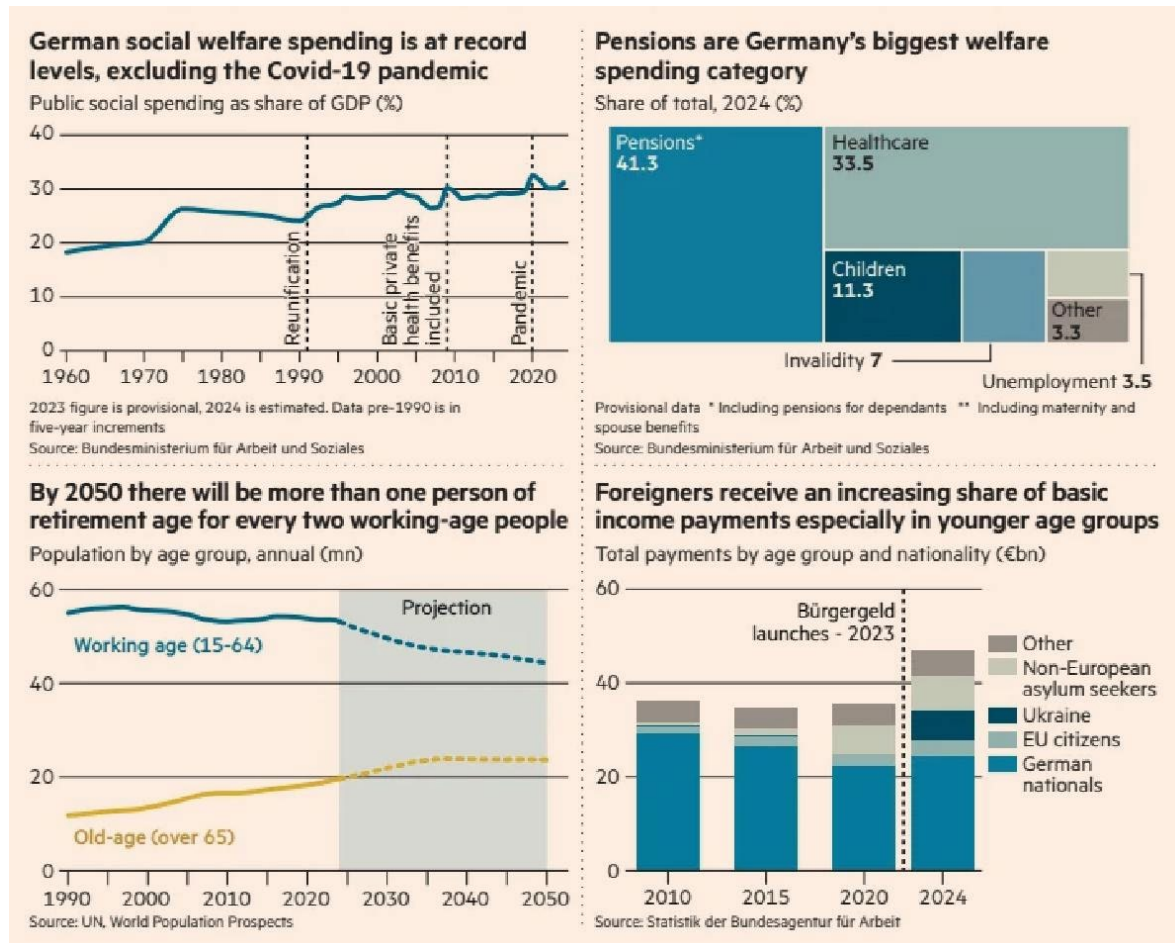


Merz battles to cut Germany's €1.35tn bill for welfare state

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Social spending has crept up amid three years of economic stagnation



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Germany's conservative Chancellor Friedrich Merz has set up a battle with his centre-left coalition partners by declaring that Europe's largest economy can no longer afford its generous welfare state. "The welfare state as we know it today can no longer be financed by our economy — and that is why we have to change it," he told members of his Christian Democrats (CDU) party in August. A reform of Germany's social security, which is part of the coalition's agreement, comes as the country is launching a €1tn debt-funded spending programme to modernise its armed forces and repair its infrastructure.

Attempts elsewhere in Europe to slash welfare spending have proved politically fraught. In the UK, Sir Keir Starmer was forced into a climbdown over plans to rein in Britain's soaring benefits bill. In France, fierce opposition to pensions reform contributed to the downfall of prime minister François Bayrou's government.

While Germany is no outlier in Europe, its social spending has crept up in recent years and its demographic time bomb threatens to undermine the welfare state's funding — just as its economy struggles to emerge from its longest postwar phase of stagnation.

Germany's welfare state dates back to the days of Chancellor Otto von Bismarck, who first introduced statutory health and pension insurance from 1881 to counter socialism. Enshrined in the country's constitution since 1949, the welfare state has grown into one of the world's largest, accounting for 31.2 per cent of the country's GDP — the highest level on record, excluding the Covid-19 pandemic when the data was distorted by emergency government spending.

Healthcare and old-age care costs have risen at faster rates than overall inflation. At the same time, the country has been stuck in economic stagnation for more than three years.

"The system is creaking," Germany President Frank-Walter Steinmeier said in a landmark speech last week in which he argued that the country's welfare state was a "treasure" but needed to be made "fit for the future".

Together with civil servants' pensions, the pay-as-you-go pension insurance and health insurance account for more than 50 per cent of total welfare expenditures of €1.35tn, according to data from the German labour ministry.

Germany's pension system has survived two world wars, hyperinflation and several currency reforms. But the rapidly ageing workforce will pose a structural challenge as 16.5mn baby boomers — people born between 1954 and 1969 — will retire by 2036 while only 12.5mn young workers will join the workforce, according to the Cologne Institute for Economic Research.

As retirees live longer, the financial pressure on the pension system will grow over time.

On top of €306bn of contributions from employers and workers, the government in 2024 paid another €118bn to fund deficits in the system, or about a quarter of the total federal budget.

This share will double to about 50 per cent over the next two decades, according to Axel Börsch-Supan, head of the Munich Center for the Economics of Ageing at the Max Planck Institute.

Merz's flagship measure so far on pensions is a plan to incentivise those willing to work beyond retirement age by exempting the first €2,000 they earn monthly — on top of their regular pensions — from income tax. But he has refrained from being specific about how he intends to overhaul the overall pensions system, and has kept incentives for early retirement untouched.

Critics point out that Merz's own camp is simultaneously pushing for measures that would worsen the problem. The coalition has pledged to maintain the current pension level at 48 per cent until 2031. The agreement includes a plan championed by the CDU's conservative Bavarian sister party the CSU to lift pension perks for non-working mothers from 2027 — at an additional cost of €5bn a year. It will be down to a commission, due to be set up early next year, to make reform proposals. Germany's welfare system has had limited success in reducing the average poverty rate. According to think-tank WSI, which is funded by Germany's trade unions, this is mainly driven by below-inflation increases in minimum payments to the non-working poor and a falling level in state pensions. The average state pension, which in 2005 was equivalent to 52.6 per cent of the average wage, has fallen to 48 per cent.

Merz has vowed to overhaul the so-called Bürgergeld, a basic income for those outside the labour force. While it accounts for just 3.5 per cent of Germany's total welfare payments, it has become a lightning rod for the far right. Introduced by the previous coalition in 2023, it is claimed by 5.5mn people — three-quarters of them deemed able to work — and costs €47bn, according to government data.

Close to 50 per cent of the payments go to foreigners, including €6.3bn to Ukrainian refugees. Critics say the system is too generous and disincentivises work, especially after a 25 per cent increase in monthly allowances during the high-inflation years of 2023-24.

For instance, a non-working couple with two children aged five and 14 can claim €2,754 a month, only €660 less than the amount they would earn if one of the parents took on a full-time job at the minimum wage, according to WSI calculations.

A commission set up by the labour ministry is to outline reform proposals by the end of the year, but Merz has already said he wants to extract €5bn in annual savings from the Bürgergeld.

Many say such a target is unrealistic. "The German constitution only provides a limited scope to cut welfare benefits," said Eckhard Janeba, professor at Mannheim university and chair of the economy ministry's academic advisory council. Any increase in welfare costs automatically leads to an increase in non-wage labour costs for employers. Under German law, employers are obliged to cover half of their employees' insurance contributions.

Since the end of the pandemic, non-wage labour costs have risen at a faster rate than total wages, eating into companies' profits and reducing the room for wage increases.

Total social security contributions, which for decades hovered below 40 per cent of total salaries, have increased to 42.5 per cent this year. They are expected to rise to close to 50 per cent over the next decade, according to IGES, a Berlin-based think-tank. But Germany's bigger structural problem remains its shrinking workforce.

Both encouraging people to work longer and less generous welfare benefits would “improve labour supply, which is hit by the baby boomers’ retirement and low fertility rates in Germany”, said Janeba. Merz’s decision to set up commissions to make proposals raises concerns that he will delay action. “The intentions are there, but we know from past experiences that reforms implemented early in an election cycle are more likely to be successful,” Janeba said.

16.5mn

Number of baby boomers — Germans born between 1954 and 1969 — who are set to retire by 2036

12.5mn

Young workers who will replace them by joining the workforce, leaving a shortfall