coal according to the Ministry of Finance. Meanwhile, the value of tax breaks is estimated at €17.6 billion (see chart 2).<sup>6</sup> These tax breaks include relief for heat and power plants and energy use by industry, as well as for savings for first time home buyers and payments of holiday wages. **Total subsidies and tax breaks currently amount to around one percent of GDP or a fifth of the projected budget deficit for this year.** The government’s program plans that lower subsidies and new taxes will yield €7.5 billion per year.<sup>7</sup>

**Germany could also raise revenues by widening the base of VAT and raising property taxes.** Broadening the VAT base by reducing current exemptions by half could raise 2.4 percent of GDP according to IMF estimates, while property taxes and service charges raise only 1.3 percent of GDP compared to an OECD average of over six percent of GDP according to a Cologne University Study.<sup>8</sup>

**Another possible option would be to introduce a wealth tax.** The DIW Research Institute last year estimated that a one percent wealth tax with a €500,000 annual allowance (which would be broadly in line with the European average) could raise €21 billion per annum, close to one percent of GDP.<sup>9</sup>

<sup>3</sup> Stiftung Marktwirtschaft: Kurzinformation: Generationenbilanz Update 2010 25 May 2010

<sup>4</sup> Bundesministerium der Finanzen ‘Nachhaltig Sparen – Gerecht Sparen: Das Sparpaket der Bundesregierung’ 2010

<sup>5</sup> Bundesministerium der Finanzen ‘Nachhaltig Sparen – Gerecht Sparen: Das Sparpaket der Bundesregierung’ 2010

<sup>6</sup> German Finance Ministry 22<sup>nd</sup> Report on Subsidies for years 2007–2010

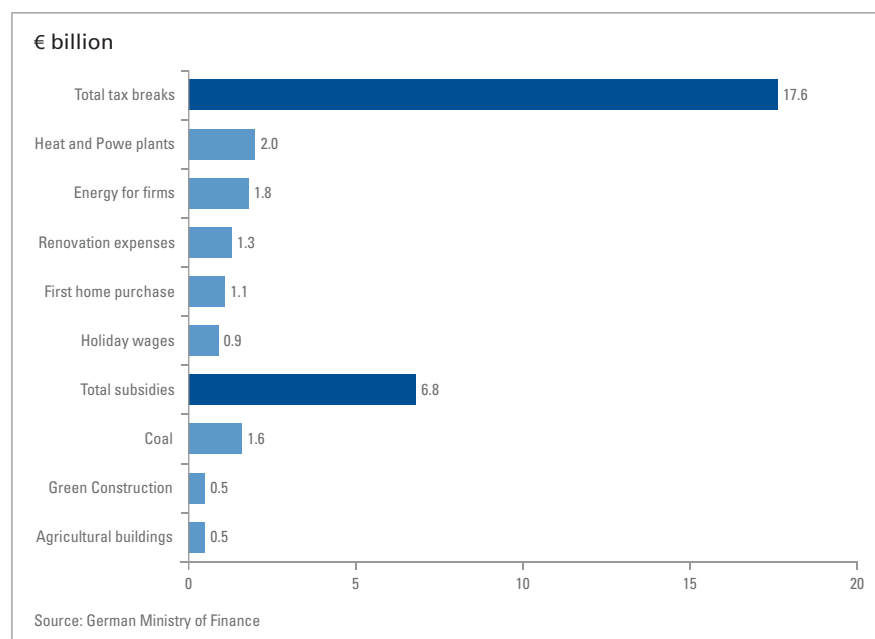
<sup>7</sup> Bundesministerium der Finanzen, op. cit. (2010)

<sup>8</sup> Fuest, C & Thöne, M ‘Ertragsabhängige und ertragsunabhängige Steuern’ University of Cologne July 2008

<sup>9</sup> Financial Times Deutschland Berlin 21.7.2009

Although less palatable than some other choices, this may still have to be considered; as *one senior public official* argues, given the scale of the fiscal improvement needed “All levers must be used.”<sup>10</sup>

**Chart 2: German subsidies and tax breaks**



Source: German Finance Ministry 22<sup>nd</sup> Report on Subsidies for years 2007–2010

In addition, as *a senior German academic* argues, “Given the already low level of domestic consumption in Germany it makes sense to avoid introducing tax increases that would hit those with a high propensity to consume most (e.g. the lower income groups) to prevent depressing spending even further.”

More radical measures to reshape the public sector at present do not appear to be in the cards and are considered ‘unlikely’ by *senior German public sector officials* interviewed with some skepticism about the opportunity for significant savings from such approaches. They agreed that when tackling deficit reduction, the focus should be on clear political leadership and institutions. Improving the budget definition process, making the process more streamlined towards the final target of deficit reduction, is key. This might involve an inter-party agreement and/or a strengthening of the Finance Minister.

**However, Germany has acted to try to prevent the recurrence of fiscal problems by introducing a new constitutional rule – the so-called ‘Schuldenbremse’ (‘debt brake’).** This specifies that the structural Federal budget deficit must be limited to 0.35 percent of GDP by 2016 (state-owned enterprises are excluded from this). With the government also seeking balanced budgets for the Länder (Federal states), the medium-term framework is now looking to lock in broadly balanced general government deficits as the norm. In order to leave space for discretionary fiscal action, Germany would have to run what *a senior academic* describes a “truly cyclical budgetary policy” with the budget in surplus in the good times.

<sup>10</sup> Bundesministerium der Finanzen ‘Nachhaltig Sparen – Gerecht Sparen: Das Sparpaket der Bundesregierung’ 2010

**An advantage of the 'Schuldenbremse' is that it will help Germany regain some fiscal space lost during the crisis and prepare for the costs looming due to its aging population** – estimated at over four percent of GDP by 2030 by the IMF.<sup>11</sup> Such a fiscal rule should also help limit the risk of short-term thinking by the authorities and focus attention on longer-term issues. That said it remains to be seen how this rule functions in practice. There are some 'get-out' clauses (for example relating to deep recessions and natural disasters) and cyclical deficits will be tolerated on the proviso they are made up in later years. The general experience with such fiscal rules in other major economies is somewhat mixed.

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<sup>11</sup> IMF op.cit. (2009)

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