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Endgame? The fiscal crisis of the German state

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MPIfG Discussion Paper 07/7

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Abstract

A longer-term perspective reveals the historical exhaustion of the financial resources of the democratic interventionist state of the postwar period. German politics present and future is shaped by a deep crisis of public finance. Its current expression is an apparently insurmountable conflict between four equally urgent political objectives: paying for social security by general taxes, rather than payroll taxes, to lower labor costs; consolidating public budgets and reducing the public debt; cutting taxes on mobile capital; and increasing public investment in response to new social problems and changing economic conditions. Analysis of the fiscal problems of the German state casts new light on the turbulences of German politics since the Schröder government's first term.

Zusammenfassung

In längerfristiger Perspektive zeigt sich ein säkularer Prozess der Erschöpfung der finanziellen Ressourcen des demokratischen Interventionsstaats der Nachkriegsphase. Die gegenwärtige und zukünftige deutsche Politik steht im Zeichen einer tiefen Krise der Staatsfinanzen. Deren aktueller Ausdruck ist ein anscheinend unüberwindlicher Konflikt zwischen vier gleichermaßen unabweisbaren politischen Zielen: der Verlagerung der Finanzierung der Sozialversicherung auf Steuern zum Zweck einer nachhaltigen Senkung der Arbeitskosten; der Konsolidierung der öffentlichen Finanzen durch Abbau der Haushaltsdefizite und der Schuldenlast; einer Senkung der Besteuerung der Erträge mobilen Kapitals; sowie verstärkter öffentlicher Investitionen in Antwort auf neuartige gesellschaftliche Probleme und wirtschaftliche Konkurrenzbedingungen. Die Analyse der Finanzierungsprobleme des deutschen Staates wirft ein neues Licht auf die Turbulenzen der deutschen Politik seit der ersten Amtsperiode der Regierung Schröder.

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Introduction

The cost of its unification in 1990 notwithstanding, Germany is still among the richer European countries.[1] Nevertheless, its public policy has in recent years been driven by increasingly severe resource constraints that have become a powerful subtext under the visible surface of party politics and government policy. In the process both became more and more preoccupied with responding to ever new fiscal emergencies while struggling to maintain for public consumption a façade of free political choice. One can speculate, as I have done elsewhere (Streeck 2006), that the soap-operatic style especially of the final Schröder years, and in particular the way in which policies, majorities, and ideologies in Germany seem to have become exchangeable, reflects growing space as well as a growing need for political stagecraft at a time when opportunities for *state*craft to make a difference are dwindling.

The fiscal crisis facing the German state is not one of public poverty. The public share in the economy is close to the average of comparable nations, and it has not significantly declined or increased in recent years.[2] State bankruptcy, in a technical sense, if there is such a thing at all, is nowhere in sight, nor should one expect an immediate breakdown of specific state functions. The problem is not one of the *level* but of the *structure* of public finance, or more precisely, of a long-term build-up of financial commitments and legal obligations which have profoundly and perhaps permanently curtailed the degrees of freedom of public policy.

To be sure, I am not dealing here with the macroeconomics of public finance. Whether a high state share in the economy stands in the way of economic growth, or whether high government deficits and the public borrowing that results from it crowd out private investment may or may not be the case, but it is not my concern. The subject of this essay is, not the macro-*economics,* but the macro-*politics* of public finance. Also, unlike unfortunately O'Connor's often-cited but rarely read and indeed hardly readable book

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1 Gross domestic product per capita was 27,250 euros in 2005, which was above the average of the fifteen member states of the EU before the latest enlargement (25,300 euros). France's per capita income was 27,270 euros and Italy's 24,210 euros. But note that among the Euro countries, Belgium (28,470 euros), Finland (29,610 euros), the Netherlands (30,760 euros), and Austria (29,920 euros) ranked higher, and some of them much higher (Statistisches Bundesamt 2006: 184). Of course this does not take into account differences in purchasing power.

2 In 2005 total public expenditure in Germany amounted to 46.7 percent of GDP, down from 48.4 in 2003. The average in 2005 for EMU member countries was 47.1 percent, ranging from 38.2 percent (Spain) to 56.4 percent (Sweden) (Statistisches Bundesamt 2006: 177).

from 1973 (O'Connor 1973), the present essay does decidedly not adhere to a Marxist-functionalist view of state finance under capitalism. Instead it pursues a historical-institutionalist political-economy perspective, one that leaves space for historical actors confronting the specific constraints and opportunities inherent in different institutional contexts and creatively interpreting – or, as the case may be, misinterpreting – the pressures and contradictions they are facing.

More specifically, based on the German case, I suggest that in a democratic welfare state, public finances may step by step evolve in such a way as to alter fundamentally the concerns, the content, the options, and the character of politics and policy-making, if not forever then for a very long period. As a result of a stream of instantly plausible and appropriate decisions, the structure of government finance may over time turn from a response to social problems into a problem in its own right, confronting policy-makers with a complex syndrome of dilemmas, contradictory demands, and irreconcilable political imperatives from which there is no ready escape. In a situation of this sort, addressing one problem inevitably and immediately exacerbates another, making it basically irrelevant what one does, and thereby making preferences and choices inherently unstable and exchangeable.

Dilemmas are of course not unknown to politicians, and indeed one of their main skills is to deal with their horns one by one, hoping that the new problems caused by solving an old problem will take time to evolve. But this presupposes a causal texture between problems that is relatively loose. If it gets tighter, neglecting the future problems caused by present solutions and dealing with them later when they have fully built up works less and less. Costs accrue instantly and predictably, and can no longer be discounted. Whatever you do, you are punished for it. As a consequence, political management may have little choice but to turn into impression management: what counts is whether the drama staged to cover up the depressing reality of policy deadlock is sufficiently entertaining.

Political scientists, including those subscribing to an institutionalist perspective, take on the whole surprisingly little interest in public finance, except where they use budget figures as handy indicators of policy priorities. But public debt and public deficits do not seem to be considered important as such.[3] Perhaps this reflects a lingering "Keynesian" conviction that deficits are somehow good for the economy, or that reference to resource constraints is basically a neo-liberal rhetorical ploy. The notion that a democratic political system may immobilize itself by gradually building up fixed fiscal commitments and constraints is rarely entertained – probably also because of a tacit assumption that politicians can always find a way around resource constraints if they only want to, ultimately by raising taxes, or that in any case the dynamism of capitalist growth will bail them out. Of course political scientists would share this view with

3 Exceptions, of course, notwithstanding. For German political science see especially the work of Uwe Wagschal (1996, 2007).

their favorite objects of attention, politicians – although it may be precisely this attitude that has contributed to driving German politics into its current and, I suggest, by now endemic fiscal impasse.

That political science does not pay more attention to public finance and fiscal constraints on policy-making might have been avoided. As William Gladstone already knew: "Budgets are not merely matters of arithmetic but, in a thousand ways, go to the root of prosperity of individuals, and relations of classes, and the strength of Kingdoms."[4] And then, of course, there is Schumpeter's famous essay from 1918 on *Die Krise des Steuerstaates* (Schumpeter 1991), to which I will have occasion to return below. In it Schumpeter made the following, often-quoted but unfortunately only rarely honored programmatic observation which this essay makes an attempt to heed:

> The public finances are one of the best starting points for an investigation of society, especially but not exclusively of its political life. The full fruitfulness of this approach is seen particularly at those turning points, or epochs, during which existing forms begin to die off and to change into something new. This is true both of the causal significance of fiscal policy (insofar as fiscal events are important elements in the causation of all change) and of the symptomatic significance (insofar as everything that happens has its fiscal reflection). (Schumpeter 1991: 101)[5]

Fiscal crisis[6]

By the turn of the century at the latest, a configuration of fiscal problems had imposed itself on German politics that increasingly monopolized the attention and began to drive the decisions of governments and political parties. The fiscal crisis – because this is what it was and is – had been building over almost three decades. Now the time had come when it could no longer be ignored. Beginning with the appointment of Hans Eichel as Minister of Finance in 1999 and reinforced by the experience of the coalition negotiations of 2002, German politicians for the first time in the history of the Federal Republic had to consider the possibility that the state they had been running might have exhausted its means, if not for good then for the foreseeable future. Schröder's announcement in 2003 of Agenda 2010, his decision two years later to call an early elec-

4 As quoted in O'Connor (1973: 2).

5 "Die Finanzen sind einer der besten Angriffspunkte der Untersuchung des sozialen Getriebes, besonders, aber nicht ausschließlich, des politischen. Namentlich an jenen Wendepunkten – oder besser Wendeepochen –, in denen Vorhandenes abzusterben und in Neues überzugehen beginnt und die auch stets finanziell Krisen der alten Methoden sind, zeigt sich die ganze Fruchtbarkeit dieses Gesichtspunkts: Sowohl in der ursächlichen Betrachtung – insofern als staatsfinanzielle Vorgänge ein wichtiges Element des Ursachenkomplexes jeder Veränderung sind – als auch in ihrer symptomatischen Bedeutung – insofern als alles, was geschieht, sich in der Finanzwirtschaft abdrückt" (Schumpeter 1953: 7–8).

6 Parts of this section draw on Streeck (2006) and Streeck/Trampusch (2005).

tion, and the formation of the Grand Coalition in the fall of 2005 can be read as, and very likely were, increasingly desperate reactions to a situation so novel that it defied and continues to defy all conventional political wisdom of the postwar era.

What is it that makes the fiscal condition of the German state so critical? Any German government that today undertakes to rule the country faces four equally urgent tasks which require immediate and indeed simultaneous address:

– Cut statutory non-wage labor costs, in the form of social security contributions, which have for years now exceeded 40 percent of a worker's pay. Almost everyone agrees that this would be by far the most effective measure to revive the labor market and reduce unemployment, especially among workers with low skills. Non-wage labor costs can be cut by cutting social insurance entitlements or, alternatively or additionally, shifting the financial base of the social security system from contributions to general taxes.

– Consolidate public finances, especially the federal budget. This is imperative for meeting the targets of the Stability and Growth Pact. More importantly, it is required for ending the growth of, and ultimately bringing down, the public debt and the drain of high interest payments on public resources. Fiscal consolidation is made more difficult by the fact that it will have to be achieved at a time when most sellable state assets have already been privatized.

– Restructure the tax system by relieving the tax burden on corporations, so as to meet international tax competition, and by shifting taxation towards consumption and personal income. This must be done at a time when individuals and families are being asked by the state to make private provisions to supplement declining public pensions, pay all sorts of coinsurance and deductibles on health care, and pay fees for formerly free public services, such as higher education.

– Increase – or better: restore to previous levels – public investment in education, research and technology, the physical infrastructure, childcare facilities – to stem demographic decline – the integration of immigrants and the like.

As indicated, the significance of this agenda is *not* that each of its items is as such extremely, and perhaps impossibly, demanding on the skills and determination of any government. Rather, it is that all four have become equally urgent, and none seems to bear postponement, although they would seem logically, and almost certainly practically, impossible to deal with at the same time. Indeed, what one might be facing here might be described as a *magic quadrangle* of sorts: *whichever of the four goals you pursue, it detracts from at least one of the three others.* For example, reducing the budget deficit while paying down the national debt is difficult enough; doing it while injecting additional tax money into the social security system seems utterly unfeasible; and raising public investment on top of this seems completely out of the question. One could speculate

whether, logically or technically, such a feat might still somehow be accomplishable. But for practical purposes one must remember that when the two Schröder governments during their seven years in office *did* significantly increase tax grants to the social security funds, and *did* lower corporate and personal income taxes, this added to the federal deficit and the debt while starving local communities of the financial means for infrastructural improvements. More importantly, due to demographic and other factors it no more than slowed down the increase in social security contributions, causing no improvement on the labor market whatsoever, while at the same time social security benefits had to be continuously, if incrementally, cut to keep tax infusions under control (Streeck/Trampusch 2005). Note that this operation, the Chancellor's masterful television performances and his immense talent for duplicity notwithstanding, consumed the entire political capital of Schröder and his Red-Green government, as evidenced not least by the September election of 2005.

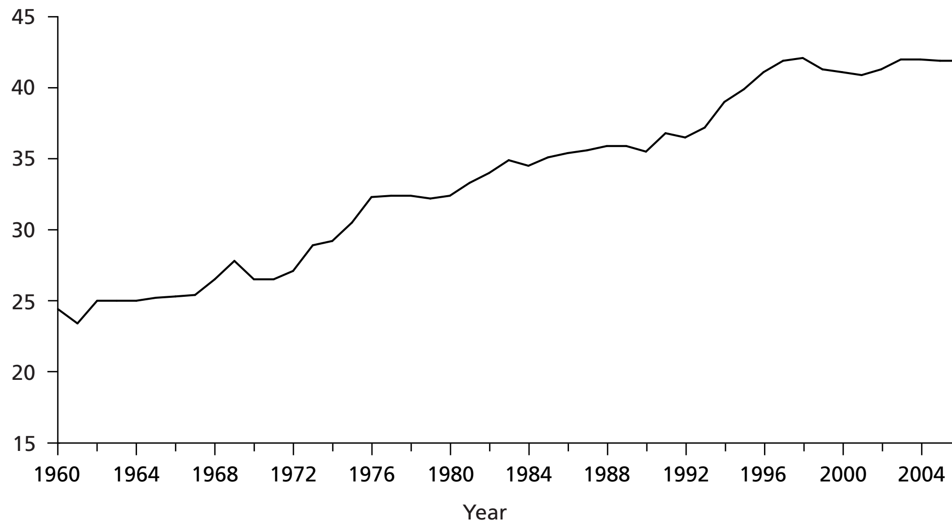
I will now look in turn at the four fiscal problems that, I maintain, together make for an unprecedented fiscal crisis of German politics that has long been in the making and will not go away in the foreseeable future.

1. The need to bring down high social security contribution rates making for high labor costs and thereby holding down the level of employment. The German "Bismarckian" welfare state is funded in principle by social security contributions assessed on the wage and paid half by workers and half by employers. Comparative research has produced strong evidence that social security contributions operate like taxes on employment, inflating the costs of labor by adding a "tax wedge" of non-wage labor costs to workers' take-home pay. *Ceteris paribus*, this must depress employment (Manow/Seils 2000; Scharpf 2000). Moreover, high non-wage labor costs interact with low employment and unemployment in a vicious circle. By making labor more expensive, they induce firms to downsize their labor force, which in Germany after the mid-1980s typically was done through early retirement. The result was an increased burden on the social security system requiring a further increase in contribution rates. High non-wage labor costs also prevent employment growth in labor-intensive sectors, especially in services, in part by driving labor into the black economy. Both low official and high unofficial employment depress the revenue of the social insurance system, again leading to higher contribution rates. As rates rise in response to simultaneously declining formal employment and increasing entitlements, labor costs also rise, depressing employment even more (Streeck 2001).

The German social security system consists of four subdivisions, each with its own budget: pension insurance, unemployment insurance, health insurance, and long-term care insurance. The politically and economically important parameter is the *aggregate rate of contribution,* which was about 25 percent of the gross wage in 1960,[7] rose to 35 percent

7 More precisely, of gross wages below a cut-off point beyond which no contributions are collected. This makes social security a highly degressive taxation system.

Figure 1 Aggregate social security contribution rate (1960–2006)



by the mid-1980s, and crossed the 40 percent threshold ten years later (Figure 1). As a share of GDP, contributions collected remained between 8 and 9 percent until 1967 and then rose continuously to about 13 percent in the early 1980s. About a decade later for the first time they reached 14 percent and remained at this level until 2003.

Even in Germany, the Bismarckian principle of funding social security by contributions was never fully implemented. In fact there was always a complex symbiotic relationship of mutual support and exchange between the social security system and the federal budget. Whereas pension and unemployment insurance have for long received some federal subsidies, health insurance was until 2003 exclusively funded by contributions, and long-term care insurance still is. Subsidies from general tax revenue can be and are used to hold down contribution rates; conversely, by transferring social policy obligations from the state to the parafiscal social security funds, governments can avoid tax increases. Over time bureaucrats and politicians became highly skilled in exploiting the interconnections between the federal budget and the social security system for complex fiscal maneuvers, as a result of which the two became ever more tightly intertwined.[8]

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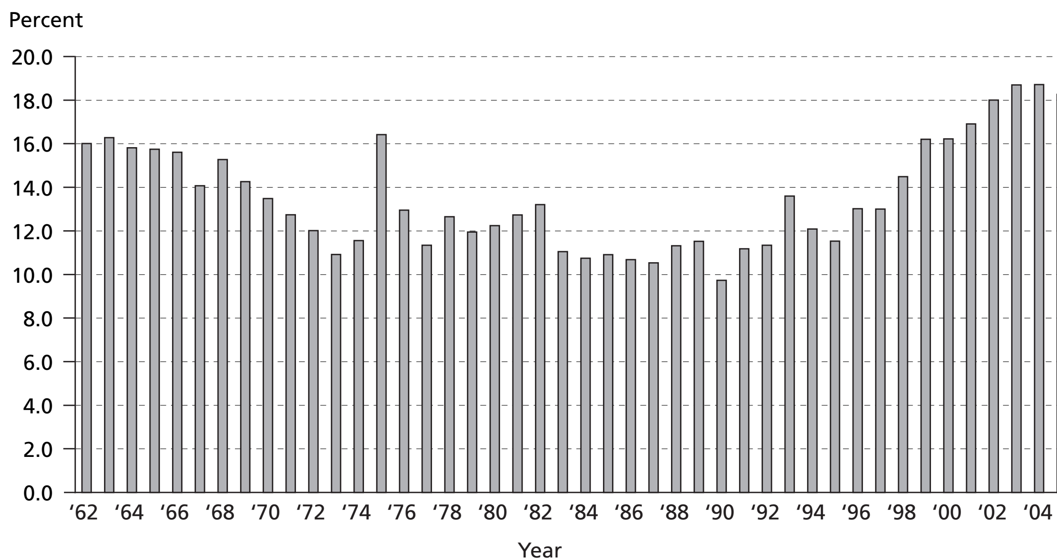
8 Similar maneuvers became customary between the four social security funds, where they were mainly used to postpone increases in contribution rates (Trampusch 2003). For example, in 1977 the government made the unemployment insurance fund pay contributions for recipients of unemployment benefit to the pension fund. This kept the pay-as-you-go pension system liquid while avoiding an increase in the contribution rate, although at the price of creating additional future entitlements. Similarly, after 1992 the unemployment insurance fund had to pay pension insurance contributions for participants in job creation measures in East Germany. While this increased the revenue of the pension insurance fund, it caused a long-term increase in unemployment insurance contributions. Moreover, to stabilize the combined social insurance contribution rate between 1981 and 1991, the government several times balanced a rise in one contribution rate by lowering another, avoiding short-term fiscal problems in one system by causing long-term problems in the other (see Streeck/Trampusch 2005).

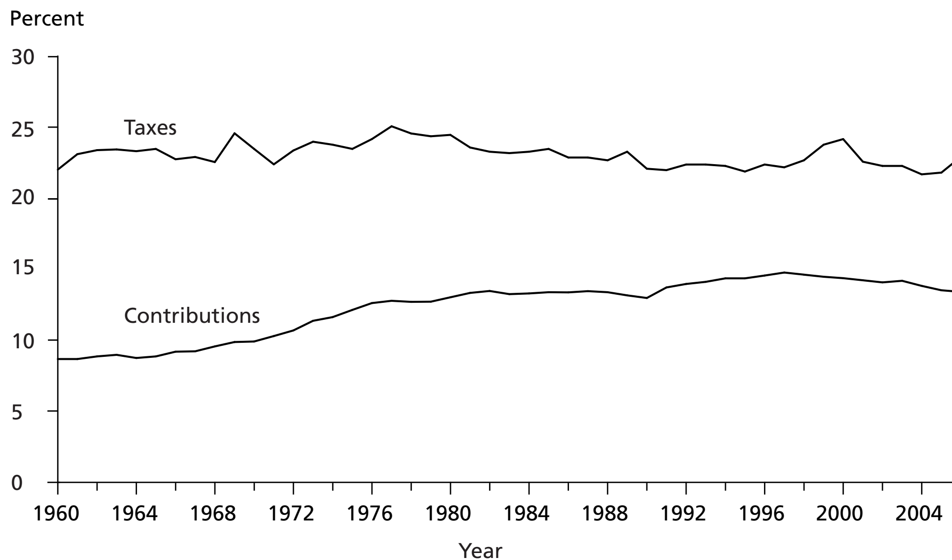
Figure 2 Federal subsidies to the social security system, in percent of total social security spending (1962–2005)



The extent to which federal funding was used to support the social security system varied over time (Figure 2). In the postwar period the government reimbursed the pension fund for expenses related to the war *(versicherungsfremde Leistungen)*. With time the share of social security spending covered by federal grants fell from 16 percent in 1962 to about 11 percent in the early 1970s. In response to the first oil crisis the social-liberal government increased state funding again, most notably in 1975, to avoid having to raise contribution rates. In the 1980s, under Kohl, this was slowly reversed, and by the end of the decade federal subsidies were back at about 11 percent.[9] Unification, however, reversed the trend once more. Trying hard to avoid raising taxes – which could have made unification unpopular in the West – the Kohl government shifted a large share of the financial burden of unification to the social security system, by imposing on it the bulk of the social welfare expenditures that resulted from the breakdown of the Eastern labor market and from the wholesale transfer of the West German welfare state to the former GDR. But the prospect of steeply rising social security contribution rates after 1996 forced the government to return to increased tax funding of social security (Figure 2). For example, at the end of 1997 another hike in the pension insurance contribution rate was avoided by raising value added tax from 15 to 16 percent, the additional tax revenue being used to refinance the pension fund. In 1999, the Red-Green government continued along the same lines with an eco tax on energy and gasoline, which also goes into the pension fund. Still, over time taxes as a percentage of GDP have declined while contributions to the social security system have risen (Figure 3).

9 As income taxes are progressive, and social security contributions strongly degressive, conservative governments tend to prefer funding social policy by contributions while social-democratic governments often prefer tax funding.

Figure 3 Taxes and contributions in percent of GDP (1960–2006)

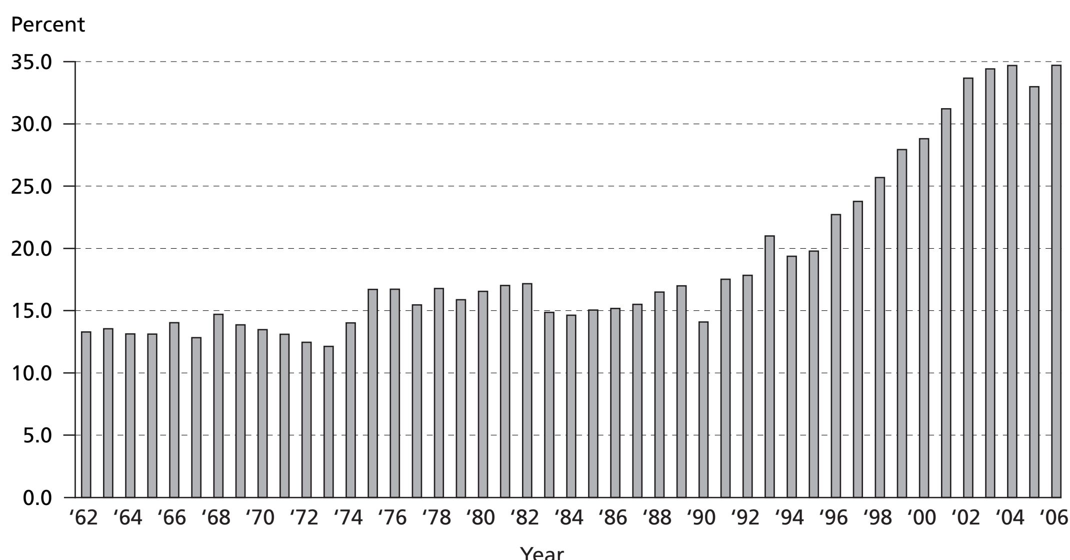


As already indicated, the reason for the policy change by the mid-1990s was the discovery that high and rising social security contribution rates were a main source of high and rising unemployment. In 1996 the combined social security contribution rate had for the first time exceeded the magic figure of 40 percent, reaching 41.1 with a prospect of further rapid increase. In response the Kohl government made it its declared target to keep social security contributions permanently below 40 percent. To this effect it began talks with unions and employers on an "Alliance for Jobs." When talks broke down the government acted on its own by cutting a variety of social benefits (for details see Streeck/Trampusch 2005) – which is widely believed to have been a major cause of its defeat in the 1998 election. Still, between 1990 and 1998, the contribution rate grew by six and a half percentage points, from 35.5 percent to 42.1 percent, of which German unification accounted for about three points (Hinrichs 1998).

Under the same pressures as his predecessor, Schröder shortly after his accession tried to restart the "Alliance for Jobs." Its founding document, in December 1998, listed as its first objective "a fundamental restructuring of the social security system," as a way to increase employment. This, too, came to naught (Streeck 2003). In subsequent years the Schröder government, just like its predecessor, found itself pursuing a policy of continuous incremental benefit cuts.[10] While it is debatable whether these were as courageous as was sometimes claimed, they were the main cause of Schröder's loss of popularity, especially in his second term, and ultimately of the fall of the state government of North Rhine-Westphalia, which was the beginning of the end of the Schröder era.

10 For more see Leibfried/Obinger (2003) and Streeck/Trampusch (2005). Generally German social policy in the 1990s has been described as slowly turning from *ausgabenorientierte Einnahmenpolitik to einnahmenorientierte Ausgabenpolitik* (from revenue raised to fit expenditure, to expenditure adjusted to available revenue).

Figure 4 Federal subsidies to the social security system, in percent of total federal spending (1962–2006)



In this respect Schröder's experience was very much like Kohl's. Indeed, in spite of the heavy political price Schröder had to pay, he never came even close to Kohl's objective of 1996 to bring down the aggregate social security contribution rate to below 40 percent. In 2005, when the Grand Coalition government took over, that rate, at 41.9 percent, was actually slightly higher than it had been in 1996.

If benefit cuts, even those going as far as to cause electoral demise, cannot bring down the contribution rate, why not restructure the social security system on the Scandinavian model and generally substitute tax funding for contributions?[11] The problem is that, as indicated by Figure 2, the very refinancing of the welfare state away from contributions towards taxes that is often proposed as an ideal method to lower the crushing burden on employment of high non-wage labor costs has for some time been under way, *albeit without any effect either on the social security contribution rate or on employment.* Looking at the pension system in particular, while in 1995 23 percent of benefits paid were funded by federal subsidies from general taxes, by 2004 this share had risen to an impressive 37 percent, or 77.4 billion euros. Without the federal subsidy the pension insurance contribution rate in the same year would have had to be 28.4 percent instead of 19.5 (Wahl 2005), increasing the combined social security contribution rate by 8.9 percentage points, that is, to almost 50 percent! In other words, in recent years there has already been a steep increase in federal tax funding of social insurance, *which was, however, completely consumed in keeping the rate of contribution constant*, and even this was possible only because in addition benefits were cut, to an extent that turned out to be politically deadly for two successive governments.

11 On the surface this should be particularly attractive to Social Democrats as it would make German public finance as a whole more progressive.

Table 1 Expenditure on labor market policy, Bundesagentur für Arbeit and Federal Government (2003–2007), in billion euros

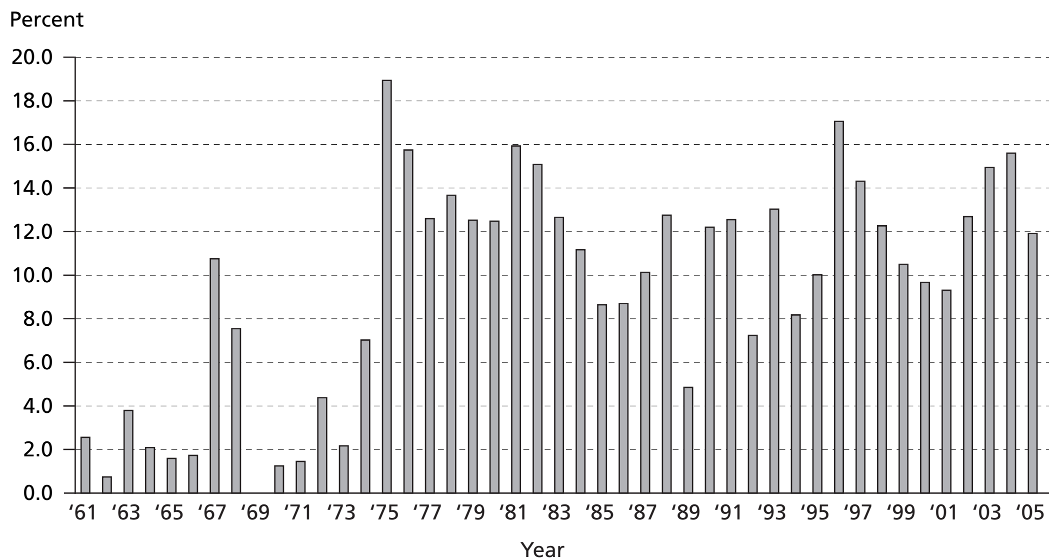
	Expenditure Bundesagentur für Arbeit		
Year	Total	… of which unemployment benefit	Federal government expenditure on labor market policy and occupational safety
2003	56.8	29.0	17.5
2004	54.5	29.1	20.8
2005	53.1	27.0	37.5
2006	50.3	26.5	38.7
2007	43.7	21.8	33.4

Sources: Bundesagentur für Arbeit (2007: 2); Bundesfinanzministerium (2006: 222).

German finance ministers, having to balance their budgets, have increasingly hesitated to support the injection of more tax money into the social security system. In part this was because of a general suspicion, based no doubt on experience, that tax subsidies were mainly sought to spare governments from having to cut back entitlements. But it also reflected the extraordinary increase in recent years in the share of the federal budget that is already being spent on keeping the social security system afloat (Figure 4). During the thirty odd years from 1962 until unification in 1990, federal subsidies to the system amounted to around 15 percent of total federal spending, give and take one or two percentage points. But then, beginning in 1991, they rose steeply to about 26 percent in the last year of the Kohl government, and came close to 35 percent in 2002, that is, *only six years later,* where they have since remained.

Actually, these figures still do not yet fully reveal the real extent to which the federal budget already functions as a reserve for an overstretched social welfare system. The Schröder reform of unemployment benefit and social assistance, which took effect in 2005, shortened the maximum period of entitlement to unemployment benefit, which is financed by contributions and paid by the unemployment insurance fund (the Bundesagentur für Arbeit), from 36 to 18 months. At the same time, the old unemployment assistance *(Arbeitslosenhilfe)*, paid out of taxes by the federal government once unemployment benefit had run out, was combined with social assistance into the so-called *Arbeitslosengeld II* (ALG II). Together with cuts in services, internal savings and an increase in value added tax (see below), this made it possible to lower the unemployment insurance rate, beginning in 2007, from 6.5 percent to 4.5 (Koalitionsvertrag 2005: 29). Correspondingly, however, federal expenditure on labor market policy, including the lion's share of ALG II, increased dramatically already in 2005, to 37.5 billion euros (Table 1), which incidentally was vastly in excess of the budgeted increase to 29.5 billion euros. While in 2007 a slight decline is expected in federal expenditure, due in large part to fewer unemployed, federal spending will still exceed the level of 2004 by 12.6 billion euros. In spite of the rhetoric about cutting costs, this is more than the simultaneous decline, by 10.8 billion euros, in the total expenditure of the Bundesagentur (2004–2007), not including

Figure 5 Net borrowing of federal government, in percent of total spending (1961–2006)



the transfer to the Bundesagentur of part of the return of the higher VAT in 2007, which is not shown in the federal budget.[12]

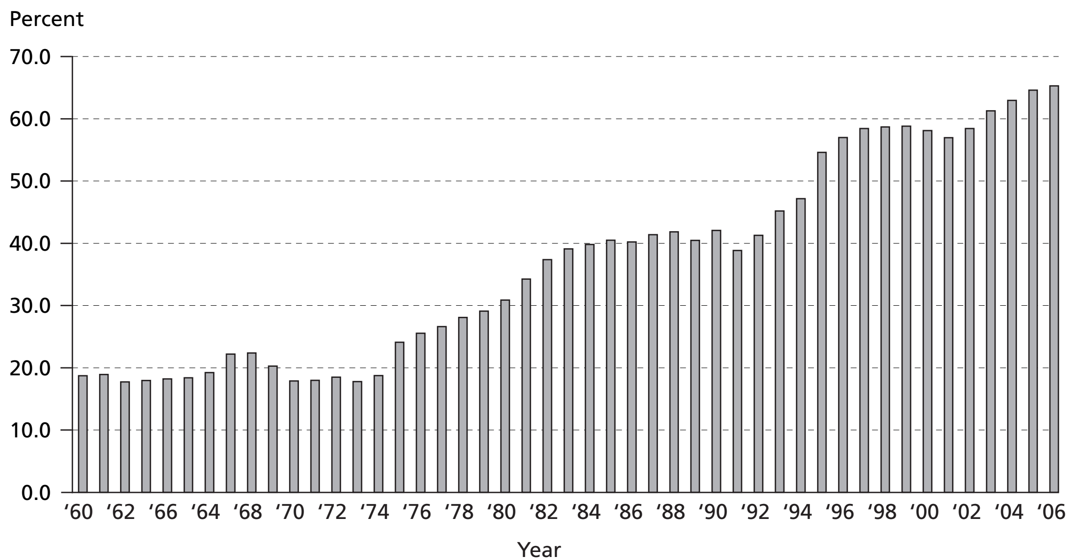
2. The need to balance public budgets and reduce the public debt. The last year in which the budget of the federal government showed a surplus was 1960. From then on, with the exception of 1969, the government added year by year to the public debt[13], in some years more, in others less (Figure 5). The deficit skyrocketed in the crisis of 1975, when it reached about 19 percent of federal spending. Keynesian economic management implies that debt is paid back when the economy picks up again, but this never happened. While by the end-1980s the yearly deficit had declined, although by no means disappeared, it rose to a new height in 1996 in the economic crisis following unification. From then on it hovered between 10 and 15 percent of federal spending. After 1996, the deficit was momentarily lowered by large-scale privatization of state property, until it increased again following the Schröder tax reform. Not surprisingly, the accumulated public debt as a percentage of GDP, which had been at or below 20 percent until 1974, almost continuously increased over three decades to more than 65 percent (Figure 6).

Unlike most of the public and political science debate, I am not concerned here with whether or not the German state has met or will meet the Maastricht targets. For several years now, new debt has exceeded the three-percent limit, and since 2003 total debt has

12 Title 1112 of the budget of the Ministry of Labor projects spending of 42.7 billion euros for 2007. The equivalent figure for preceding years is not easily accessible, especially for purposes of exact comparison between the costs of the old *Arbeitslosenhilfe* and the present ALG II.

13 Total public debt in Germany is roughly equally shared between the federal government and the Länder. For complex institutional reasons, the level of indebtedness of the two basically develops in parallel.

Figure 6 Public debt, in percent of gross domestic product (1960–2006)



been higher than the sixty percent of GDP allowed by the Stability and Growth Pact. Much more important for my argument, however, is the fact that deficits have not been due to a discrete event, like a war or an economic slump, with a beginning and a foreseeable end. Rather, the steady increase in public debt in the one-and-a-half decades since unification (Figure 6) has obviously coincided with the steep rise of the share of the federal budget devoted to funding the deficits of the social security system (Figure 4). This suggests an endemic, or chronic, shortfall of government revenue.

Figure 7 The effective deficit, in percent of total federal spending (1990–2006)

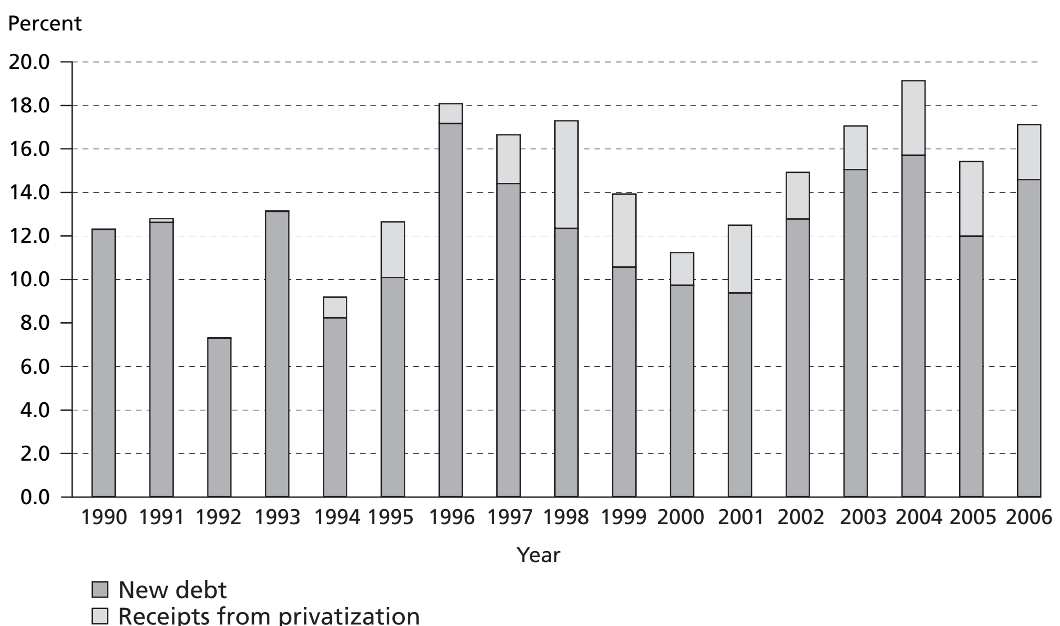


Table 2 Receipts from privatization, current deficits and the effective deficit

Year	Receipts from privatization (million euros)	Current deficit (million euros)	Effective deficit (million euros)	Receipts from privatization as a percentage of current expenditure
1990	34,0	23,900	23,934	0.0
1991	341,0	25,985	26,326	0.2
1992	20,0	15,931	15,951	0.0
1993	63,0	30,710	30,773	0.0
1994	2,295	19,847	22,142	1.0
1995	6,075	23,972	30,047	2.6
1996	2,112	40,025	42,137	0.9
1997	5,077	32,572	37,649	2.2
1998	11,578	28,854	40,432	5.0
1999	8,276	26,107	34,383	3.4
2000	3,647	23,801	27,448	1.5
2001	7,592	22,800	30,392	3.1
2002	5,353	31,863	37,216	2.1
2003	5,159	38,649	43,808	2.0
2004	8,636	39,542	48,178	3.4
2005	8,919	31,182	40,101	3.4
2006	6,616	38,300	44,916	2.5

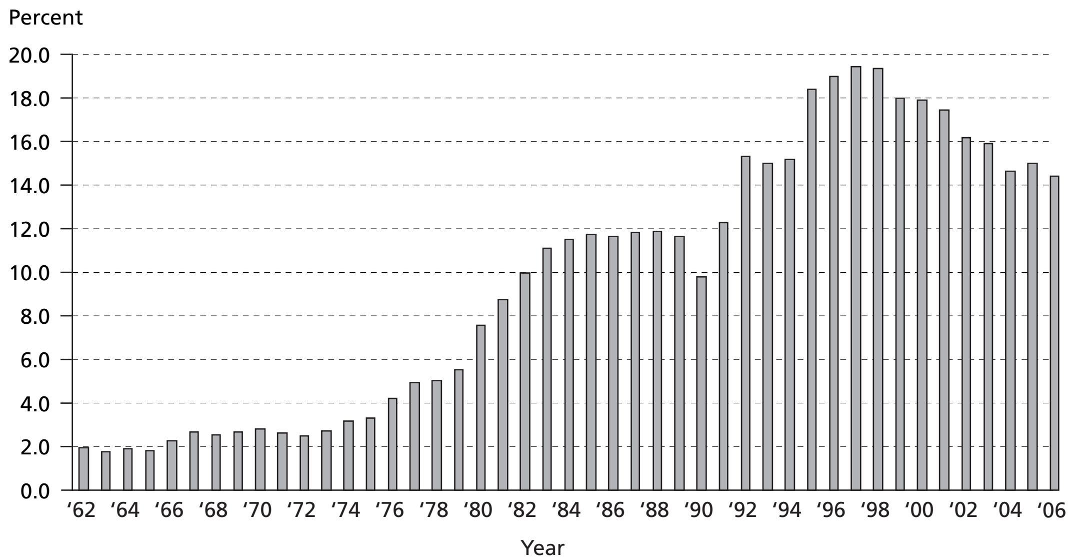
Source: Bundesfinanzministerium (2006).

This suspicion is reinforced if one takes into account that in the late 1990s accelerated privatization of government property provided a cushion against even higher deficits and a further increase in the national debt. Privatization, of course, produces one-time effects that are by their nature not sustainable. Current deficits and the receipts from privatization may be added to indicate what one might call the "effective deficit"[14]. From the mid-1990s on, the effective deficit regularly and considerably exceeded the new debt, hiding a much steeper increase in the gap between revenue and expenditure than is apparent (Figure 7). All in all, privatization in the eleven years from 1996 to 2006 added about 81 billion euros to the federal government's spending power, which would otherwise have had to be borrowed from financial markets (Table 2).[15] By the time the Grand Coalition government took office, however, most of the public "family silver" had been sold. Early on, the new Minister of Finance publicly speculated about selling off the *Autobahnen* to private investors, which would have yielded between 100 and 127 billion euros, amounting however to no more than 6.7 and 8.5 percent of the

14 In German, *das strukturelle Defizit.* Strictly speaking, the effective deficit also includes other one-time revenues as well as postponed expenditure. In February 2006 it was estimated by the Finance Minister of the Grand Coalition to amount to about 20 percent of the federal budget, or 50 billion euros – more than 10 billion more than the visible deficit (Steinbrück 2006). The Prime Minister of Baden-Württemberg even speaks of 60 billion euros (Oettinger 2006).

15 Unless otherwise noted, figures for 2006 and 2007 are from the official budget as passed by the Bundestag in 2006 and from the 2006 budget projections for 2007, respectively.

Figure 8 Federal government debt service, in percent of total federal spending (1962–2006)



total national debt (FAZ.NET, 17 October 2005). Since privatization would have meant user fees for drivers, the proposal caused a strongly negative reaction from the public and the plan was never mentioned again.

German public debt as a percentage of GDP (67.7 percent in 2005) seems not excessive by international comparison. Other countries, notably Belgium (93.3) and Italy (107.5), carry much higher debt burdens.[16] While it would be interesting to see how they survive, this cannot be pursued here. As far as Germany is concerned, shortly before the turn of the century, almost one fifth of federal expenditure was required to service the federal debt (Figure 8). Thereafter the share leveled off somewhat, mainly because interest rates in international money markets fell. Still, in 2006 debt service was scheduled to require about 39.5 billion euros, or 15 percent of total federal spending (262 billion euros), which was a little more than the new debt (38.3 billion euros). In other words, federal debt had reached a dimension where paying the interest on it, even at a time when interest rates were low, was possible only by taking up the same amount in new debt, at a level of about 3 percent of GDP.[17]

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16 Average public debt in the Euro area in 2005 was 70.8 percent of GDP (Statistisches Bundesamt 2006: 141). However, the combined unfunded obligations of the federal government and the Länder are a multiple of the debt visible in public accounts. For 2002 the *Sachverständigenrat* (the German Council of Economic Advisers) estimates the "implicit public debt" to amount to 271 percent of GDP, which adds up, with the explicit debt, to 331 percent (Sachverständigenrat 2003: 276). Estimates of this sort cannot be taken literally. However, public accounts cannot either, and it is conceivable that in other countries obligations are visible that remain implicit and invisible in Germany. Clearly more research would be needed here.

17 It is hard not to employ the polemical concept of the *Schuldenfalle* ("debt trap") here. New debt of 40 billion euros means additional interest payments of about 2 billion per annum, that is, an increase in debt service of 5 percent, at current interest rates.

Summing up so far, unless the federal government manages somehow to reduce its indebtedness, it will for a major share of its budget remain at the mercy of volatile capital markets. As a rule of thumb, if the average rate of interest on the public debt rises by one percentage point, the federal government will eventually have to face additional debt service of about 7.5 billion euros, which is roughly 19 percent of current debt service and about 3 percent of the current federal budget (Bankenverband 2006: 61).[18] There are no provisions in public budgets for interest rate fluctuations. Public debt will continue to grow at least nominally as long as yearly deficits remain. Even with the aggregate contribution rate continuing to be as high as it is, federal support for the social security system will likely have to increase further. Indeed, the Grand Coalition government has already announced new injections of tax money in the health care system to hold down a projected increase in contributions. Moreover, it will soon have to address the endemic deficit of the long-term care insurance fund, which will also require tax subsidies if social security contributions are not to rise.[19]

3. Strong pressures to lower taxes on capital and the middle classes. The situation is further complicated by the fact that political and economic pressures to *lower* taxes, especially taxes on capital and personal income, are strong enough to counter whatever pressures there may be for *increasing* them. In a programmatic speech that the newly appointed Finance Minister of the Grand Coalition, Peer Steinbrück, gave in January 2006 to the Frankfurt Chamber of Industry and Commerce (Steinbrück 2006), he celebrated as a major achievement of the Red-Green government that it had "accomplished the most comprehensive tax reform in the history of our country." As Steinbrück pointed out, "on January 1, 2005, our income tax rates reached a record low," adding that, at about 20 percent of GDP, the overall German tax ratio was now far below its long-term average of 23 percent. Moreover, he mentioned that total federal expenditure had increased be-

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18 Put otherwise, an average increase in the rate of interest of only 0.11 percent would amount to additional expenses for the federal government of about 1 billion euros (FAZ.NET, 17 June 2006).

19 Another factor that will forcefully work against consolidation of public finances is the impending rapid increase in the retirement pay of civil servants *(Beamtenpensionen)*. Civil servants, who in 2005 comprised 6.1 percent of the workforce, have a separate pension system which is both noncontributory and unfunded: their pensions are paid entirely out of current government revenue. During their active duty civil servants cost the state less than comparable employees as no social security contributions are due for them. As the large number of civil servants appointed in the 1960s and 1970s (their number almost doubled between 1960 and 1980; Bundesinnenministerium 2005: 47) reach retirement, however, expenditure for their – comparatively high – retirement benefits is bound to rise sharply. The problem affects the Länder more than the federal government. According to Oswald Metzger, a member of the Landtag of Baden-Württemberg, it is estimated that the Land's 82,000 pensioners of 2006 will have more than doubled to 180,000 in 2020 (Bankenverband 2006: 40). Overall, the number of public sector pensioners will rise from 929,000 in 2005 to 1.47 million in 2025; expenditure on their pensions will double from 26 to 50 billion euros per year, and unless benefits are cut in a major way the Länder will have to devote 15.4 percent of their tax revenue to the pensions of their former civil servants, as compared to (already!) 9.5 percent in 2005 (Bundesinnenministerium 2005: 63, 65).

tween 1999 and 2004 by only 0.4 percent, which in real terms meant a decline – as Steinbrück proudly noted, "for the first time in the last sixty years!" (Steinbrück 2006).[20]

Steinbrück's speech may well be read as admitting that the increase in public debt in recent years was to a significant extent the result of the deep tax cuts of the Schröder era. Still, notwithstanding the need to balance the budget and bring down public debt, the tax reforms of the Red-Green government were presented, not as a mistake, but as something to be proud of and build on. One might be tempted to regard this as a *captatio benevolentiae* in front of an audience that included the leading executives of the *Finanzplatz Frankfurt*.[21] But already the Schröder government had been highly responsive to the need, untiringly spelled out by the epistemic community of German economists, for corporate taxes to be cut in response to international tax competition, and for personal taxes, especially on high incomes, to be also cut, so as to motivate the *Leistungsträger*[22] of German society to redouble their efforts for the sake of general progress.

In fact, the tax take of the German state was never high, and indeed, as we have seen, social security contributions were, or had to be, increased over time to allow for, or close the gap caused by, declining levels of taxation (Figure 3). Taxes as a percentage of GDP rose steeply in the crisis of the 1970s, to be gradually reduced to previous levels under the Kohl governments of the 1980s (Figure 9). In the years immediately after unification they remained unchanged, which, as pointed out above, was possible only because social security contributions were raised. It is true that after 1997, when contributions were strangling the labor market, taxes increased to more than 24 percent of GDP in 2000, two years into Schröder's first term. But then, this was the year when the Schröder tax reform package was passed, after a long and quite bizarre history (Ganghof 2004). Originally, in 1999, the reform was planned to involve a tax cut of about 3 billion euros; in the end, due to a deal with the opposition which commanded a majority in the Bundesrat, tax revenue forgone had grown more than tenfold, to 32 billion euros (Ganghof 2004: 177). The result was "internationally competitive" tax rates together with rising deficits in public budgets.

How realistic is it to expect that the fiscal crisis of the German state could be resolved by increased taxation? Pressures from business for tax cuts will remain, and indeed the Grand Coalition has committed itself to another major reform of corporate taxes in 2007. Just like the Schröder reform that preceded it, this is explained as a response to in-

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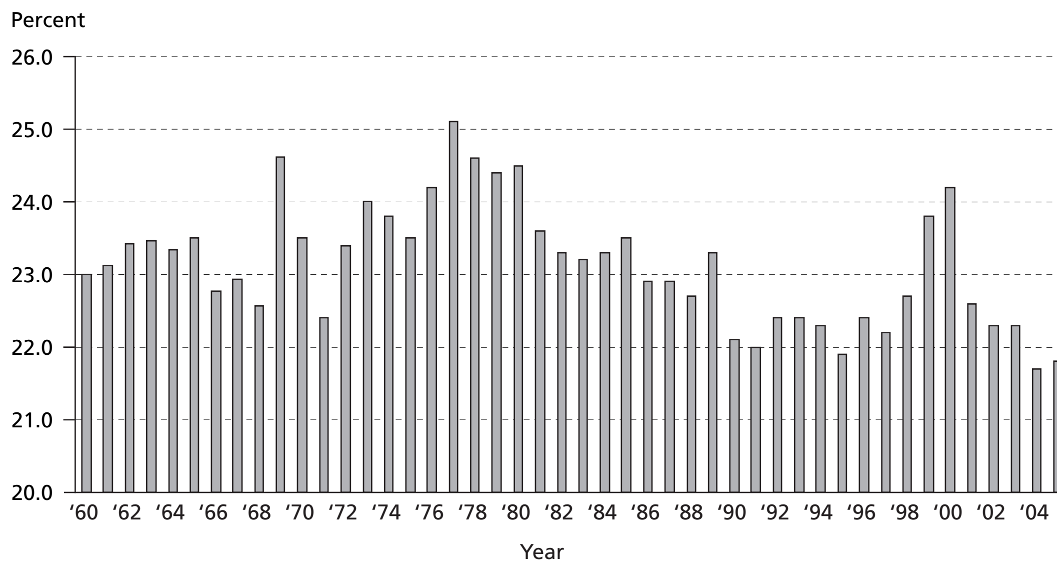
20 Nominally, federal spending declined between 1999 and 2001, and again, after two years of modest increases, from 2003 to 2004, in spite of high receipts from privatization (Table 1) and high deficits.

21 Remember, however, that the Frankfurt banking community benefits in a major way from the steady and secure stream of the German state's interest payments on the growing national debt.

22 Freely translated, the hard-working and high-earning few to which Germany owes its prosperity.

Figure 9 Government tax revenue, in percent of GDP (1960–2005)



ternational tax competition.[23] As to its effect on overall tax revenue, the debate is about whether and for how long the impending reform should reduce the tax burden on business, or whether and over what period of time it has to be *aufkommensneutral*, with total tax collected remaining constant. While the Finance Minister and the Christian Democrats have agreed on a reform model that will cut corporate taxes by between 5 and 8.5 billion euros, at least in the years immediately after the reform (FAZ, 3 November 2006: 15), the Social Democrats are willing to support structural reforms but insist on revenue remaining the same (FAZ, 21 November 2006: 13). However the tug-of-war will end, an *increase* in tax revenue is not being contemplated by anybody, except as a hoped-for (supply) side-effect of additional economic growth.

The question, then, becomes whether tax relief, or at least stable taxes, for business can be combined with higher taxes for individuals, especially those with middle-class and high incomes. A tax regime of this sort would resemble the Scandinavian model of "dual income taxation," with low taxes on "sensitive" capital income and high taxes on

23 "You can be in favor of tax increases – but then one must know what this means given the high mobility of capital and the international competition between tax systems" (Steinbrück 2006; translation by the author). Whether there is international tax competition and what it implies for national taxation regimes is a matter of intense debate. The mainstream answer is probably that, while international competition forces nation-states to change their tax systems, especially with regard to nominal corporate tax rates, there is more than one way tax regimes can be made internationally competitive (Ganghof 2005). Still, the debate seems to be becoming less sanguine with respect to the consequences of tax competition for democracy and redistributive politics – compare Campbell (2004) on the one hand and Ganghof and Genschel (2007) on the other. In any case, German policy-makers have long agreed that the German tax system is exposed to effective tax competition, especially within Europe, and therefore requires major adjustments.

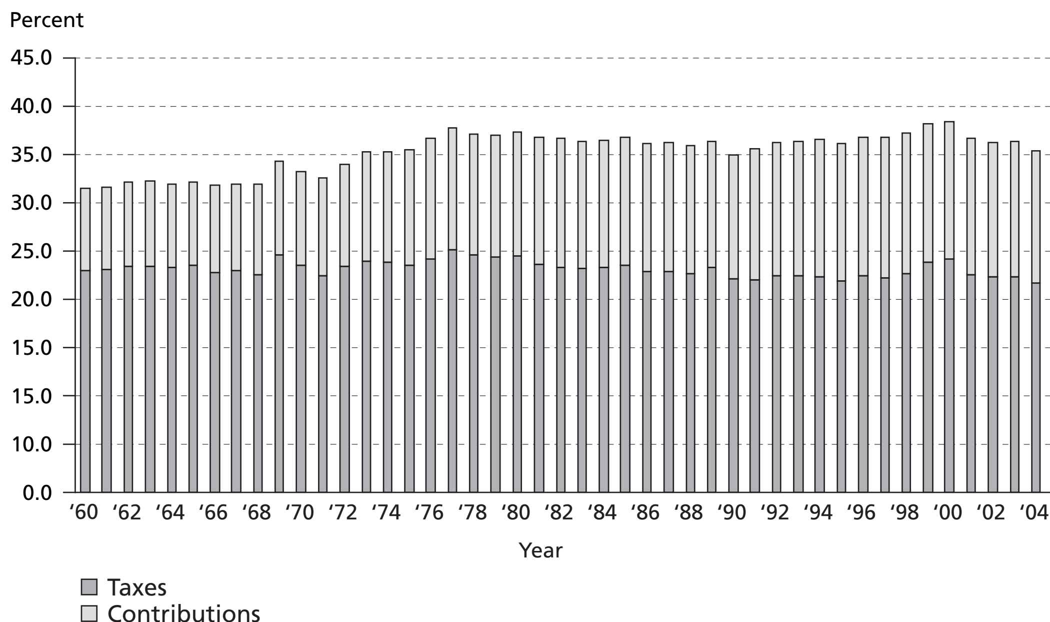
income from the labor of immobile "production factors," that is, individuals (Scharpf 2004). International comparison shows that dual income taxation is perfectly capable of financing an extensive and redistributive welfare state (Ganghof 2005). German institutional conditions, however, strongly militate against it (Ganghof 2004). Even leaving aside institutional "veto players" like the Constitutional Court, a move towards a dual income tax would mean legislating increases on personal income while simultaneously granting tax relief to business, or at least leaving business taxes unchanged. Although some think this might be politically feasible (Scharpf 2004), one may just as well doubt it. Clearly the CDU/CSU, having campaigned on a platform of more tax cuts on top of those implemented by Red-Green, would have to insist on the middle classes, their core constituency, not being asked to give up the tax relief handed to them by a Social Democratic Chancellor. But then, given the current topsy-turvy state of German politics, electoral commitments may not count much, especially for parties in a Grand Coalition.

On the other hand, resisting tax increases for the middle classes may not seem entirely frivolous at a time when individuals and families are being asked to compensate out of their own pockets the various benefit cuts – in health care, future pensions, education, and the like – that the government has already imposed or is planning to impose (Streeck/Trampusch 2005)[24]. Scandinavians are said to be willing to pay high taxes in return for the wide array of high-quality public services they receive; whether Germans are willing to pay *rising* taxes at a time of *declining* services would seem to be a different matter altogether. In fact there might be a vicious circle at work: stripped of cash the state cuts services and benefits and starts collecting user fees, in response to which citizens' willingness to be taxed – and even more so of course their willingness to be taxed *more* – declines. One might also suspect that increases in personal taxes are harder to sell the higher the government deficit and the accumulated debt. Since part of the additional public revenue would have to go into closing the deficit, if not lowering the level of debt, it would not be available to fund better services or public investment; in fact it would be payment for benefits already consumed in the past, and partly by a different generation.

How politics operates in conditions of this sort is illustrated by what happened in the first year-and-a-half of the Grand Coalition. Not being able to raise taxes on capital – indeed planning to lower them – and hesitant to raise personal income taxes for high income earners and the middle class, the Grand Coalition, apart from abolishing a number of tax privileges, increased value added tax (VAT). During the election campaign the CDU/CSU had announced as bitter medicine a VAT increase of two percentage points. The additional revenue was to be used to hold down or lower social security contribu-

24 In Steinbrück's programmatic speech, he articulates what has become commonplace among the German political class: that expectations concerning government benefits are "dramatically out of proportion with public revenue," that "the condition of public finances no longer allows funding the welfare state at current levels," and that social policy must "concentrate on indispensable tasks," the most important of which is "to enable the individual to participate and take part in the market" (Steinbrück 2006).

Figure 10 Taxes and contributions in percent of GDP (1960–2005)



tions, on the model of the one-point increase in 1998 which went into the pension fund. Although the SPD had vigorously opposed the "Merkel-Steuer," the Grand Coalition surprised the public by raising the tax by three rather than two points, albeit only from 2007 on.[25] Just one of the three points is to go to the unemployment insurance fund (Koalitionsvertrag: 29). The two other points, under pressure from the cash-starved CDU Länder prime ministers, were shared between the federal and the Länder governments, as a palliative for their endemic budget problems. The VAT increase consumed enormous political capital and is for this reason alone unlikely to be followed by further tax increases. Indeed it constitutes a political liability for the planned reform of corporate taxes, as opponents will be sure to claim that whatever tax relief for business may be built into the reform will in fact be financed by the 2007 increase in consumption taxes paid mainly by the average consumer.[26]

25 The postponement, which helped the SPD save face, was officially explained by an expected positive demand effect in 2006, as people would move forward major purchases of consumer durables to avoid the higher tax rate.

26 The orders of magnitude involved are suggestive. One VAT percentage point in 2007 is expected to amount to 6.5 billion euros (Bundesfinanzministerium 2006: 15). The losses of revenue associated with the impending reform of corporate taxation are estimated by it supporters to equal between 5 and 8.5 billion. On the other hand, while replacing revenue from corporate taxes with revenue from VAT makes the tax system overall more degressive, using VAT to replace social security contributions, which is the most degressive element of the tax system, may have a progressive effect. Since German VAT rates are low compared to other EU countries, further increases in VAT to refinance social security would seem politically feasible.

Looking to the future, it may be useful to keep in mind the long-term evolution of the combined share of taxes and social security contributions in German GDP (Figure 10). Apart from the slow but significant shift from the former to the latter, what seems most remarkable is the overall stability of the combined tax take at a level of between 36 and 38 percent. This, too, suggests that a major rise in state revenue is unlikely to occur.

4. The need to increase public investment. The postwar state of democratic capitalism drew its legitimacy from its intended and perceived function as an agent of societal problem solving, the warfare state having turned into a state devoted, in a comprehensive sense, to the "welfare" of society. Democratic government was above all to attend to the arising needs of citizens and rid society of social inequities emerging in the course of its economic development. Politics was to be responsive to, for example, the risks of unemployment associated with technological progress; changing skill requirements of workers and changing demands for education; the aspirations of groups excluded, or in danger of becoming excluded, from the social and economic mainstream; or the consequences of changing family structures. For this governments required disposable public resources that could be allocated and reallocated in line with evolving social structures and emerging social needs. Taxing and spending in the postwar democratic welfare state was above all geared to making the lives of citizens more secure and less unequal than they would otherwise be in a capitalist market society.

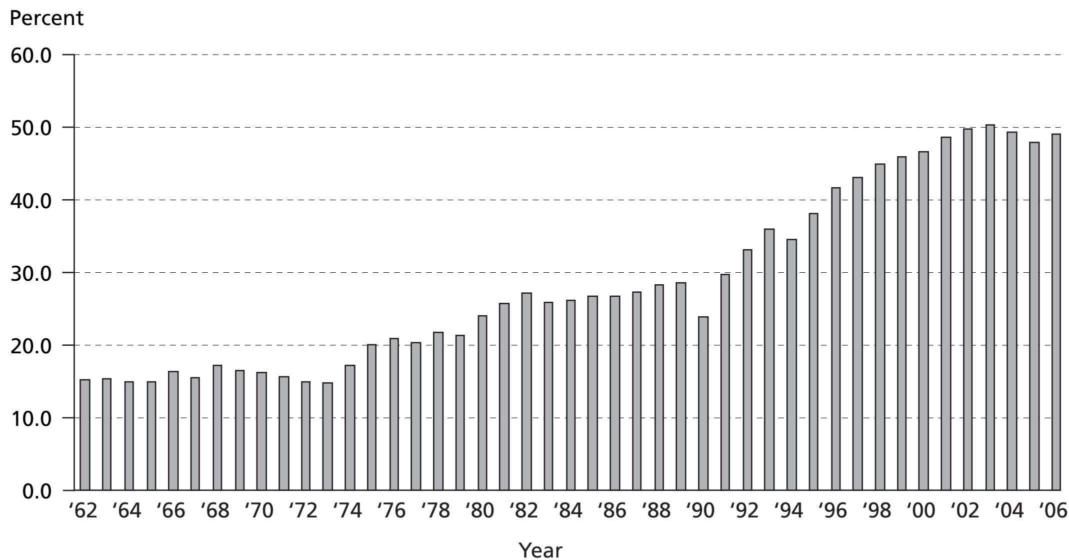
The essentially Social Democratic agenda of postwar democratic capitalism lives on, if only rhetorically. As the Finance Minister of the Grand Coalition pointed out in his speech of January 2006:

> We must provide for equality of opportunity to contain the centrifugal forces in our society that undermine its cohesion and solidarity. These forces are becoming increasingly visible: between poor and rich urban neighborhoods, between the old and the young, between families with and without children, between native citizens and immigrants, between those with and without easy access to education, and not least between organized and unorganized social groups. I urge you to take notice of such forces before they reach the well-to-do neighborhoods. They will cause high costs that will ultimately have to be paid by the taxpayer. They come at the expense of human community, and in the longer run they destroy the confidence in social and democratic structures, without which there can ultimately be no successful economy. To contain those centrifugal forces, it is not enough to sing the praises of the market or to wave the magic wand of "deregulation." For this you need an active state. Not a fat state, but one that can do the job. And such a state has its price. (Steinbrück 2006; translation by the author)

State expenditure to address social problems may be categorized as investment in a more equitable and therefore less conflictual future society. The concept is not unknown to German fiscal policy as the Constitution stipulates, in Article 115, that new debt must not exceed new investment. There are, however, no legal consequences if the Bundestag passes a budget that does not meet this requirement.[27] Moreover, the way it is legally

27 In fact, technically speaking the federal budget has for years been unconstitutional in that new debt has regularly exceeded expenditure counting as investment. For example, for 2006 the bud-

Figure 11 Share of federal budget spent on subsidies to social security and on debt service (1962–2006)



defined, investment refers mainly to tangible assets such as roads, canals, railway tracks, and other buildings. Federal investment expenditure in this sense has for some time been equivalent to between 8 and 9 percent of the total budget, and this is where it is projected to remain in coming years (Bundesfinanzministerium 2006: 14).

Whether the official concept of investment is still appropriate is increasingly being questioned. Money spent to address, for example, the manifold social needs caused by immigration does not currently count as investment although it may yield a higher future return to society than, say, another stretch of autobahn. Demands to divert spending to social as distinguished from physical investment do, however, collide with an astonishing secular ossification of fiscal commitments and spending priorities, which has gradually diminished and indeed seems about to eliminate altogether the disposable part of the federal budget. During the three decades from the early 1970s to today, the combined share of federal expenditures spent to subsidize the social security system – mainly the pension funds – and to service the national debt (in other words, the share of federal spending needed to satisfy the legal entitlements created by governments in the past for *Rentner* on the one hand and *Rentiers* on the other) went up, more or less steadily, from about 15 to about 50 percent (Figure 11)! To realize the extent to which this has diminished the degrees of freedom of German national policy-making, one needs to know that the remaining half of federal expenditure is mostly taken up by only three – also long-term – spending categories: social assistance to the long-term unemployed (ALG II; 38.5 billion euros, or 14.7 percent), personnel (26.2 billion euros,

get provided for new debt of 36.3 billion and for investment of 23.2 billion euros. The majority of the Länder have also for some time run unconstitutional budgets.

or 10.0 percent), and defense (23.9 billion euros, or 9.1 percent), which sum up to no less than 33.8 percent.

In the past three decades, that is to say, federal spending commitments have rapidly rigidified, cutting ever more deeply into what one might call the government's disposable income, and thereby dramatically detracting from its capacity to deal with social problems that were not known in the formative years of today's German state. Over time the federal budget has turned into a "frozen landscape"[28] of commitments entered into in the past for what was then the future and is now the present. As a consequence, the degrees of freedom of federal policy-making have narrowed to an extent unknown in the history of postwar public finance and the postwar interventionist state. Not least in light of the almost eerie steadiness of the rise in fixed inherited commitments, it is hard to imagine how this trend could in any foreseeable future be reversed. In fact, as we have seen, there are strong pressures for even higher subsidies to the social security system so as to avoid social security contributions rising again and further; for consolidation of public budgets and reduction of public debt; and for lower or at least unchanged levels of taxation, all of them standing very effectively in the way of the state recapturing space for discretionary allocation, regardless of what new social problems may arise and what it may cost in the long term to fail to address them.

The real fiscal crisis of the German state, then, would seem to be a long-term loss of capacity to respond to new social problems in a changing society – that is, to be the sort of state that the democratic welfare state of the postwar settlement was supposed to be, and needed to be to command legitimacy. In fact, the process may have gone so far that what we are observing may well be regarded as the end of the interventionist postwar welfare state as we know it – an end no less real because it is coming gradually and taking its time. Indeed, the functional and structural death of a social formation may be two different things, the former not being belied by the time required for the latter to be consummated. In the meantime, during what may well be the long goodbye of the postwar state, politics may be confined to pretending still to be in control while in reality slowly adjusting to a radically reduced role in society. This, too, is nicely exemplified in the Steinbrück speech, with its insightful references to the new social cleavages and the need to rebuild the consumptive welfare state into one emphasizing "activation" through, above all, education. Not a single word is said in this carefully crafted text about what it would cost, for example, to change the German education system into one that could provide something even faintly resembling equality of educational opportunity, not to speak of equality, or less inequality, of outcome – apart from hints that the money would somehow have to be found by cutting existing entitlements. How this might be done, in the face of the manifold demographic and political pressures to the contrary, is not even touched upon.

28 I borrow the term from Esping-Andersen (1996), who used it in a different context, adapting it in turn from the seminal book by Seymour Martin Lipset and Stein Rokkan, *Party Systems and Voter Alignments: Cross-National Perspectives* (1967).

The new politics of the tax state

Refinancing social security out of general taxes makes consolidation of public budgets more difficult, stands in the way of tax relief, and is likely to be achieved at the expense of public investment. Consolidation of public finances conflicts with reduction of statutory non-wage labor costs, especially if pursued in combination with tax cuts, and requires much political capital if it is to be accompanied by increased public investment. Tax relief puts upward pressure on non-wage labor costs, and to be compatible with budget consolidation it requires cuts in public expenditure, very likely including investment. Whichever of the four most urgent policy priorities a German government decides to pursue – reforming the Bismarckian welfare state, escaping from the debt trap, keeping mobile capital in the country and enabling families to take care of themselves, and investing in the country's future – it is bound to conflict severely and immediately with at least one, and very likely with all, of the three other, equally urgent priorities.

What sort of public policy may be expected in a situation like this? Going by almost two years' experience with the Grand Coalition government of Germany, the new politics of the tax state[29] is distinguished by low ambitions, unstable preferences, and a tendency to replace craftsmanship with gamesmanship, or insight with optimism. Concerning the first, the coalition agreement of 2005 states that "CDU, CSU and SPD will ensure that non-wage labor costs (social security contributions) will permanently remain lower than 40 percent" (Bundesregierung 2005: 28) – which is exactly the target that the Kohl government set for itself as far back as 1996, that is, a decade earlier. While for 2006 the government left the rate unchanged, at 41.9 percent, for 2007 a decline to 40.3 percent was envisaged, to be accomplished mainly by refinancing the unemployment insurance fund out of the increase in VAT.[30] It is obvious that changes of this dimension will not impart the sort of demand-side shock to a dysfunctional labor market that would be required to set off a new employment dynamic, especially in the service sector – also because the reduction will be spread thin to apply to all employment regardless of income or sector. Quite understandably, then, the coalition agreement abstains from naming any numerical target or time frame for the reduction of unemployment.

Lack of ambition is also evident in the government's plans for financial consolidation. Early on the parties agreed to postpone all unpopular measures to 2007, allowing time in 2006 for a build-up of good feelings. Also, the SPD may have insisted on a decent interval between the change in the Chancellorship and the beginning of the inevitable cruelties, making it more difficult for the Christian Democrats to put the blame on the failings of the Red-Green era. There were also three Länder elections in 2006. In any

29 To paraphrase the title of Paul Pierson's important book (Pierson 2001).

30 At the same time, the government increased the pension insurance contribution rate by 0.4 percent while effectively freezing pensions for an indefinite future. The final aggregate rate for 2007 will depend on the effect of health care reform on health insurance contributions which is as yet uncertain (February 2007).

case, for 2006 the Finance Minister accepted a record deficit of 38.3 billion euros, which due to increased revenue from VAT and several smaller measures was to decline to 22 billion euros in 2007 and to remain approximately at this level for the subsequent two years. Public investment, defined as above, was set at a constant 23 billion euros a year from 2006 to 2009. In other words, debt accumulation was projected to continue, at between 8.1 and 7.3 percent of total federal expenditure, whereas investment was not to increase. Although this kept within the Maastricht deficit guidelines and rendered federal budgets again constitutional, a balanced budget, as it had for a while been the official goal of the Schröder government, is not part of the present government's operative agenda.

What, then, will happen to "reform" policies under conditions of this sort? Like the two Schröder terms, we can expect a continuous stream of cautiously administered gradual cuts of benefits and tax privileges, spread as thinly as possible or, to the contrary, focused on small groups with, hopefully, little electoral clout. Most if not all of the skills of the political class will be consumed by electorally optimized allocation of pain, in a policy pattern of the smallest inevitable adjustments. Improvised repair jobs temporarily fixing public budgets, including the social security funds, will, as they have for years, take up the bulk of political capital and public attention. The only exception appears to be the unlikely field of family policy, where the demographic catastrophe demands some sort of perceptible government action.[31] Closer examination reveals, however, that due to insurmountable constraints on available resources, what is actually happening amounts to not much more than a very gradual reshuffling of inherited budget allocations, mercifully hidden by a smokescreen of *Kulturkampf* over the pros and cons of combining motherhood with paid employment.

In particular, beginning in 2006, the government as a first step increased tax deductions for expenses on childcare. The measure benefited mainly couples with two incomes, which did not make it popular with low-income or single earner families. It was therefore advertised primarily as promoting legalized employment in households. There is no information as yet (February 2007) on what, if anything, the new tax rules have cost, and whether the expected labor market effect has materialized. Later in 2006, a new transfer to working couples was introduced, to be paid for up to 14 months if one parent stayed home to take care of a newborn child *(Elterngeld)*. As the benefit is to replace lost income, middle-class parents receive more than low-income families, while single-earner families and the unemployed receive nothing. This was different from an older benefit, *Erziehungsgeld*, which the government had to scratch to be able to pay for its successor. *Elterngeld* is estimated to cost about 3.9 billion euros a year, 1 billion more than the old *Erziehungsgeld*, meaning that the additional spending amounts to a little more than 0.3 percent of the federal budget. The minister in charge, in her speech to the

31 Family policy could be considered investment in a more generic sense. The same holds for expenditure on research and science. Most of what will be said in what follows on family policy applies *mutatis mutandis* to the latter area as well.

Bundestag, called this a "quantum leap" (FAZ, 23 June 2006: 8). The puny magnitude of the program – which is billed as the government's principal instrument to turn around the secular decline in fertility – as well its distributional implications were hidden from public view by a passionate ideological debate about whether the government could and should extend the duration of the benefit from 12 to 14 months on condition that the second parent, usually the father, also took at least two months off the job to care for the child. That question was eventually answered in the affirmative, pleasing the advocates of social progress.

The third, and final, project of the present government's *Familienpolitik* is to increase the number of childcare centers. This, too, is being heatedly debated between the forces of progress and tradition, the issue apparently being whether the creation of more publicly financed childcare centers might somehow make mothers who raise their children at home feel less socially valued. In the real world, of course, the German national government, unlike that in Sweden, has no mandate whatsoever to run childcare centers. To get into the act nevertheless, the idea seems to be to forgo the planned increase in child allowances in 2009. Together with a simultaneous tax increase for married couples without children, the money thus collected would then in some as yet undetermined way be turned over to local communities, which would in addition somehow be made to add funds they save due to the declining birth rate[32] and use the sum total (a hoped-for 6 billion euros) to build crèches (FAZ.NET, 23 February 2007). The objective, according to the minister in charge, would be a tripling of crèche places to 750,000 by 2013, that is, over a period of six years. Again, the disproportion between the modesty of the project and the public uproar it has caused appears nothing short of amazing.

Concerning our second point, for policy-makers acting under the constraints of a magic quadrangle of the German sort there is very little value in consistency. Whatever objective they choose to pursue will immediately cause costs in terms of other, equally pressing objectives, while the benefits will very likely be modest. This makes for a certain arbitrariness of policy choices. For example, the *Koalitionsvertrag* announced an end to the infusion of tax money into the health care system, in pursuit of financial consolidation. But when it turned out during discussion of the 2006 health care reform that this would have to result in significantly higher contributions, plans were ventilated by the leaders of both parties, including the Chancellor, for major tax subsidies to the health insurance funds. The debate picked up steam when tax revenues turned out to exceed expectations at the end of the year, until it was ended by the Finance Minister who insisted on fiscal consolidation being given priority. Subsequently extant subsidies were phased out as originally planned. At the same time, a new subsidy was introduced amounting to 2.5 billion euros in 2007 and 2008 and set to increase from 2009 on by 1.5 billion euros a year, until it reaches 14 billion euros. No provision for this was made in the government's medium-term financial planning, and how the new federal subsidy

32 Note, however, that the family policies of the government are aimed at *increasing* the birth rate!

to the health care system will be funded will have to be decided along the way, at some indeterminate time in coming years (FAZ, 3 February 2007: 6).

Third, as lingering memories of the Golden Age suggest, economic growth may heal whatever problems of public finance may arise, and indeed being capable of infectious optimism concerning its impending return may have become the most important qualification for a German politician today. Sustained growth, were it to come, could reduce the burden of debt even if governments continued to draw on the future to satisfy the claims of the present, just as it could increase tax revenue, at a rate well above the rate of growth, and thus close the gap between current receipts and current expenditure.[33] The problem is, of course, that high economic growth can no longer be relied upon as a matter of course,[34] in part but by no means only because of a population that is both shrinking and ageing. In fact, while growth is desperately hoped for to create the financial resources required to refinance the welfare state, consolidate public finance, lower taxes and invest in the future, the government also insists that lower non-wage labor costs, a balanced budget, tax relief and an improved public infrastructure are the *preconditions* of renewed growth, and have to be achieved precisely in its absence and without its assistance.

In practice, while nobody knows what might reignite sustained growth of a dimension sufficient to resolve the crisis of German public finance, its prospect has turned into the *deus ex machina* of the drama of the German political economy – a benevolent exogenous force endowed with supernatural powers for which one can only wait until it somehow emerges and sets things right. How the need to be optimistic has undermined the professionalism of German policy-making is indicated by a recent confidential report of the Federal Accounting Office. It notes that the influential *Arbeitskreis Steuerschätzung* – a body of experts from the federal and Länder governments meeting twice a year to estimate future tax revenue – has for years now produced overoptimistic estimates, with the error in some years being as high as 7 percent of total revenue. The Accounting Office explained this by the federal government having consistently supplied the *Arbeitskreis* with exaggerated growth forecasts. According to the FAZ (14 November 2006: 11), the Accounting Office pointed to a close relationship between excessive estimates and the increase in the federal deficit: "Since federal governments failed to reduce expenditure in spite of tax receipts being lower than expected, new debt

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33 The two other magic bullets, inflation and cutting the value of the currency, are no longer available for EMU members.

34 The order of magnitude of what is realistically possible is revealed by the euphoria in early 2007 concerning the fact that the government saw fit to increase its growth forecast for the year from 1.4 to 1.7 percent, with a possibility of yet higher growth in 2008. Due to the increase in VAT, inflation was expected to reach 2.3 percent in 2007, compared to 1.7 in 2006. For 2006, the government had expected real growth to be at 1.4 percent; as a result of an unexpected economic upturn in the middle of the year, it turned out to be as high as 2.5 percent (Bundeswirtschaftsministerium 2007; FAZ, 1 February 2007: 11).

developed almost in parallel [*spiegelbildlich*] with the differences between predicted and actual tax revenues."[35]

Conclusion

Over time the German democratic welfare state has accumulated an ever-growing burden of fiscal obligations to *Rentner* and *Rentiers,* to a surplus population excluded from a high-wage labor market, and to its own employees. Even quite desperate attempts in recent years to reverse the buildup of long-term liabilities have failed. Enormous political capital has been spent but all that has been achieved is, at best, a temporary halt in an apparently inexorable march into fiscal and, as a result, political immobility. Given the dimension that the problem has by now assumed, it seems worth considering at the end of this essay whether there might be a point of no return in a trend of this sort; whether that point might actually have been reached in the German case; and what this might mean more generally for our understanding of contemporary politics, the modern welfare state, and institutional change.

Most of today's political scientists treat the phenomena they observe as fluctuating within an essentially immutable property space – that of the modern state – populated by complex causal connections that are as yet insufficiently understood but may be clarified in the course of cumulative scientific progress. While considerable variation between the cases located in the space is allowed for, the space itself is, as it were, treated as given. An alternative perspective would regard empirical observations, not as momentary ups or downs in the values of a fixed set of interrelated variables, but as moments in a historical process, like growth, ageing or decay, as a result of which the world, its causal texture and the entities housed in it would be different today from what they were in the past. In a historical-evolutionary perspective like this, the dictum of Heraclitus, according to which "you can't step twice into the same river," would apply: as time passes the world changes, sometimes through outside intervention, but always and also through its own daily functioning.

The question this raises is whether we should not conceive of the political institutions whose functioning we observe as undergoing continuous transformation, if only by accumulating past experiences and decisions that condition new experiences and require new decisions in the future. Not only would this enable us to conceptualize institutional change, including transformative change, as gradual and endogenous, which seems highly useful (Streeck/Thelen 2005). It would also open a window on that most elusive of all problems in social science, namely whether social formations can exhaust them-

35 Translation by the author. The unwavering reliance of fiscal planners on interest rates for the public debt remaining low belongs in the same category.

selves – die off or wither away – to be replaced with something new. Not only Marx was intrigued by this, but so were all of the classics of social science, until their historical-dynamic approach to the world was displaced by analytical model-building on the image of modern physics and of the ahistorical nature it believes it is dealing with.

Indeed, here we may once again return to Schumpeter and his essay on the *Steuerstaat*, in which he distinguishes between accidental and systemic crises of fiscal systems:

> Every fiscal system can occasionally break down. But this by no means signifies the collapse of its *principle*. So long as the cause … does not follow from the inner logic of the system, and as long as remedies can be found within the system … so long the collapse may be of interest perhaps to the historian, but not to the sociologist.[36] In such a case we cannot conclude that there is an underlying social process of change. (Schumpeter 1991: 105)[37]

Is the fiscal crisis of the German state the result of accidental, contingent, avoidable mismanagement, or is it indicative of a historical transformation that is driven by an "inner logic" of the modern state as an institution – one that very likely would be at work in other countries as well, although perhaps at a different pace and in different forms? According to Schumpeter, for there to be a crisis of a financial system, and not just one of individual cases operating under the system, one would have to find "obvious, ineluctable, lasting failure due to unalterable social change" (Schumpeter 1991: 106).[38] Germany with its unfortunate institutional legacy of a Bismarckian welfare state and a political system infamously beset with an abundance of veto points might simply be a pathetic outlier. However, its peculiarities notwithstanding, the German case might just as well be indicative of a more general, systemic crisis of the interventionist tax and welfare state of the postwar era as it matures and moves into the twenty-first century. Obviously the best way of finding out would be a comparative analysis of the fiscal situation in other countries, to determine whether increases in national debt and a growing burden of pension and other entitlements have emaciated state capacity elsewhere as well and to a similar extent as in Germany. This cannot be done here.

Still, there are at least two good reasons why it nevertheless seems worthwhile to speculate about the issue. The first is, clearly, the breathtaking steadiness of the build-up of public debt after the end of the Golden Age, the long-term dynamic of the rise of both

36 Of course the sociologist Schumpeter had in mind was not your normal sociologist of today, but one interested in understanding the significance of contemporary society in the context of its past and its possible future.

37 "Jedes Finanzsystem kann gelegentlich zusammenbrechen. Das bedeutet noch lange nicht den Zusammenbruch seines Prinzips: Solange die Ursache … nicht aus den inneren Notwendigkeiten des Systems folgt, und solange ein Heilmittel innerhalb des Systems gefunden werden kann … , solange ist ein Zusammenbruch höchstens für den Historiker, nicht aber für den Soziologen interessant, solange kann nicht auf einen tiefern sozialen Umbildungsprozeß geschlossen werden …" (Schumpeter 1953: 11).

38 "[A]ugenfälliges, unentrinnbares, dauerndes Versagen infolge tiefer unabänderlicher sozialer Veränderungen" (Schumpeter 1953: 14).

the social insurance contribution rate and the share of the federal budget needed to subsidize the social security system, and the almost linear growth over three decades of the share of federal spending devoted to covering unfunded liabilities to pensioners and creditors. Having gone on in parallel for such a sustained period, reinforced but certainly not caused by an event as incisive as unification, there is an air of inevitability and irreversibility to these developments that makes it legitimate to suspect that underlying them must be something, whatever it may be, that qualifies as what Schumpeter referred to as "obvious, ineluctable, continuous failure due to unalterable social change."

Second, it is not that one could not think of a mechanism that might be driving what would appear to be a case of an evolutionary self-destruction of a social institution in the course of its regular operation. Democratic governments need to mobilize resources to address social problems and, what may be the same, satisfy claims of powerful constituents. Mobilizing resources by taxing the current citizenry is bound to cause resentment and resistance, however, while solving present problems drawing on future resources is politically much less costly. Committing future citizens instead of potentially vindictive present citizens can be done comparatively easily by intertemporal redistribution – for example, by creating entitlements to pensions benefiting present voters (or rewarding present trade unions for urgently needed wage restraint) but to be paid by future voters, or by incurring debt in capital markets to be serviced and repaid later.[39] While technically there seems to be no limit to this, perhaps one could speak of "obvious, ineluctable, lasting failure" of the fiscal system, following Schumpeter, if and when the resources that are at present borrowed from the future must be used in their entirety to pay the interest on past borrowing from the present. In Germany this condition seems to have been reached in 2005 and 2006.

As political leaders learn by doing, one can expect them with time to become more adroit at moving taxation from a resistant present to a defenseless future.[40] Moreover, with the future hidden under a veil of uncertainty, politicians will in good conscience give in to temptations to make recklessly optimistic assumptions on the capacity of the future to solve the problems of the present: strong economic growth and a healthy dose of inflation will arrive in time to reduce the debt all by themselves; rising productivity will pay for higher taxes; interest rates may remain low; or the economy may unexpectedly pick up, as it did in 2000 and 2006. And while consuming for present purposes the future political capacity of the interventionist state – clogging the political agenda of coming generations, freezing their spending priorities, and foreclosing their space for fiscal and political discretion – political leaders, just as the public at large, are prevented

39 According to Wagschal (2007: 77), bourgeois governments, representing a clientele that would more than average suffer from tax increases, seem to be more likely than left-of-center governments to add to the national debt.

40 The impact of this mechanism is at best mitigated, but certainly not suspended, by short-term favorable contingent conditions such as the fiscal drag that makes tax receipts grow faster than the economy, as it currently (in late 2006 and early 2007) does in Germany. The long-term deterioration of the fiscal position of the state has taken place in spite of such effects.

by the limits of the human imagination from anticipating future social and political needs substantially different from current ones.

As already pointed out, whether this mechanism is at work in modern democracies generally can be established only by empirical research. Concerning Germany, however, one might well suspect that incremental consumption of future political options over three decades has changed the political game to such an extent that a return to what used to be regarded as normal in the late 1970s is effectively foreclosed. Even with extraordinary economic growth, the room for maneuver for public policy is likely to remain tight for at least another decade, and may under realistic assumptions become tighter yet.[41] Even if a turnaround were achieved at some future point, sequence will matter – meaning that the world would have become different as a result of adjustment of expectations and behavior to what will by then have been several decades of crisis of the interventionist tax state. Economic liberalization will have steadily advanced – if not by policy then by default – as a slow but inevitable response to the emaciation of the state and the attrition of its disposable resources. *Entstaatlichung* may never become a German government's declared program, but then it may not need to as it may happen nevertheless, as a consequence of fiscal exhaustion. Especially the middle classes will after another decade of fiscal crisis have learned to live without government-organized social solidarity, just as they learned in the past to rely on it. Thus as politicians keep talking about health care reform, more and more people will understand that the only health care reform they may benefit from in their lifetime is to eat more vegetables and stop smoking. Concerning pensions, already today nobody expects the state to deliver anything other than an unending series of benefit cuts, however dressed up. Those who can afford it have begun to save for their old age, those who cannot must wait and see. Similarly, the number of private schools is growing, and well-to-do parents send their brighter offspring to American or British universities. In the spirit of true liberalism, more and more people are helping themselves, which will make them even less willing to let the state take the rest of their money to help those who cannot. Even if the fiscal means might again become available to reconstitute the interventionist welfare state, the structure of a changed society may no longer generate the necessary level of political demand for it.

41 This holds regardless of the much talked-about sudden tax glut at the end of 2006. As a result of it actual new debt for the year declined by 10.3 billion euros to 27.9 billion euros. Also, the total state deficit fell to 1.9 percent of GDP and thus remained well below the Maastricht ceiling. But planned new debt for 2007 remained at about 20 billion euros, and the Finance Minister continued to refuse naming a date for a balanced budget. Moreover, he pointed out that the result for 2006 included one-time revenue from privatization in the order of 11 billion euros, which meant an effective deficit of about 40 billion euros even in an extraordinarily good year (FAZ, 13 January 2007: 14).

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