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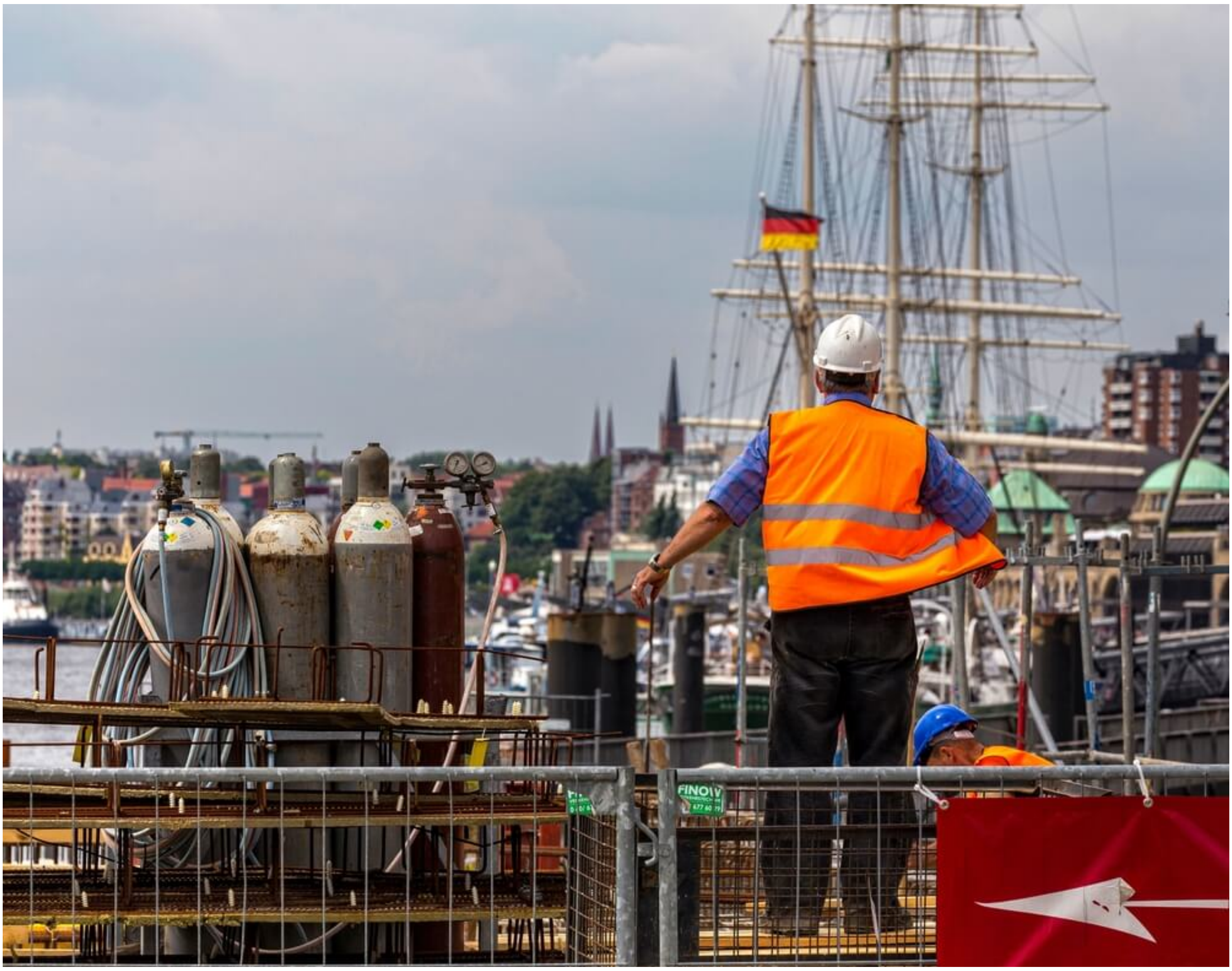
Germany on the brink of fiscal sustainability - can the welfare state survive in its current form?



Every year, Germany spends more than 1.35 trillion euros on pensions, healthcare and social benefits. That is around 31% of its GDP, the highest proportion among the major European economies.

The social contract, which has been in existence for decades, is currently the focal point of political and fiscal discourse.

The question is no longer whether a welfare state is desirable, but whether such a structure is financially viable.

The growing costs of demography

The expenditure structure clearly shows where the problem lies. Pensions and healthcare account for more than half of total expenditure. (The Federal Statistical Office, Destatis, confirms that public spending reached 49.5% of GDP in 2024 — including all government spending, not just social spending.)

A system based on solidarity between the generations is now dependent on transfers from the federal budget because the contributions of the working population no longer cover expenditure.

> The budget must simultaneously cover pensions, healthcare, finance infrastructure, the energy transition, and defence programmes

In the next ten years, around 16.5 million citizens will retire, and only 12.5 million younger people will enter the labour market. The gap between taxpayers and benefit recipients is widening, and the state is already diverting tens of billions of euros each year to close the deficit in its funds.

At the same time, the German economy is slowing down. After stagnating in 2023 and 2024, growth in 2025 is barely above zero. The weaker income growth makes the burden of social transfers even more pronounced.

The budget must simultaneously cover pensions, healthcare, finance infrastructure, the energy transition, and defence programmes. This is not only a fiscal challenge but also a question of priorities.

Labour costs and competitiveness

The growth in social spending has a direct impact on labour costs. Contributions and parafiscal charges already account for a significant proportion of gross wages, which reduces the scope for investment and employment.

Employers warn that the German "tax wedge" - the difference between the total labour costs paid by the employer and the net earnings received by the employee - has become one of the main factors undermining the competitiveness of industry.

High taxes and levies make wages expensive for employers and modest for employees. When rising energy costs and investments in decarbonisation are added to this, German companies lose part of their advantage on the global market.

> The key lies not in cutting individual benefits, but in expanding the base of those who pay

The political debate is also centred on basic social benefits, Bürgergeld. The conservative part of the government claims that high social benefits discourage people from looking for work and create a dependency on state aid.

In contrast, the other political bloc points out that the problem does not lie in the alleged unwillingness of employees to work but rather in the chronic shortage of skilled labour, which Germany cannot compensate for either through immigration or the domestic education system.

Even if individual transfer payments were cut, the overall savings would be small compared to the demographic pressure. The key lies not in cutting individual benefits, but in expanding the base of those who pay.

The options for Berlin

In reality, Germany only has a limited number of instruments at its disposal. Extending working life and providing incentives to keep older people employed could alleviate labour shortages and stabilise the pension system.

Extending compulsory insurance to a larger number of professions, especially liberal professions, would reduce volatility but also open up new future rights, which requires a carefully managed transition.

> Every new service or standard that is included in public funding brings with it obligations that the budget will have to bear for decades to come

The most sensitive point is the indexation of benefits. Pensions have been increased by 3.74% in 2025, which is socially justifiable but fiscally difficult to cope with if productivity and wages do not follow this growth.

The same problem exists in the healthcare system: every new service or standard that is included in public funding brings with it obligations that the budget will have to bear for decades to come.

Political consequences

Chancellor Friedrich Merz and his coalition must make a decision that carries a significant political cost. Major, radical reforms to pensions or the healthcare system could trigger serious public resistance and social unrest.

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It is therefore very likely that Berlin will take the path of gradual solutions. This means that older workers will be incentivised to work longer, that pensions and other benefits will rise more slowly than before, and that part of the burden of funding the welfare system will be shifted from wages and contributions to other taxes, such as excise duty or property tax.

This will not be popular, but it makes fiscal sense. If the burden remains solely on employees and employers, competitiveness will continue to decline.

Shifting part of the burden to consumption or property can maintain the flexibility for employment and investment.

Broader European framework

This debate is not unique. As the largest economy in the EU, Germany has the role of fiscal anchor for the rest of the continent.

If Berlin shows that it cannot control the growth of its own social costs, confidence in European economic policy will be weakened.

Investors not only look at balance sheets but also at the predictability of policy. And predictability means that the rules for financing the welfare state must be clear and stable.

> Every per cent of GDP that flows into increasing social transfers reduces the scope for strategic investments

At the same time, Germany must invest in infrastructure, defence, and energy. Every per cent of GDP that flows into increasing social transfers reduces the scope for strategic investments.

The war in Ukraine and global competitiveness require new allocations of resources, making the sustainability of the social sector a matter of security and industrial power, not just social policy.

The German welfare state can only survive if it adapts to real economic opportunities.

Either Berlin will identify a way to make social spending sustainable, or Germany itself will become an example of how Europe's largest economy is becoming a source of instability for the Union.