Global Counsel

Germany's fiscal trilemma: why Europe could lose out

Blog post by Senior Associate Thomas Gratowski, 5 March 2018

Sunday's result of the SPD membership vote has been welcomed across Europe. Many, from Paris to Rome and Madrid, are relieved that the SPD will be part of the next government (and the FDP in opposition). What makes Social Democrats so attractive is their commitment to 'more Europe' and eurozone reform, and their openness to put additional German money on the table to achieve it. The prospect of greater risk sharing in the eurozone has helped lift the euro in recent months. The hope is that Europe will benefit from both, more German money and Germany's reputation as a sound fiscal manager. A closer look at the grand coalition agreement however calls into question whether it can deliver both.

Germany's public finances are likely to deteriorate over the next few years. People in the know in in Berlin admit that the coalition agreement contains much higher spending commitments over the next four years than the €46bn of fiscal legroom identified by the parties at the beginning of the coalition talks. Last week, the business-friendly Cologne Institute for Economic Research came up with some concrete numbers. Their research suggests that, in contrast to the 46bn, total additional spending will likely be €91.5bn by 2021 – with negligible revenue-raising measures. The federal government will spend the lion's share but spending by social insurances, as well as states and municipalities, will also add €22.6bn to the total. The study also warns that the number could be higher if, for instance, the promotion of digitalisation cannot be fully financed by G5 license auctions which are expected to raise €15-17bn.

The second interesting point that the economists from Cologne make concerns timing. Their analysis shows that from 2021 onwards, the federal government will run a budget deficit unless tax revenues are significantly boosted by tax hikes or a further upturn in the economy. A large part of the potential deficit in 2021 would come from a higher contribution to Europe. The EU's next Multiannual Financial Framework which will start the same year is expected to demand higher contributions to the EU budget. The departure of the UK is leaving behind financial headaches in Brussels. There are also questions about how more European commitments in areas such as border protection and defence cooperation can be funded. The new formula currently discussed in Brussels for member states' contributions is one of 1.1X% of GDP – up from the straight 1%.

The CDU/CSU and SPD have explicitly stated that a new grand coalition would be willing to contribute more to the EU budget. The Cologne economists demonstrate that additional contributions at the lower end of what is currently discussed could amount to €7.8bn. Experts from the CDU previously suggested it could reach up to €9bn, perhaps because new budgetary lines for the eurozone might require further resources. This poses the question of whether Germany faces a fiscal trilemma where it must choose between domestic priorities, Europe and a balanced budget.

There is little doubt that the grand coalition is built on an expansive domestic agenda and a formal commitment to the ‘black zero’. Europe could lose out.