FISCAL PERFORMANCE IN GERMANY: WHEN DO GOVERNMENTS CONSOLIDATE AND HOW DO THEY SURVIVE THIS?

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ABSTRACT

This chapter traces the evolution of fiscal performance in Germany. Whereas the long-term trend sees a continuous increase of cumulative debt, the economic fundamentals and explicit and implicit efforts of consolidation allowed to government to keep deficits manageable. The reasons for successful consolidation vary, but one key factor is the role of electoral competition. When electoral pressure was high, and governments could not easily blame others, consolidation efforts remained limited or else led to severe political consequences.

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1. Introduction

In this study we will argue that German fiscal performance depends on the political survival of governments. If the electoral risks of fiscal consolidation are high, governments will be very reluctant to introduce harsh measures. Active fiscal consolidation is therefore bound to the political context and the electoral fate of governments in particular.

Hypothesizing the link between political survival and fiscal consolidation idea is not trivial. Germany is well known for its relatively conservative and moderate economic policies in general, and its fiscal conservatism in particular. In this sense, Germany is a least likely case for the problem of political survival, if there is a permissive consensus for retrenchment and balanced budgets. Moreover, reunification has increased the fiscal pressure on governments enormously and could make electoral pressures secondary. Finally, we will see that in some instances, governments managed to avoid the blame of consolidation relatively well. Yet, we will also see that fiscal consolidation put governments under substantive electoral pressure and political survival risk.

How is fiscal consolidation possible, and under which circumstances? We will see that reforms entailing fiscal consolidations are only observed under highly restrictive circumstances, namely huge external pressures that can serve as mechanisms of blame avoidance. If these circumstances are absent, projects of fiscal consolidation either have disastrous electoral consequences such as the second Schröder government or they won't happen. The German case is hence an important and somewhat counterintuitive illustration of the nexus between political survival and fiscal consolidation.

We start our overview with briefly narrating the evolution of German fiscal performance over the last 30 years. We link this discussion to the major episodes of fiscal consolidation and the socio-economic background factors that delimit governments' room to maneuver. In section three we identify six major episodes of fiscal consolidation in the last three decades. In sections four to six, we go through these episodes highlighting the role of electoral competition in the size and occurrence of fiscal consolidation. Section seven develops further implications of the German case.

2. Long-term Evolution and Structural Context of Fiscal Performance

The overall fiscal performance shows two somewhat contradicting features. One the one hand, the overall levels of debt have continuously risen across the last decades and put governments on increasing pressure. There are several factors are important to explain this rising trend: socio-economic changes as well as a large welfare state. On the other hand, German public finance shows remarkable resilience, and the capacity of significant corrections. This is due a combination of fortunate economic factors as well as the governments' attempts to keep public debt at bay.

Let us begin with the rise in debt. Figure 1 shows that the overall trend of cumulative debt in Germany increased over the last 30 years. This rising trend reveals enormous **socio-economic pressure**. Germany is one of the OECD countries in which population ageing takes place the fastest and population growth has been negative for the last 40 years except for several waves of immigration. This has had a tremendous impact on the level of explicit government debt. Its impact is even stronger on the implicit debt of the PAYGO pension system where estimates go up to 200 percent of GDP (Holzmann, Palacios, and Zviniene 2004). Economic growth has been moderate since the end of the golden era of the 1950s and

60s, and the international exposure of the countries, otherwise a hugely beneficial factor for the economy (Hall and Soskice 2001), puts more mobile forms of tax revenues under strain (Genschel 2002; Ganghof 2006).

[Figure 1 and table 1 about here]

Part of this increase in public debt is related to German welfare state which is large, if not very large in international comparison (Adema 2001; A. Kemmerling 2004). To be fair, a huge part of increasing public deficits was due to German reunification which led to some 5% of Western German GDP being redistributed to the Eastern parts per year, yet the way how the German political economy and governments reacted to the crises exacerbated the situation (Manow and Seils 2000).

These fundamentals have left their mark also on the German **budget structure**. On the expenditure side, the welfare state and the debt burden dominates every other category. The share of federal budget spent on subsidies to social security and on debt service reached 50% in 2006 (Streeck 2007: 25). The tax mix is strongly tilted towards payroll taxation (including social security contributions). Income from corporate and personal taxation has been stagnating on relative terms for the last 25-30 years (OECD revenue statistics), whereas VAT is on the rise, nowadays almost matching the revenue capacity of the contributions to social security (A. Kemmerling 2009a; OECD 2010). Tax revenues are relatively evenly distributed between the national and Länder level, whereas most of the expenditure actually occurs at the Länder (plus municipality) level.

Given the relatively conservative monetary and fiscal rules, governments cannot easily refinance themselves or buy their own debt. The PAYGO pension system and the relatively weakness of stock markets (Verdier 2000) lead to the fact that large 'new' institutional investors are a relatively new phenomenon. In the German political economy most public debt is still in the hands of traditional domestic institutional investors, banks and insurance companies.[2]

That said, recent analyses of fiscal sustainability over the long-term show that Germany is in a very good position, especially if compared to other countries (see table 1). For instance, the European Commission compiles information showing how much of fiscal adjustment is needed to offset the impact of ageing on the public sector through rising healthcare, pension and other expenditures. More precisely, the S2 indicator below (which indicates the short and long term adjustment required to satisfy an inter-temporal budget constraint in which the cost of ageing is included) shows that Germany has public finances as sound if not more as France, and finds itself in a much stronger position than the United Kingdom and the EU in general. More, figure 1 suggests that if anything, the Great Recession seems to have proved to be a structural break in fiscal politics in Germany: while the German debt to GDP ratio was highly correlated with the French one (R squared is 0.98 for the period 1977-2010), after 2010 the German debt path seems to have bifurcated towards a lower trend, while the French and the British ones are still rising.

[2] Domestic investors hold 38% (compared to a Eurozone average of 28%), residents outside the Eurozone hold 34% – see (Artus 2012)

Some authors might argue that this sustainability is perhaps the consequence of **fiscal institutions**. Indeed, fiscal governance is fairly tough in Germany. Regarding fiscal rules, a standardized measure comparing the 28 EU member states over the time span of 1990-2011, shows that Germany was always above average (value of 0.72 and increasing to 1.19 in 2011). The same was true of the index on Medium Term Budgetary Frameworks (MTBF),[3] indices of fiscal delegation (power of the finance minister to manage the public purse) and of the fiscal contract (ability for a government to set binding guidelines that limit deficits) (Hallerberg, Strauch, and von Hagen 2009: 72).

And yet, fiscal rules and institutions did not prevent German governments from running high deficits and pile on debt. A good example of this is the German "Debt Brake". It was introduced as Art. 115 of the German Grundgesetz (Basic Law or Constitution) in 1969 to make sure that federal debt does not increase much. At that time the ratio of federal public debt to GDP was 20% (Kastrop et al. 2009). Despite the debt brake this ratio increased to around 80% over the next forty years. International fiscal rules, so much promoted by the German government itself and international institutions like the European Commission or the European Central Bank, do not do the trick either. The clearest example of this is the Stability and Growth Pact (SGP), which stipulates that deficits of member countries should not go beyond 3% of GDP and their debt should not go beyond 60% of GDP. Implemented in 1997 by Eurozone members under German pressure, it was more honored in the breach than in the observance: the compliance rate the SGP over the first ten years among Eurozone members was as low as 42.8% (the compliance rate was higher in non-Eurozone members, 46.2% in Central and Eastern European countries and 81.6% for the UK, Sweden and Denmark).[4] Five years after its inception, the SGP had went through a major crisis due to the fact that Germany and France, having refused to abide by the rules (their deficits were above 3%), decided with other Eurozone members to hold the SGP in abeyance. All in all, the case for an independent effect of fiscal institutions on the budget balance is not as strong as it seems at first sight.

Other institutions such as the federalist structure or the corporatist insertion of industrial partners did not stem the tide of rising debt either. Similar things apply to social pacts that were rarely successful in post-war Germany. Instead, **economic fundamentals** played a more fortunate role for the fiscal performance in Germany. First, domestic savings are traditionally among the highest in the world.[5] Second, the sheer size of Germany's industrial base has given the German economy a pivotal role in European financial markets. Third, and perhaps most importantly, Germany has also been a relatively safe haven for capital inflows in times of financial crises after World War II. Due to the conservative stance of the German Bundesbank, German governments face relatively low interest rates, with a very low risk premium compared to other countries (Hallerberg and Wolff 2008). This has become particularly evident again in recent times, when the government refinanced its debt at negative real interest rates. Fourth, German governments occasionally managed to reduce successfully part of the implicit and explicit debt. To these instances of fiscal consolidation we will now turn.

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[3] Data retrieved from the Fiscal Governance Database of the European Commission accessible at http://ec.europa.eu/economy_finance/db_indicators/fiscal_governance/index_en.htm (retrieved November 6, 2013).
[4] Authors' own calculation based on the preventive and corrective arms of the SGP for the period 1998-2008.
[5] According to World Bank advanced economies had on average savings amounting 17.53% of GDP for 2011, while Germany had 22.81% (http://data.worldbank.org/indicator/NY.GNS.ICTR.ZS).

3. Six Episodes of Success and Failure in Fiscal Consolidation

Between 1970 and 2012, the German CAPB (Cyclically Adjusted Primary Balance) has been in balance or close to balance only five times: in 1970, 1971, 1973, 1989, 2012 (AMECO database). This data also reveals that Germany only consolidated in 16 years after World War II (AMECO database). However, CAPB data only reveals the fiscal performance, but not necessarily the role government policy plays in fiscal performance. The CAPB contains several sources of measurement error. Errors may stem from the high volatility of economic activity and asset prices, which influences tax collection through booms and busts (Girouard and Price 2004; Romer and Romer 2007). Even if the CAPB is supposed to tease out discretionary actions, it does not inform us about the intentions of policy makers. For instance, those may decide to tighten policy to cool down an overheating economy rather than to set debt on a sustainable path (cf. Finland or Ireland in the 2000s).

To find out about actual efforts of fiscal consolidation, one needs to triangulate CAPB data with two other sources of information: First, episodes of fiscal consolidations are recognized by using governmental plans (Devries et al. 2011). Second, those episodes are cross checked with qualitative case studies (Hallerberg 2004; Mulas-Granados 2006; Ganghof 2004; Zohlnhöfer 1999). The qualitative evidence can help to check whether the Devries' data is complete. One of the major problems of the Devries data is that it does not yield information about efforts of fiscal consolidation, unless they were officially listed. But in fact, many implicit measures might have an enormous effect on public finance and fiscal performance in the long run: changing the formula for social benefits, increasing the retirement age, increasing sanctions on benefit recipients etc. For each episode we will check whether the explicit measures were supported or counteracted by implicit measures.

This procedure leads to six major episodes of consolidation out of German fiscal history from 1980 to 2012 (Figures 2 and 3). Those six episodes followed in the wake of three conjectural shocks (the recession of the 1970s, the early 1990s, 2000s and 2010s) and one structural shock (German reunification in 1990). The first episode took place in 1982-84, with the inception of the Kohl administration in the shadow of the oil crisis. The Kohl government did consolidate the budget somewhat in the first years, but later on the government's attention moved away from consolidation. Consolidation returned to the fore after reunification. The later Kohl governments struggled with the simultaneous challenges of applying the Maastricht criteria for EMU access and financing the reunification of the country. Despite these efforts, the 1990s saw a period of unprecedented new debt. The next consolidation already happened under a new, red-green government. Initial consolidation efforts were backed by a benevolent economic environment, but were soon abandoned. The Schröder government returned to consolidation after the dot-com crisis and launched a series of structural reforms that eventually led to its undoing in 2005. The incoming grand coalition of CDU/CSU and SPD had to consolidate the budget again until the international financial crisis led to a complete reversal towards deficit spending. In the sixth and last consolidation, the second Merkel government reversed the course again, but the consolidation only partially offset the additional debt due to the crisis.[6]

Hence, we see that fiscal performance was dramatically altered by major external events such as reunification or the financial crisis. We also see that consolidation efforts are

[6] Compared to Breuer et al. (2011), we did not include the consolidation episodes of Helmut Schmidt in the 1970s, we split the Schröder episodes into two distinct ones and we include the German fiscal consolidation since 2010.

unevenly distributed, and happened under different types of governments. Finally, governments seemed to do more consolidation in the beginning of their respective terms, and especially once voted into office than in later years. These observations call for a more systematic inquiry into the determinants of German fiscal consolidation.

[Figure 2 and 3 about here]

4. Kohl I and II: From blaming to fearing opposition

Helmut Kohl's predecessor had a stressful life. Between 1974 and 82, Helmut Schmidt had to cope with the consequences of two oil crises and the end of a long period of high growth and fiscal stability. German gross public debt doubled from 17.85 to 36.49% of GDP, and the CAPB reached 4.6% of GDP in 1975, only to be brought back to 3.0% of GDP in 1977. During these years it was very obvious that government could only control the expenditure side of the budget as from 1976 onwards the Bundesrat was in the hands of the opposition (Fritz W. Scharpf 1991; Hallerberg 2004) and made reforms of revenues more difficult. The second oil shock increased tensions in the government coalition between SPD and FDP. Stimulated by policy experiments like those of Thatcher and Reagan, the FDP increasingly pressed its coalition partner for monetarist solutions, mainly embodied by cuts in social transfers to spur private investment regarding budgetary consolidations. This generated conflicts with the SPD preferring to ring-fence the welfare state and placing the burden of adjustment on business and the upper part of the income distribution. The FDP could not agree to these measures and defected from the coalition with the SPD, proposing a new alliance with the CDU/CSU.

A new government was ushered in, initially without new elections, as Helmut Kohl merely formed a new coalition between CDU/CSU and FDP. However, he was looking for a stronger mandate, and orchestrated a dissolution of the parliament. New elections gave his government a comfortable electoral margin. In the wake of Thatcher in Britain and Reagan in the United States, a change was expected to happen in the way fiscal retrenchment was to be conducted (Zohlnhöfer 1999). The new government wanted to first deal with deficits before embarking on a thorough tax reform.

The Kohl government dealt with the deficit on two fronts (Devries et al. 2011: 39): on one side, Kohl let spending cuts fall on social programs (unemployment benefits, payments for retraining the unemployed, child allowances). In 1984, civil servant salaries were reduced and unemployment benefits cut down from 68 to 63% of net earnings, and unemployment relief decreased from 58 to 56 percent. However, we see clear limits how far Kohl could go. The strong political representation of (denominational) workers' interests in the CDU made it impossible for Kohl to go further (Zohlnhoefer 2001). In certain policy areas such as early retirement, the CDU even increased pension expenditure (W. Streeck and Trampusch 2005) .

On the other side, Kohl strived to increase indirect taxation. It started with tax hikes on excises and on unemployment insurance and on pensions in 1982. VAT increased in 1983, as well as contribution rates to social security. As a whole, fiscal consolidation mainly concerned the lower part of the earnings distribution.[7] Those were most touched because expenditure cuts fell on expenditure items like the annual pension increase, the income

[7] As Zohlnhöfer argues the government did try to introduce a levy on the better off in the form of a forced loan *(Investitionshilfeabgabe)*. It was supposed to be a 5% surcharge on the income tax burden, similar to the solidarity surcharge after reunification, but unlike the latter, it was judged unconstitutional by the federal supreme court.

support programs, family allowances (but those were targeted mainly at the wealthier households), educational grants, unemployment benefits and fees in the health care system. In those spending cuts, the Government was clearly supported by the Bundesbank.

In later years, the new government shifted its attention to other areas such as a major tax reform reducing the burden on firms and middle incomes as well as cuts in the trade tax (Ganghof 2004). Fiscal consolidation became of secondary importance till reunification. Combating unemployment gained in political salience, and led to a rise in passive transfers and rising pension debt.

The episode hence gives a relatively clear picture: The early 1980s were still dominated by the recent second oil shock and the spike in international interest rates, so problem pressure was an important issue, but the actual government efforts quickly subsided over time. In the beginning, a right-wing government indeed implemented reforms in the traditional logic of partisan politics: cuts in expenditure. The U-turn of the liberal party (FDP) from a SPD-FDP to a CDU-FDP government gave the new Kohl government a relatively comfortable margin in terms of electoral competition (see figure 3). Moreover, the CDU ran its electoral campaign and its early years in government quite successfully blaming the previous government for the tremendous increase in public debt. Yet, once the government parties started losing Länder elections and the margin shrank dramatically, reform efforts decreased and debt started cumulating again.

[Figure 4 about here]

The second Kohl consolidation (1991-1997) was much less coherent ideologically: alternating stop and go policies in tax hikes and expenditure cuts in order to react to the deep recession of 1991 and the fundamental problems of financing German Reunification. The closer the deadline of EMU qualification and the higher the pressure of the "drei punkt null" politics, the more hectic were the measures, culminating with the large consolidation of 1997. The mix of fiscal consolidation switched from expenditure cuts (subsidies to industries reduction in unemployment compensation, reducing tax exemptions) and increase in indirect taxation (VAT from 14 to 15%, especially on oil, gas - increase in the fuel tax in 1991-1994 - and tobacco), raised direct taxes, broadening the tax base and fighting tax evasion, to a more balance fiscal consolidation including a solidarity pact in 1995-1997. This pact between the Federal Government, the Länder, local governments and the opposition of Social Democrats included tax hikes with income tax surcharge of 7.5%, increase in wealth tax, spending cuts in defense, industrial subsidies, pay for civil servants and federal employment. The year 1997 saw the culmination of the biggest yearly fiscal consolidation in Germany (1.6% of GDP) which included, among spending cuts, wage restraints, spending limits on regional level, health insurance benefits, and reducing the eligibility for unemployment benefits, spending freeze at the federal level, and among tax hikes, higher social security contribution rates. And yet, in the end, Germany only qualified for EMU thanks to fiscal gimmicks, not unlike Greece (Savage 2008).[8]

[8] After reunification, intra-German *transfer flows* increased from 139 in 1991 to 189 bn DM in 1997, amounting to a total 1.37 trillion DM between 1991 and 1998. When it became clear that the transfers would become permanent, the government started to impose a solidarity surcharge in 1991 and re-imposed it again in 1995. Since PIT and CIT needed to stay internationally competitive, the burden fell largely on social security contributions. These changes de-correlated tax revenues from GDP growth, and thus made fiscal planning very difficult and incurred financing gaps (von Hagen and Strauch 1999).

Problem pressure, external restrictions, or partisan ideology are insufficient to explain the government's efforts of consolidation. One relevant factor of later years was the Bundesrat as a powerful veto player. For instance, the SPD in opposition vetoed Finance Minister Waigel's proposed tax hikes in other fields of taxation. Yet, Waigel found new ways, for instance, by using re-valued gold reserves of the Bundesbank to repay federal debt, thus bringing the deficit under 3% of GDP. More promising is an explanation on grounds of electoral competition. Reunification gave a tremendous, but short-lived boost for the CDU, which gave the government some electoral breathing space. However, the government had promised not only a relatively short and painless period of transition, but also that no tax increases were going to be necessary to finance reunification. Hence, in the medium run, blaming opportunities were limited, and consolidation efforts came at a tremendous electoral risk (see narrow margins close to later elections in figure 4).

5. ***Schröder*** **I and II: From experimentation to gambling for resurrection**

Like the Kohl era, the Schröder era saw two fiscal consolidations. Yet, paradoxically, while the Kohl governments ended up implementing fiscal consolidations mainly based on taxes, the Schröder government behaved more like a Nixon going to China (Ross 2000): much of the consolidation took place on the expenditure side, with cutting unemployment benefits as the most notorious example (Achim Kemmerling and Bruttel 2006; Palier and Thelen 2010).

In its very beginning the coalition followed the expected partisan pattern and reversed some of the conservative retrenchment of previous years (C. Egle and Zohlnhöfer 2007). The coalition ended a spending freeze in 1998. Social spending was to increase by 12% (Hallerberg 2004: 99). But soon, reforms took a different path. In March 1999, finance minister Oskar Lafontaine resigned because of disputes in the cabinet and at the EU level over tax harmonization. His successor Hans Eichel changed course and increased VAT by one percentage point. The government's political situation worsened after it lost the majority in the Bundesrat, so that it became more difficult to implement tax-based consolidation. In 2000, the behavior of the coalition moved even further away from its political ideology: the consolidation package of 2000 had clear similarities to a right-wing consolidation, with a decrease in taxes (0.05% of GDP) and a cut in expenditures (0.75% of GDP). Those cuts concerned the social expenditures and the indexation of pensions, subsidies and the public sector wage bill. More surprising still was the fact that the government even did this consolidation while at the same time implementing a major tax reform that relieved the tax burden on (large) companies. And it did so even against the opposition of a CDU-dominated Bundesrat, buying out some of the politically divided Länder governments (Ganghof 2004; Zohlnhöfer 2004).

This reorientation of the fiscal consolidation strategy during the early Schröder government is mirrored in conflictive intra-party politics. In 1998, the SPD was split between "modernisers" and "traditionalists", the latter preferences being strongly voiced by Oskar Lafontaine. As finance minister and chairmen of the party he had a strong influence on the shape of the consolidation package (Harlen 2002). With the departure of Lafontaine, Schröder re-orientated governmental policies towards new priorities satisfying what he saw as the core of the 'new labour' electorate. Thus Schröder switched to a rhetoric accentuating individual values and less focused on the traditional values of equality (Harlen 2002: 6).

Hence, this episode was marked by the political consequences of SPD's move to the middle of the political spectrum. But it is also the consequence of unresolved problems on the

labour market. The traditional German solution, i.e. converting elderly unemployed people into retirees had become impossible, and the specter of high non-wage labour costs was borne (Kemmerling 2012). Due to the high rates of unemployment, government popularity plummeted like a stone (see figure 4). The government responded with a more moderate stance on fiscal policy. Even though popularity recovered somewhat, the next elections seemed to be lost. Three events rescued the government eventually. First, the government took a very popular pacifist stance against the war in Iraq, whereas the leading opposition held to the US administration. Second, the flooding in Eastern Germany gave the Chancellor a boost. Third, the government started a political offensive: it used a scandal at the Central Agency for Jobs to commission a set of far-ranging labour-market reforms that would also affect social security (Achim Kemmerling and Bruttel 2006). While in the long run, these measures would proof detrimental to the party, in the short run they contributed to just enough additional votes to guarantee a razor-thin majority in the 2002 elections (C. Egle and Zohlnhöfer 2007). Yet, it was a gamble that eventually backfired.

The second fiscal consolidation of the Schröder government was incoherent and mainly triggered because of concerns related to the Stability and Growth Pact. In 2003, the government increased taxes by 0.74% of GDP, trying to raise higher revenues from income, business and indirect taxes. In 2004, by contrast, the government relaxed the constraints on the revenue side of the budget and switched to an expenditure-based consolidation, making the cuts fall mainly on social transfers and subsidies, most which were summarized in the so-called Agenda 2010. This agenda was the aftermath of the electoral pledges two years earlier, but only now the effects became clear to the people. The most important example of these cuts was in unemployment benefits (so-called Hartz IV reform). Whereas previously, unemployed people received unemployment benefits for an unlimited time, the government introduced a maximum period of 12 months. Even if the net effect on expenditures was around zero in the short run, the long-run effects of the reform contribute to fiscal consolidation by lowering unemployment rates. The reform constitutes, therefore, an important example of an implicit measure to consolidate public budgets.

All in all, the Red-Green coalition first raised cyclically adjusted expenditures from 44.6 to 44.9% of GDP between 1998 and 2002, before it reduced them to 44.1% of GDP in later years. The Schröder governments indeed turned away from traditional partisan politics. Problem pressure was a reason, but it was arguably more the rising levels of unemployment than of debt that made the government react. Once the government was in the domain of impending electoral losses it started gambling for resurrection. In doing so one may argue that its behaviour is consistent with the forecasts of prospect theory (Vis and Kersbergen 2007). However, whilst in the short run the strategy seemed to work, in the medium to long run it upset both traditional voters and allied trade unions. Therefore, the example also shows the vagaries of a government taking an off-the-equilibrium approach to consolidation and reform. It was a rare occasion to judge the actual size of voter retaliation: the second Schröder government resigned early. Moreover, ever since then the SPD's public support hovers around a level which is five to ten percent lower than before.

6. **Merkel I and II: From no competition to no need**

By the time an unexpected Grand Coalition emerged from the 2005 election, many observers of the German political economy argued that Germany was more and more going through a crisis, of which the main symptom was the "crisis of the fiscal democracy" (Miskimmon, Paterson, and Sloam 2009; Streeck 2007; Streeck 2009; Streeck and Mertens 2010). The Economist called Germany the "sick man of Europe" in the beginning of the

2000s. Given the poor state of German public finances (gross public debt increased to 68.6% of GDP in 2005), the situation was conducive to a fiscal adjustment. However, soon the government felt less need to undertake fiscal reforms. The business cycle became favourable and the outgoing government's Agenda 2010 had prepared the ground with drastically lower rates of unemployment, even if reforms came at the heavy price of increasing inequality and a huge low-wage sector.

This recovery partly explains why explicit fiscal adjustment of the Grand Coalition was mild at best. In general, grand coalitions are said to lack ambition when it comes to fiscal consolidation, not least due to programmatic differences (Wagschal and Wenzelburger 2012; Zohlnhöfer 2011). Nonetheless, 65% of the consolidation efforts happened on the expenditure side. In 2006, the coalition enacted expenditure cuts estimated by the IMF to be at the level of 0.5% of GDP. In 2007, the expenditure cuts, which fell mainly on social transfers like allowances job seekers and social transfers (the aftermath of Hartz IV), where balanced with tax hikes. Those tax hikes continued the trend started in the 1980s to shift the tax mix to regressive taxation (A. Kemmerling 2009b). VAT alone saw a hefty increase by three percentage points from 16 to 19%.

As a result the 2007 budget came close to being in balance. The cyclically adjusted balance fell from -3.3% of GDP in 2003 to -0.8% of GDP in 2007. Indeed, cyclically adjusted revenues fell from 45.0% of GDP in 2003 to 42.9% of GDP in 2007, and expenditures from 45.26 in 2003 to 40.95 in 2007. Moreover, the government did finally tackle the long-term issue of implicit pension debt. The grand coalition was the first government to implement a substantial increase in the statutory retirement age to 67. This had been an electoral taboo in post-war Germany (A. Kemmerling 2009b). The government also tightened its own 'hand-cuffs' on fiscal policy, by introducing a new and tougher debt brake. In part this was a response also to the 2002 to 2006 budgets being unconstitutional according to German federal supreme court (Grasl and König 2010).

All in all, the episode shows grand coalitions are not always as bad as critics would argue. One mechanism which makes grand coalitions work is that while electoral competition is still present, it is less painful. Blame sharing can reduce the reluctance to introduce unpopular reforms such as extending retirement age. Also the increase of VAT by 3 percentage points is easier to spread over both major parties. The grand coalition made sure that none of the two partners alone had to take the blame of unpopular reforms.

In 2009, the voters decided against the grand coalition, and Merkel could run a minimum-winning coalition with the FDP. Fiscal policy was thoroughly under the shadow of the Great Recession of 2008. Germany opted for a path of a more balanced fiscal consolidation than its European neighbors: it reduced cyclically adjusted expenditures by 2% points between 2010 and 2012 and increased revenues on average by 2% points between 2008 and 2012, contrary to other countries[9]. The overall ambition of coalition government between conservatives (CDU/CSU) and liberals (FDP) was limited. The government inherited a relatively large package of fiscal stimulus of about 3.0 percent of GDP implemented by the grand coalition in late 2008 and early 2009 to which was added the effect of automatic stabilizers – around 4.2% of GDP (Christoph Egle and Zohlnhöfer 2010; Schelkle 2012; Cameron 2012). Much of this package consisted of permanent reductions in taxation and social security contributions and created a legacy for future consolidations.

[9] The UK consolidated its public finance mainly on the expenditure side, while France did the opposite.

One issue is, of course, that except for the huge and contingent bail-out packages for other EMU members, the economic environment was surprisingly moderate. True the first reductions in output were tremendous, but at the time the CDU/FDP took over, the effects of the stimulus seemed to have kicked in (Schelkle 2012). Moreover, in certain aspects, Germany became a winner of the financial crises of its neighbors, leading to the fact that the German finance minister could refinance debt at negative real interest rates. Hence, while it is true that some observers saw German public finances in dire straights (Wolfgang Streeck 2007), and even questioned democracy in a country in which only 17% of the public budget is left to discretionary spending (Streeck and Mertens 2010), this did not produce strong incentives for the government to react.

Electoral competition, however, has resurfaced as a political constraint. True, the CDU, and Merkel in particular, face a relative long period of honeymoon in public opinion, but the two major camps are very close to each other, especially since the communist PDS could tip the balance between right and left. Since the German finance minister can currently issue debt at negative interest rates, serious efforts of consolidation seem to be unnecessarily risky from an electoral perspective. The Merkel government seems to have opted for 'resting on its laurels'. All in all, so far, the German mix of passive and active consolidation since 2010 seems to work: Germany was in 2012 the only EU Member State to post a surplus of its public finance (0.2% of GDP), the upward path of public debt is broken and switched to a downward path instead and the structural balance is in positive territory.

7. Conclusion: The Art of Surviving Fiscal Consolidation

The six episodes of fiscal adjustments in Germany show us that several conditions need to hold to make fiscal consolidation politically feasible. The economic environment is an important context factor that explains part of the size and occurrence of fiscal consolidation. Institutional factors are also visible such as the role of the Bundesrat in blocking tax hikes changes reform politics. Also, the presence of an external constraint like the need to qualify for EMU led to a more balanced burden of adjustment and a social pact.

Other factors prominent in the literature (Hodson 2004 and von Hagen, Hallett, and Strauch 2001) seem to be less relevant for the German case. For instance, explicit tripartite social pacts are less visible than in other countries (see the contribution of Marzinotto in this volume). For instance the Solidarity Pact of 1993-1995 (which is formally still in place through the Solidarity Pact II until 2019) was a government initiative that brought together the federal government, the Länder and the political parties to finance the Reunification (with a Solidarity Surcharge on the income tax of 7.5%), but did not include social partners. And when the state does implement labor market reforms such as in the case of Schröder, often it does so against the will of trade-unions.

Instead, the German case illustrates the importance of electoral competition and the politics of blame avoidance looming into governments' attempts of fiscal consolidation. Whereas Kohl governments till 1994 and Merkel governments after 2005 show behaviour on the equilibrium path, the last Kohl government and, in particular, the Schröder governments show the fatal electoral and political consequences of behaviour off the equilibrium path. In these rare circumstances we see the electoral price tag of fiscal consolidation in full swing.

Figure 5 shows the relationship between the electoral competition of the two major political camps and the annual deficits. A clear negative correlation between the two is visible: when deficit are high, electoral margins are low and vice versa. This is especially true before reunification, but also holds for the period thereafter.

[Insert figure 5 about here]

It follows that episodes of fiscal consolidation are subject to political and economic selection bias: only when economic pressure mounts, and only as much as political rationale would allow for. Otherwise, German governments were very cautious in their use of consolidation strategies. Hence, the logic of political survival has important implications for fiscal performance. Successful episodes of consolidation will mainly happen if they are also successful politically. This creates a sort of selection bias. For instance, not all types of reforms are equally likely to happen. Few governments ever implemented the flip side of Keynes' deficit spending: reducing debt during periods of economic boom. But then it is hard to assess the success of (anti-)keynesian fiscal consolidation without correcting for the possibility of non reform (Alesina and Ardagna 2009). This is an important area of future research.

Moreover, if the German case shows the political perils of fiscal consolidation, and Germany is a case of a relatively conservative fiscal and monetary culture, the situation in other countries will be worse. In other words, Germany is a least likely case and may underestimate the electoral consequences of fiscal consolidation. Also, the German governments faced certain structural advantages that other governments do not have at their disposal. The constraint of European monetary integration had a different role in Germany compared to other countries. While Italy, for instance, anchored itself to a "vincolo esterno" (see the chapter by Marzinotto in this volume and Dyson and Featherstone 1996), Germany was the anchor itself and it entered the EMU with an overvalued exchange rate. From this point of view, one can see fiscal consolidations, the measures dubbed "fiscal devaluation" (increased VAT, see Fahri, Gopinath, and Itskhoki 2013; de Mooij and Keen 2012), wage restraint and structural reforms as a way to regain lost competitiveness. Hence, the tensions between political pressures and economic context are arguably much worse in other countries of the OECD, which makes political survival of fiscal consolidation all the more delicate.

This brings us to our normative implication: since successful fiscal consolidation only seems possible if it means economic as well as political success, internally or externally imposed debt rules might not work. They especially will not work if they create too much of a disadvantage for incumbent politicians in the race for re-election. Therefore, such rules need to adhere to some sort of political impartiality, i.e. they should neither benefit nor harm the government vis-à-vis the opposition. In that sense, fiscal pacts and other forms of inclusive, deliberative policies might work better than management by sterile institutionalization.

This point is perhaps best proved by the infringement of the Stability and Growth Pact in 2002-2003 by Germany and the failure of the German debt brake since its inscription in the German constitution in 1969. This does not bode well for the reform of the German debt brake in 2009. Even though explicit fiscal consolidation at times it works, more often than not the reasons for success are structural. In the German case the drastic inflow of private capital tremendously decreased the pressure from public debt. Moreover, a consideration of explicit efforts of fiscal consolidation is misleading. Most of the fundamental reforms are parametric or systematic changes in social expenditure. The Schröder reforms, and the pension overhaul and the resulting very low unemployment rates relieved the pressure on the budget. Also a

political coalition agreeing that fiscal balance is good for the competitiveness of the export sector. If anything, this suggests that fiscal rules are endogenous: fiscal performance and fiscal rules are driven to a great extend by the political dynamics in Germany.

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Table 1. Long-term sustainability of public finances in Germany[10]

S2 Indicator	2006	2009	2012
Germany	4.4	4.2	1.4
France	4.0	5.6	1.6
United Kingdom	4.9	12.4	5.2
EU Average	3.4	6.5	2.6

Table 2. Yearly details of German fiscal consolidations

	Year	Total	Tax	Spend
DEU	1982	1.18	0.56	0.62
DEU	1983	0.87	0.3	0.57
DEU	1984	0.18	-0.41	0.59
DEU	1991	1.11	1.08	0.03
DEU	1992	0.46	0.27	0.19
DEU	1993	0.11	-0.07	0.18
DEU	1994	0.91	0.08	0.83
DEU	1995	1.08	0.84	0.24
DEU	1997	1.6	0.5	1.1
DEU	1998	-0.1	0	-0.1
DEU	1999	0.3	0.3	0
DEU	2000	0.7	-0.05	0.75
DEU	2003	0.74	0.74	0
DEU	2004	0.4	-0.7	1.1
DEU	2006	0.5	0	0.5
DEU	2007	0.9	0.5	0.4

Table 3. Tax/Expenditure mix in German consolidation episodes

	Total	Tax	Spend	% Tax	%Exp	Δ Debt[a]
Kohl I	2.23	0.45	**1.78**	20.18	**79.82**	2.46
Kohl II (EMU)	5.27	**2.7**	2.57	**51.23**	48.77	17.30
Schröder I	0.9	0.25	**0.65**	27.78	**72.22**	-0.31
Schröder II	1.14	0.04	**1.1**	3.51	**96.49**	1.82
Grand Coalition	1.4	0.5	**0.9**	35.71	**64.29**	-2.89
Merkel	2	1	1	50	50	-0.5

[a] In percentage points of GDP. Source: Devries et al. (2011).

[10] Source: (European Commission 2012; European Commission 2009; European Commission 2006).

Figure 1. Comparing public debt in Germany, France and the UK

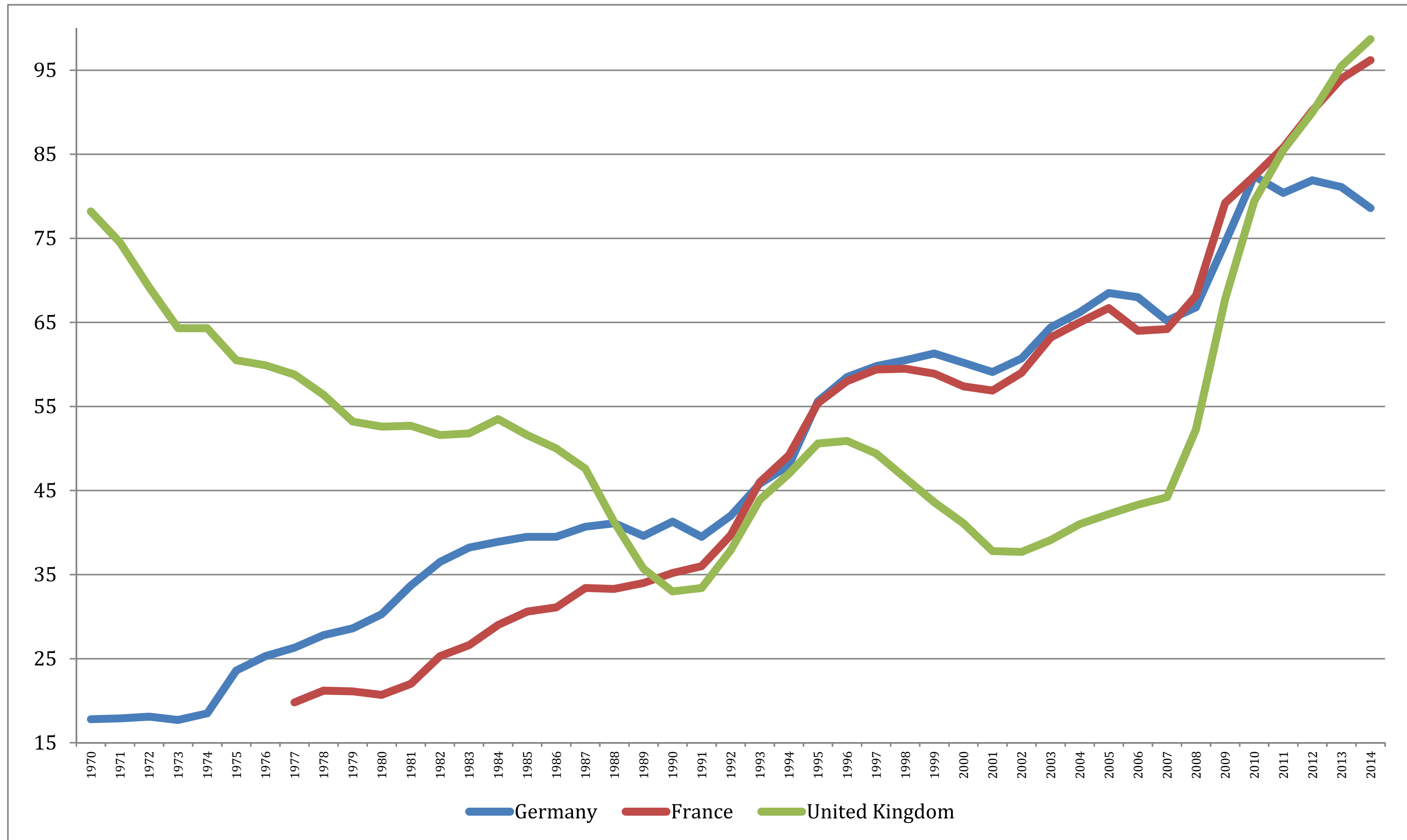
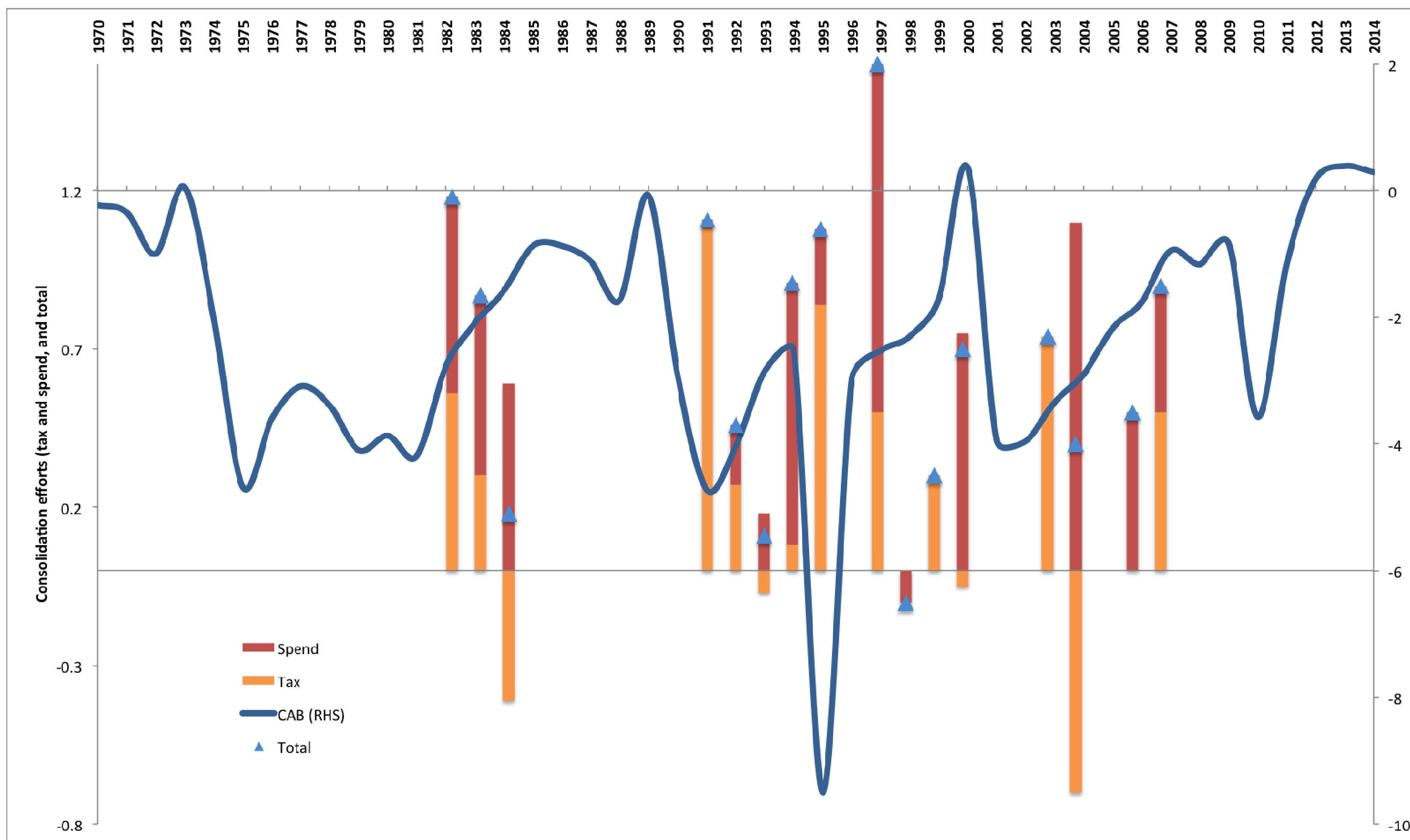


Figure 2. German cyclically adjusted balance and episodes of consolidations[11]



[11] CAB is from the AMECO database and episodes of consolidation are from Devries et al. (2011). See appendix for more detailed information.

Figure 3. German gross public debt, federal elections and consolidation episodes

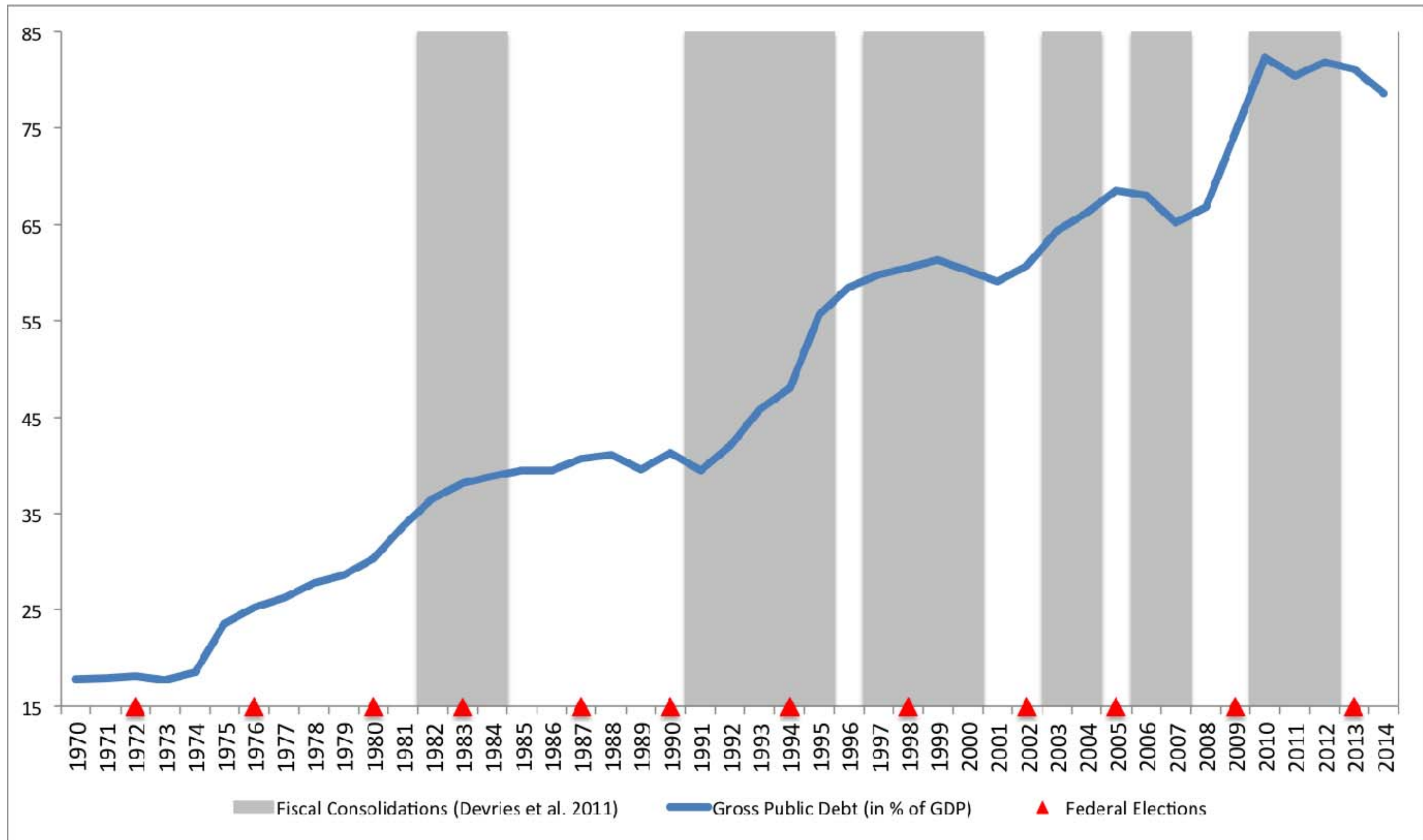
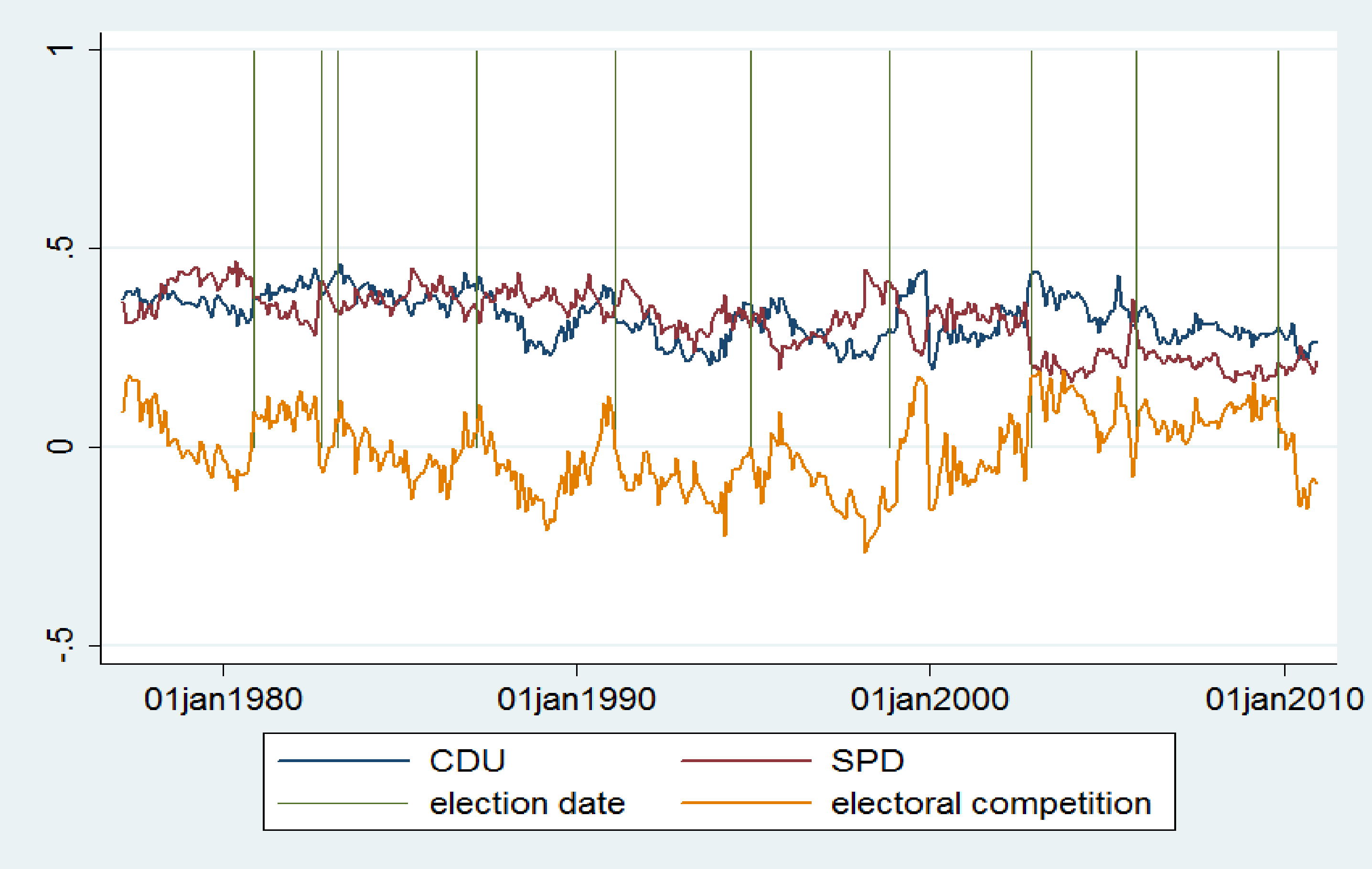
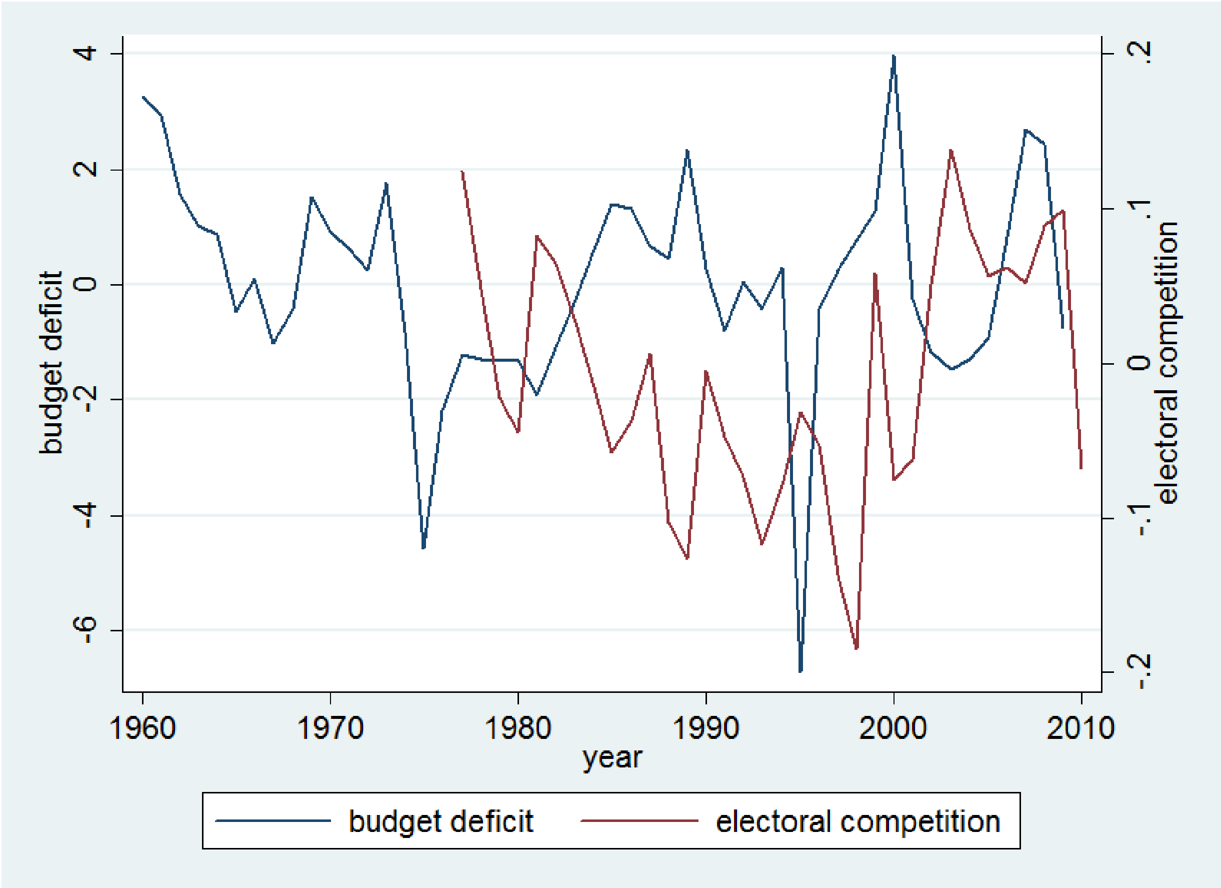


Figure 4. Public Opinion



Source: Own graph on basis of the 'Sonntagsfrage' ('If there was an election next Sunday, which party would you vote for?') Electoral competition is the difference between the shares of CDU+FDP and SPD+Greens. The source is Politbarometer, cumulative file (GESIS).

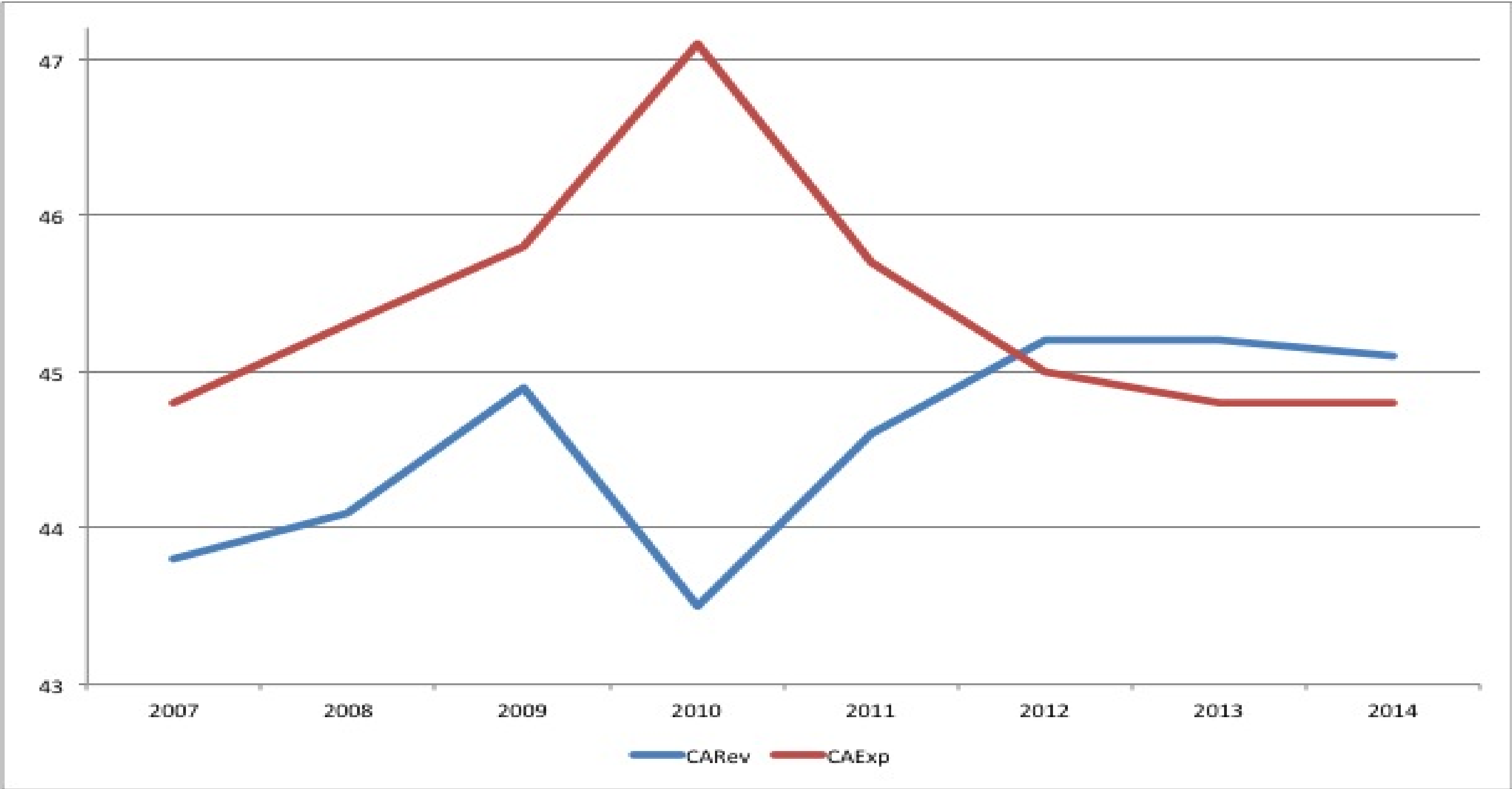
Figure 5. Public Opinion and Public Deficits (CAB)



Source: Own graph. Electoral competition as in figure 4. Primary annual budget deficit (source OECD).

Figure 5. Cyclically adjusted primary expenditure and revenues in Germany[12]

[12] Source: AMECO.



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