Will the German fiscal package fizzle out?

The lack of reforms and weak economic data have recently raised doubts that the German government's financial package will significantly boost the economy in the coming year. However, based on the planned measures, we still expect a considerable fiscal stimulus of almost 1% of GDP in 2026. Downside risks to the 2026 growth forecast of 1.4% are only due to the fact that the recent weak economic data could lower the starting point for the forecast.

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So far, economists are expecting strong growth for 2026, ...

At the beginning of March, the future coalition partners, the CDU/CSU and SPD, agreed to exempt defense spending of more than 1% of GDP from the restrictions of the constitutional debt brake and to set up a extra-budgetary fund of €500 billion, primarily for investments in infrastructure. CDU leader Merz alluded to Mario Draghi's “whatever it takes” statement. As a result, most economists revised their growth forecasts for 2026 upward. They now expect a growth rate of 1.2% for the coming year.

... but question marks have recently appeared

But question marks have recently appeared. During the summer, it became increasingly clear how different the CDU/CSU and SPD's ideas on economic policy are. The SPD brought tax increases into the discussion, even though the coalition agreement rules these out and provides for gradually lower corporate taxes from 2028 onwards. There is little sign of the promised "autumn of reforms", meaning that massive additional government spending is unlikely to be accompanied by higher trend growth.

In addition, key economic data has recently been disappointing. After several consecutive increases, the Ifo business climate index fell unexpectedly in September. Furthermore, order intake, adjusted for big ticket orders, slumped by more than 3% in August, meaning that at best it can be described as moving sideways at a low level. The massive decline in industrial production also caused a stir, even though this was partly due to an unusually high number of factory holidays in the automotive industry in August.

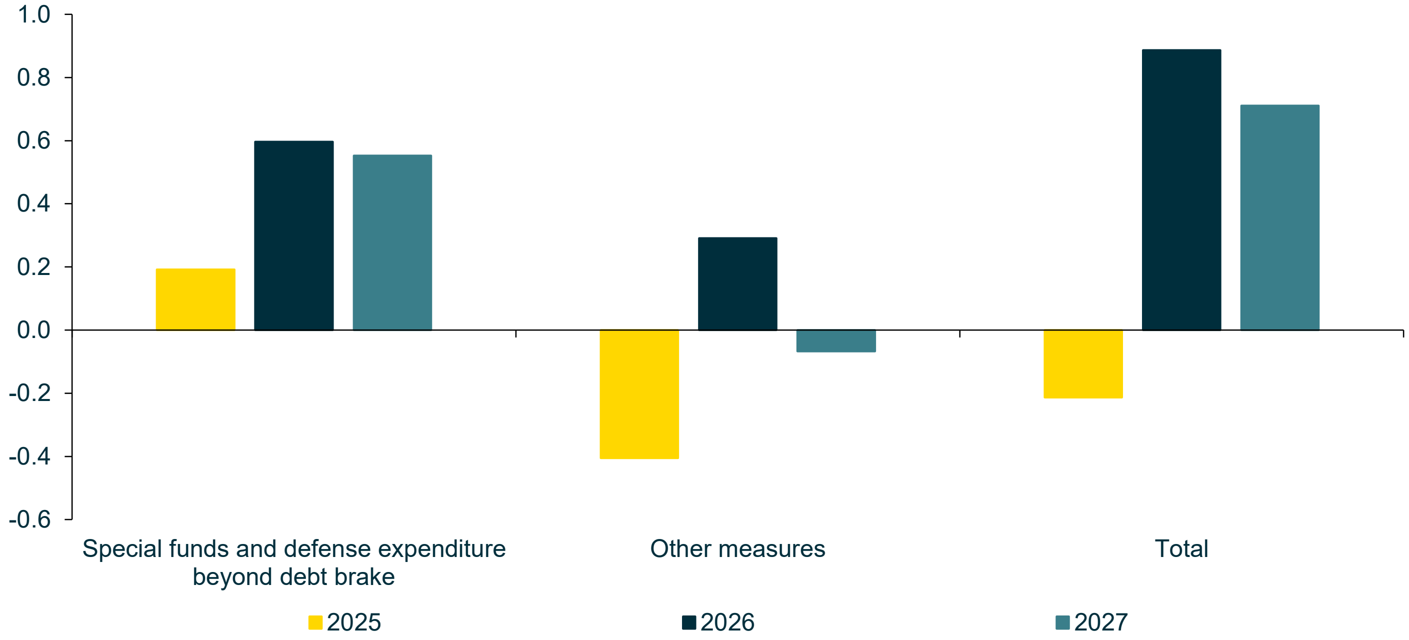
Fiscal policy has actually dampened growth this year...

As a result, the economy has recently been weaker than previously assumed. However, this does not contradict the expectation that a more expansionary fiscal policy will boost the economy. After all, the budget for 2025 and the law on the extra-budgetary fund only came into force at the beginning of October. The economic data available so far, at best for September, cannot yet have responded positively.

Rather, fiscal policy has had a slightly restrictive effect so far this year. This is because of higher social security contributions, the elimination of inflation-related special payments – companies were able to pay their employees up to €3,000 tax- and social security-free until the end of 2024 – and numerous other measures. Private households and companies were burdened with a net total of €17 billion, according to calculations by the **joint diagnosis of the economic research institutes**, which corresponds to around 0.4% of GDP (Chart 1). In addition, the long-standing lack of a federal budget led to “provisional budget management,” which further curbed federal spending this year.

Chart 1 - Fiscal policy will give growth a boost starting in 2026

Impact (+) and relief (-) on the general government budget from fiscal policy measures in the respective years, in billion euros, estimates from the joint economic forecast by economic research institutes



Source: Joint diagnosis of the German economic research institutes, Commerzbank Research

… but in 2026 it will boost the economy

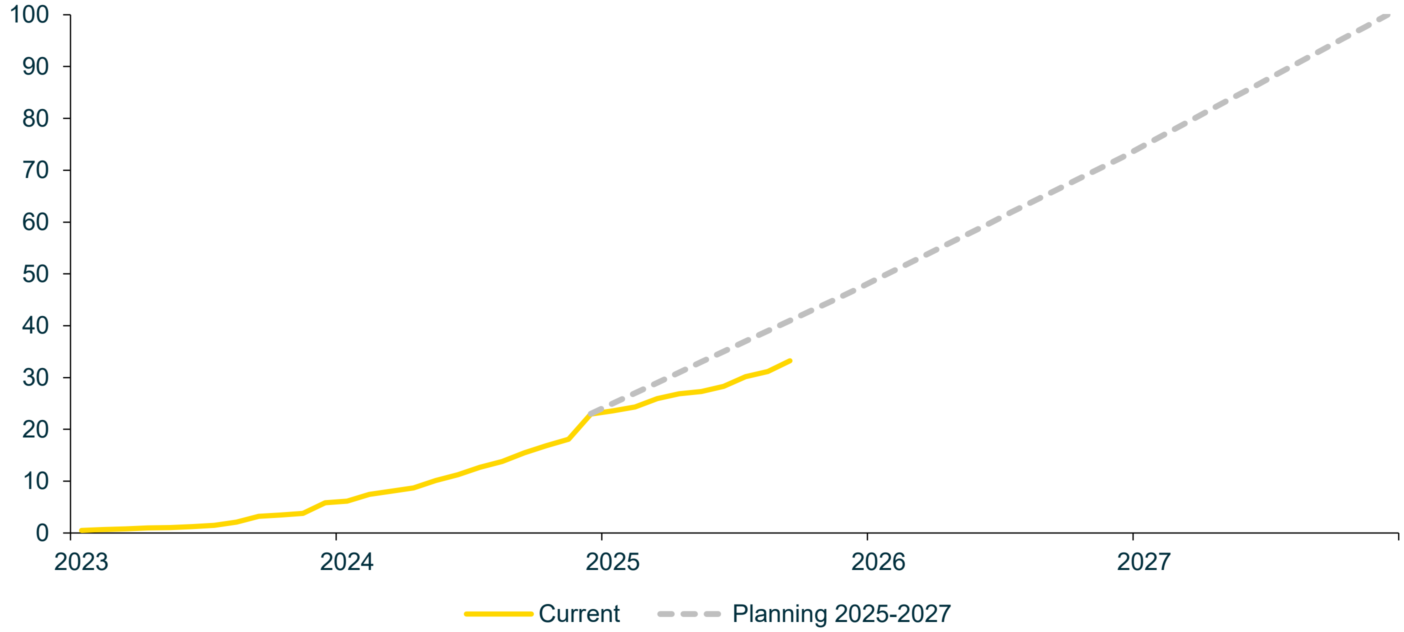
This is likely to change next year at the latest. Unlike this year, the legislative changes will boost the economy on balance. The biggest positive items are the "Tax Development Act" initiated by the traffic light coalition, which, among other things, compensates for bracket creep, the improved depreciation conditions of the "investment booster", the lower VAT in the hospitality industry, and relief on grid fees.[1] These and other measures will relieve the private sector by a net total of €10 billion, which, compared to the burden of around €17 billion this year, represents a swing of a good €27 billion or 0.65% of GDP. With the end of "provisional budget management," the swing could be even greater.

In addition, there are likely to be additional expenditures for defense and infrastructure in 2026 from the extra-budgetary fund, which is now operational. According to the draft budget, the deficit in 2026 will be almost €125 billion higher than in 2024, mainly due to the exemption of part of defense spending from the debt brake and initial expenditures from the extra-budgetary fund, representing almost 3% of GDP. In fact, expenditures will probably rise less sharply in 2026. This is supported by bottlenecks at the relevant companies and the lengthy planning and approval processes, as indicated by the hesitant use of funds from the Bundeswehr special fund this year (Chart 2).

We have based our calculations on the joint diagnosis of the economic research institutes and expect spending on defense and infrastructure to increase by just under €26 billion in 2026. This would correspond to 0.6% of GDP.

Chart 2 - Extra-budgetary funds for the German Armed Forces are only being disbursed slowly

Aggregated defense spending, which was financed from the extra-budgetary fund for the German Armed Forces; dashed line: development according to the federal budget for 2025 and 2026 and financial planning for 2027



Source: German federal government, German Finanzagentur, Commerzbank Research

Combining higher spending on defense and infrastructure with additional expenditures resulting from legislative changes, the total fiscal stimulus for the coming year amounts to approximately 0.8% of GDP. Given a burden of 0.2% this year, this suggests that economic growth in 2026 will be around 1 percentage point higher than in 2025.[2]

The fact that the fiscal stimulus is so high is also due to the fact that the federal government has shifted a considerable amount of investment spending from the core budget to the extra-budgetary fund in the budgets for 2025 and 2026. In addition, part of the defense spending is no longer subject to the debt brake. Together, these two factors considerably increase the federal government's financial leeway in 2026. It can quickly increase other expenditures, which is not so easy in the areas of infrastructure and defense. This will help the economy in 2026 and 2027, even if the long-term growth outlook is weakened when investments are partially replaced by consumer spending.

Conclusion: Substantial pick up in growth

All in all, the fiscal stimulus is likely to be quite high in the coming year, at around 1% of GDP. The halving of the ECB deposit rate to 2.0%, which is below the neutral level that we see at just under 3%, also points to higher growth. If we nevertheless see certain downside risks for our 2026 forecast of 1.4%, it is only because of the recent weaker economic data, which could lower the starting point for the coming year. The picture will become clearer next Thursday when the Federal Statistical Office publishes GDP for the third quarter and possibly revises previous quarters.

[1] Some of these relief measures, such as the lower VAT rate for the hospitality industry, have not yet been finalized, as the federal and state governments are still debating how to distribute the associated costs among public budgets. However, we assume that they will ultimately come into effect on January 1 as planned. (back to text)

[2] This does not include possible changes in the states, which are now allowed to have a structural deficit of 0.35% of GDP and will also receive a good €8 billion each year from the extra-budgetary fund for infrastructure. In some cases, this should spare the states – and the municipalities, to which the states are to pass on at least part of the funds from the extra-budgetary fund – otherwise necessary consolidation measures, but at least part of it is likely to flow into additional spending or tax cuts, thereby also boosting the economy. (back to text)

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