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Will the German debt brake be further loosened?

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By partially excluding defense spending from the debt brake and creating a special fund for infrastructure, the German government has already massively increased its fiscal policy leeway. Nevertheless, a commission is meeting for the first time this week to propose a reform and thus, presumably, a further loosening of the debt brake. We discuss what changes are possible and conclude that the federal government's fiscal policy leeway is unlikely to increase significantly.

Debt brake already significantly loosened…

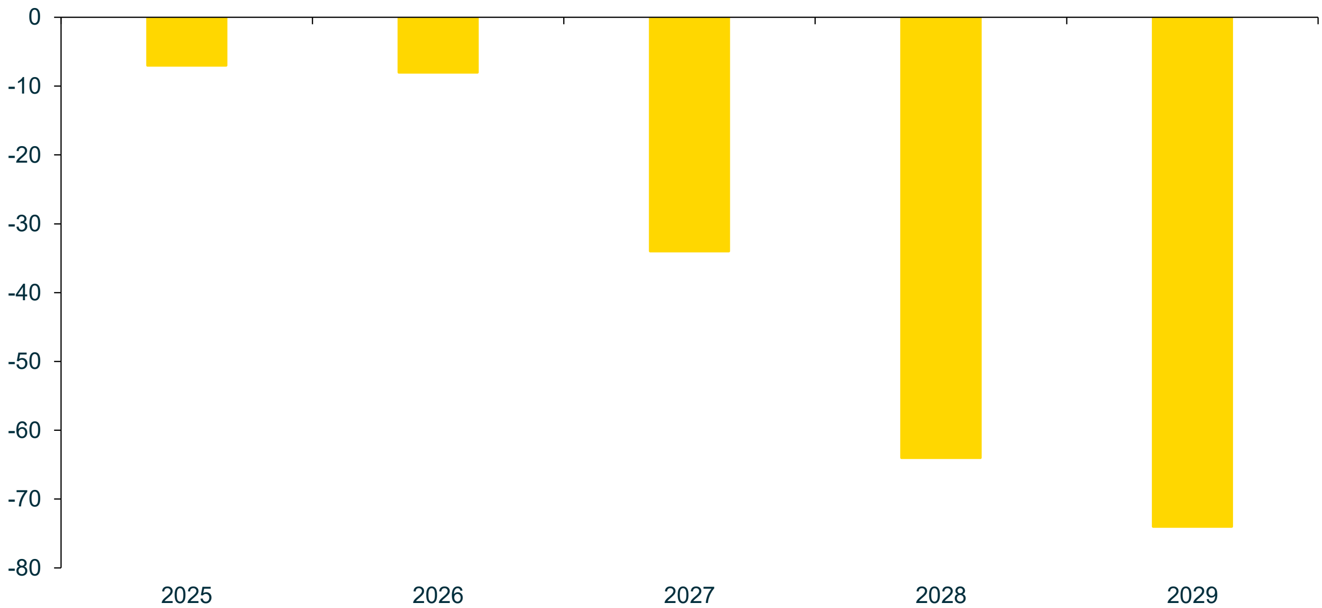
In the spring, the CDU/CSU and SPD, with the support of the Greens, significantly loosened the debt brake enshrined in the German constitution (see also box). Firstly, a special fund for infrastructure investments was approved, through which €500 billion can be raised on the financial market and spent over the next twelve years without this being counted towards the debt brake. Secondly, the portion of defense spending that exceeds 1% of GDP is no longer counted towards the debt brake. These changes will enable the federal government to take on new debt of €174 billion in the coming year, of which only a good €36 billion would have been permitted at the beginning of 2022 – i.e., before the special fund for the Bundeswehr, the German armed forces, was established.

… but still too strict for the government, …

Despite this noticeable de facto loosening of the debt brake, the federal government is in financial straits. This is because the financial plan for the years 2027 to 2029, which was presented a few weeks ago, is obviously very tight. Even in its current form, the debt brake will be stretched to the limit, and the investment ratio in the core budget will be just over 10% in all years, which is just high enough to allow the use of the special fund's resources. Nevertheless, according to the government, in the years 2027-2029 there will be a total shortfall of more than €170 billion (Chart 1).

Important disclosure and analyst certification (AC) at end of document

Chart 1 - Huge holes in the financial planning of the German government
Undetermined additional spending cuts and undetermined additional revenues in the federal budgets for 2025 and 2026 as well as in the financial planning until 2029, in bn Euro



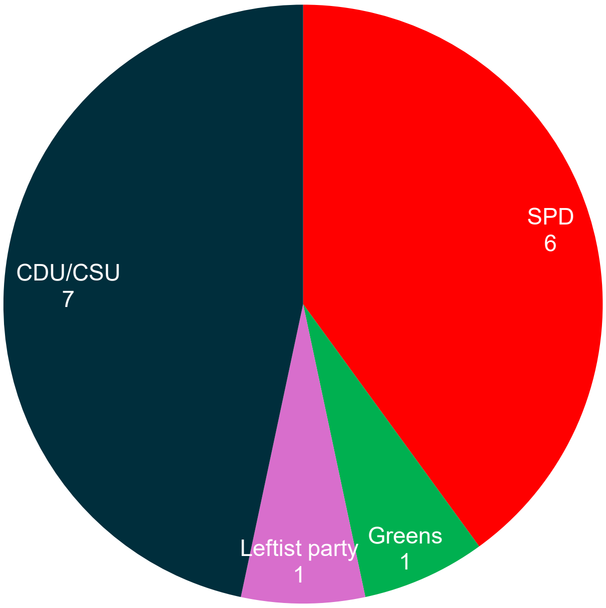
Source: Federal government, media reports, Commerzbank Research

… which is why the debt brake is now to be officially loosened

Against this backdrop, it comes as no surprise that the government is pushing ahead with the reform of the debt brake already agreed in the coalition agreement. According to media reports this week a commission will begin work and is expected to present proposals for changes to the debt brake by mid-November. According to the coalition agreement, this reform is to be implemented by the end of the year, although most recently there has been talk of March next year.

The composition of the commission suggests that its proposals will aim to further loosen the debt brake. This is because the members nominated by the SPD, the Greens, and the Left Party will together have a majority in the commission (Chart 2), and these parties are calling for further relaxation. However, there is likely to be resistance to further loosening of the rule from the ranks of some members proposed by the CDU and CSU.

Chart 2 - Majority likely to support further easing of debt brake
Number of members of the commission for reforming the debt brake proposed by each party



Source: Federal finance ministry, Commerzbank Research

It remains to be seen whether the “camps” in the commission can agree on proposals. If so, these are likely to be rather moderate. However, it cannot be ruled out that those in favor of relaxation will use their narrow majority to write far-reaching changes into the final document.

However, the commission's report will not be a preliminary decision on the upcoming changes. This is because some of them may require a two-thirds majority in the Bundestag and Bundesrat for implementation. If the government does not want to be dependent on AfD votes, it must win the support of the Greens and the Left Party. However, it is questionable whether the CDU and CSU are ready to negotiate with the Left Party and, if so, whether such negotiations would ultimately lead to a result.

Even more investment...

According to the press release announcing the members of the commission, the commission is to propose changes that “enable additional long-term investment in strengthening the German economy beyond the term of the special fund for infrastructure and climate neutrality, while at the same time ensuring the sustainable development of public finances.”

In view of this mandate, it would make sense to treat investments differently under the debt brake. There are repeated proposals to exclude the relevant expenditure from the debt brake. This would obviously give the government additional scope for spending as well on investments as on other purposes. However, such a change is likely to meet with resistance from the Greens. When the special fund was set up in March, they insisted that only “additional” investments could be financed from the special fund. At their insistence, it was therefore included in the constitution that the funds from the special fund may only be used if at least 10% of the core budget expenditure – i.e., the federal budget without the various special funds – is spent on investments.

... hardly possible at first

One solution would be to treat investments in the future in a similar way to defense spending, i.e., to exclude from the debt brake all investments financed from the core budget that exceed an investment ratio of 10%. However, this would hardly enable more investments. This is because it is already questionable whether the investments currently planned for the coming years and financed by the special fund can be implemented as planned. And if even more investments were actually possible, the funds from the special fund could also be drawn down earlier. Consequently, such a change to the debt brake would only make it easier for the federal government to finance investments once the financial leeway provided by the special fund has been exhausted. However, this will only be the case in the next decade. Thus, although such a proposal would fulfill the commission's mandate, it would not change the gaps in the financial planning for the years 2027 to 2029.

A general loosening of the debt brake ...

This would require a general relaxation of the debt brake, i.e., the federal government would be allowed to incur higher new debt in general. Currently, the federal budget and – since March – the state budgets are each allowed to have a cyclically adjusted deficit of 0.35%. These upper limits could be raised. However, such a measure would very obviously be aimed primarily at making life easier for the government, which is likely to be received negatively by those parts of the CDU and CSU that were already critical of the relaxation of the debt brake in the spring, and it is questionable whether the chancellor will risk such a conflict within his government.

... or at least a postponement of the repayment of emergency loans?

The pressure to consolidate would be somewhat reduced if the “emergency loans” taken out during the pandemic and the energy crisis, as well as the loans taken out for the Bundeswehr special fund, were repaid later. According to the current planning, this is to happen from 2028 or 2031 at the latest. This would burden the federal budget with a good €9 billion from 2028 and slightly more than €14 billion from 2031 at the latest (Chart 3) [1].

Since the constitution only stipulates that the emergency loans must be repaid “within a reasonable period of time” and this “reasonable” is not defined in more detail, postponing repayment would at least not obviously violate its provisions. For a later repayment of the debts of the Bundeswehr special fund, the corresponding implementing law would have to be amended, for which a simple majority in the Bundestag would suffice. However, it is not certain whether such a postponement would withstand scrutiny by the Federal Constitutional Court, not least because there would be a risk that the repayment would never ultimately take place.

Reform will hardly solve the government's financial problems

Bottom line: Contrary to what some politicians may have hoped, the financial problems looming in the coming years are unlikely to be solved or even significantly alleviated by loosening the debt brake. Public finances will therefore remain a constant source of conflict within the governing coalition.

This is all the more true given that the government is already stretching EU rules to the limit with the fiscal policy it has already adopted. The federal government may hope that the EU Commission will be very “flexible” in its interpretation of these rules. However, many eurozone countries, which currently have to reduce their deficits because of these rules, would certainly interpret a further relaxation of Germany's already expansionary fiscal policy as a signal to be less ambitious in their efforts, which would further accelerate the rise in the already high level of government debt in the eurozone.

Box: The German debt brake

The principles of the debt brake are laid down in Articles 109 and 115 of the German constitution. In principle, it consists of two rules:

1. Federal government spending may not exceed its revenue by more than 0.35% of GDP, with this upper limit decreasing or increasing depending on the economic situation. Revenue and expenditure do not take into account the effects of “financial

transactions," i.e., expenditure on the acquisition or revenue from the sale of assets. Since the amendment to the constitution in March of this year, the federal states are also allowed to run a deficit of 0.35% of GDP, adjusted for economic effects.

2. In "emergency situations," the Bundestag may suspend the debt brake. However, the additional debt incurred in this way must be repaid within a "reasonable" period of time.

In addition, there are various regulations that have been laid down either in the Debt Brake Act or by statutory order.

In spring 2022 and March of this year, two special funds were created through which loans can be taken out that are not counted toward the debt brake. Loans of up to €100 billion can be taken out through the Bundeswehr special fund, and loans of up to €500 billion can be taken out through the Infrastructure and Climate Neutrality special fund. In addition, last spring, it was enshrined in the constitution that (broadly defined) defense spending would only be counted toward the debt brake up to a level of 1% of gross domestic product. (back to text)

[1] According to the current decision, 9.2 billion euros of emergency loans taken out directly from the federal budget will be repaid each year from 2028 (until 2058). From 2031 (until 2061), an additional €1.7 billion per year will be added for the repayment of loans taken out via the Economic Stabilization Fund for Energy (WSF-E). In addition, according to the relevant law, the loans taken out for the Bundeswehr special fund are to be repaid within a "reasonable period" from 2031 at the latest. We assume that these repayments will be made as late as possible and – as with the "emergency loans" – spread over 31 years, resulting in additional repayments of €3.2 billion per year from 2031 onwards. From 2044, according to the draft implementation law, the loans taken out via the special fund for infrastructure investments must also be repaid, but this is unlikely to be a concern for the current federal government. (back to text)

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