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Economic Insight

# German debt illusions

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**An economy operating at full capacity can only invest more in armaments and infrastructure if it produces less of other goods. More public debt will not alter this.**

In the next ten years, the barely operational German armed forces and the dilapidated public infrastructure will receive the enormous sum of more than 1,000 billion euros. The government should finance such core tasks not with new debt but by cutting spending or by raising taxes. Investment in armaments and infrastructure would then come at the expense of public or private consumption.

## **If armaments and infrastructure are financed on credit, ...**

However, German politicians are reluctant to prioritize spending. They prefer to maintain the illusion that it is possible to invest more in investment in armaments and infrastructure without cutting spending in other areas. That is why they want to finance both almost entirely on credit – the infrastructure through an off-budget vehicle (“special fund”) and the armament by exempting defense spending above one percent of GDP from the constitutional debt brake.

## **... an artificially inflated demand hits...**

If the government doesn't want to buy all weapons in the US, it has to buy a lot of them in Germany or in other European countries. This is even more true for the renovation of schools, roads and bridges. But then a debt-financed increase in demand would hit economies that are already operating at full capacity. This is because despite the weak economy, skilled labor is still in short supply and in the coming years the working-age population is set to fall significantly.

## **... a highly utilized economy...**

If, in this situation, defense and construction companies demand a massive increase in the number of workers, labor will become even scarcer, wages and prices will rise, and inflation will increase. Because the two sectors will be flooded with public contracts in the coming years and will be able to pay high wages, they will attract the workers they need from other sectors, which will then be able to produce fewer goods.

## **... and inflation ultimately crowds out consumption**

Debt financing does not change the fact that an economy that is already operating at full capacity can only invest more in armaments and infrastructure if the production of other goods is cut back. It is an illusion to believe that credit financing can eliminate the scarcity of resources. But the attempt has considerable side effects: the resulting inflation increases uncertainty and reduces investment by other companies. In addition,

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low-income citizens suffer more from inflation, and the higher public debt burdens future generations, who have to pay higher taxes to cover rising interest payments.

All in all, the government should not refrain from cutting back on consumption – for example, on social transfers, the bloated federal administration or on subsidies for climate protection, which would be much cheaper with CO2 prices. In any case, infrastructure spending should not be shifted from the regular to a special budget in order to finance even more consumption.



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