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Economic Insight

What happens to the debt brake?

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The debt brake anchored in the German constitution was one of the major points of contention in the former ruling coalition. The next federal government is likely to relax it. We discuss options for reform. These, however, are unlikely to end the dispute.[1]

Debt brake: a guarantee for stable public finances or a brake on growth?

The debt brake, which has been part of the German constitution for 15 years (see also box), is one of the major points of contention in federal politics. While some praise it as a guarantee for stable public finances, others see it as a brake on growth, as it would prevent urgently needed public investments. It is not coincedental that the Chancellor's ultimate demand to his Finance Minister to suspend the debt brake for the coming year (and the later's refusal to do so) sealed the end of the governing coalition of SPD, Greens and Liberals (FDP).

Little room for maneuver in fiscal policy …

One thing is clear: the debt brake noticeably restricts the scope for fiscal policy. This was less noticeable before the pandemic, as the state benefited from a flourishing economy and, in particular, falling interest rates. As a result, both additional spending on social policy and compliance with the debt brake were easily possible at the same time.

Since the end of the zero interest rate policy at the latest, this is no longer possible. In addition, it has become clear that infrastructure and the German armed forces have been disastrously neglected for a long time, meaning that significantly higher expenditure is required here. Politicians must therefore set clear priorities for additional expenditure in order to comply with the upper limit for new borrowing set by the debt brake.

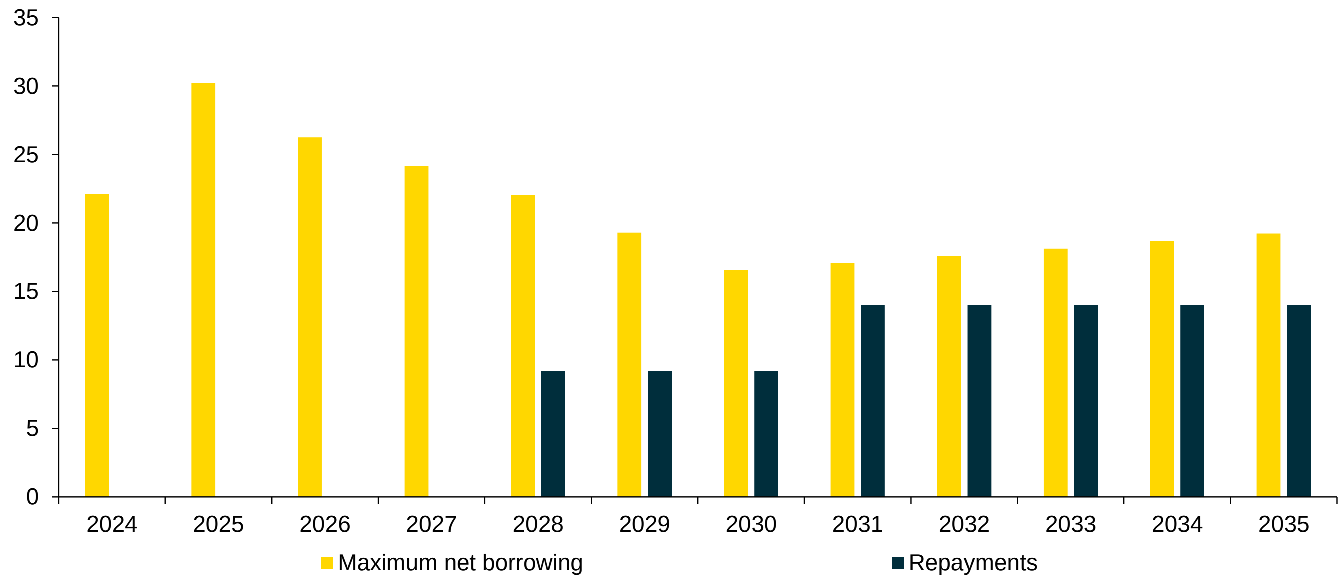
… fuels discussion about easing

Since the coalition fell apart, hardly a week had gone by without calls for a reform or even the abolition of the debt brake in order to enable the financing of additional expenditure deemed necessary through new debt. These demands were heard particularly frequently from representatives of the Greens, the SPD and the Left Party. These parties also officially advocate a relaxation of the debt brake. After rejecting changes to the debt brake for a long time, the candidate of the Christian Democrats (CDU) and their Bavarian sister party CSU for chancellor recently also showed himself to be open to this if it would enable additional investment. At the state level, there had already been many supporters of a relaxation within the CDU. Alongside the AfD, which will almost certainly not be a member of the next governing coalition, only the FDP has so far categorically rejected a change to the debt brake.

Pressure will increase ...

However, as the FDP will probably not be part of the next coalition, at least based on the current poll results, there is much to suggest that the debt brake will be changed in the coming legislative period. The necessary 2/3 majority is also likely to be found for this, not least because the scope for financial policy will continue to shrink in the coming years as long as the current legal status will not have been changed. According to the current planning, the "emergency loans" taken out during the pandemic and the energy crisis are to be repaid from 2028, and from 2031 the debts of the Bundeswehr Special Fund will also have to be repaid (Chart 1) [2]. As a consequence, without a change to the debt brake, the federal government will hardly be able to take on any new debt on balance from 2031 onwards in a normal economic situation [3].

Chart 1 - Repayment of emergency loans reducing leeway for fiscal policy
Maximum net borrowing permitted by the debt brake based on the Federal Government's potential estimate and the Commerzbank growth forecast, normal capacity utilization from 2030; repayments for emergency loans and Bundeswehr special funds, in EUR billion



Source: Federal ministry for finance, Commerzbank Research

At the same time, there will be additional burdens on the federal budget: the special fund for the Bundeswehr is likely to be exhausted by 2028 at the latest, meaning that the federal budget will have to cover the part of defense spending financed in this way up to that point if Germany wants to continue to spend 2% of its GDP on defense, as agreed in NATO. To achieve this, the expenditure financed via the federal budget in 2028 would have to be around 100 billion euros, almost twice as high as currently planned for 2027 – the last year in the last valid financial plan – at just under 52 billion euros. In addition, the federal government's contributions to statutory pension insurance are also likely to increase massively during this period without a thorough pension reform. Finally, according to the current legal situation, the EU will probably have to repay the debt taken on to finance the "reconstruction fund" from its budget from the end of the 2020s, which means that the EU contributions of the member states are likely to increase.

… and pave the way for a "reform" of the debt brake

In order to finance this additional expenditure while complying with the debt brake, a strict prioritization of expenditure and a far-reaching reform of the statutory pension insurance and social security system would be necessary. However, this would require numerous unpopular decisions and it is questionable whether the next federal government will have the political strength to do this. This is all the more true as, according to current polls, the SPD or the Greens will be part of the next German government. Both have been pushing for a relaxation of the debt brake for some time. The CDU and CSU are unlikely to allow a coalition to fail over this issue, especially as there are increasing signals in this direction from them too, as mentioned above.

… and pave the way for a "reform" of the debt brake

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What changes would be conceivable?

There is therefore much to suggest that there will be some changes to the debt brake next year. There are various options:

(1) A different way of calculating the cyclical component

The hurdles for a measure that was already envisaged in the coalition agreement of the coalition, that has now fallen apart, are comparatively low – at least at first glance – namely a change to the procedure by which the cyclical component of the maximum permitted net borrowing is determined (in addition to the "structural" component of 0.35% of GDP).[5] This is because – in contrast to most other proposals for a reform of the debt brake – no amendment to the constitution and therefore no 2/3 majority in the Bundestag and Bundesrat is required for this. Rather, according to the law on the debt brake, an agreement between the Ministry of Finance and the Ministry of Economics is sufficient.

Although such an amendment has also been advocated in the meantime by the Finance Minister and thus the Liberals, it has not been implemented. We can only speculate as to the reasons for this. In addition, such a reform would not increase the scope for fiscal policy in general, but only in individual years. Over a longer period of time, the differences are likely to largely even out. Consequently, this revision is unlikely to take the pressure off fiscal policy.

(2) Postponing the repayment of emergency loans (forever?)

The pressure to consolidate would be reduced somewhat if the repayment of emergency loans were postponed. The former Federal Minister of Finance had brought this up for discussion in the event that the debt ratio of currently just under 64% falls below the upper limit of 60% set in the Maastricht Treaty.

As the constitution only stipulates that repayment must be made "within a reasonable period of time" and this "reasonable" is not defined in more detail, this would at least not obviously violate its provisions. However, it is not certain whether such a postponement of redemption would stand up to scrutiny by the Federal Constitutional Court, partly because there would be a risk that redemption would never take place in the end. In addition, such a measure would not solve the massive budget problems looming from 2028, but would at best alleviate them. This is because the scope for fiscal policy would not increase compared to the current situation.

(3) An increase in the structural component

It is also frequently suggested that the federal government should generally be allowed to take on more new debt by increasing the structural component, which currently corresponds to 0.35% of GDP. Some people point out that the recently revised deficit rules at European level allow a structural deficit of 1.5% of GDP. If this value were to be adopted, around EUR 50 billion in additional debt could be taken on in the coming year.

However, this additional leeway is unlikely to benefit the federal government alone. This is because the states would have to approve the necessary amendment to the constitution in the Bundesrat with a 2/3 majority. As a price for this, they would certainly demand that they receive at least part of this additional leeway. After all, the debt brake currently requires them to have a structurally balanced budget, i.e. a structural component of zero.

(4) Special treatment of investments

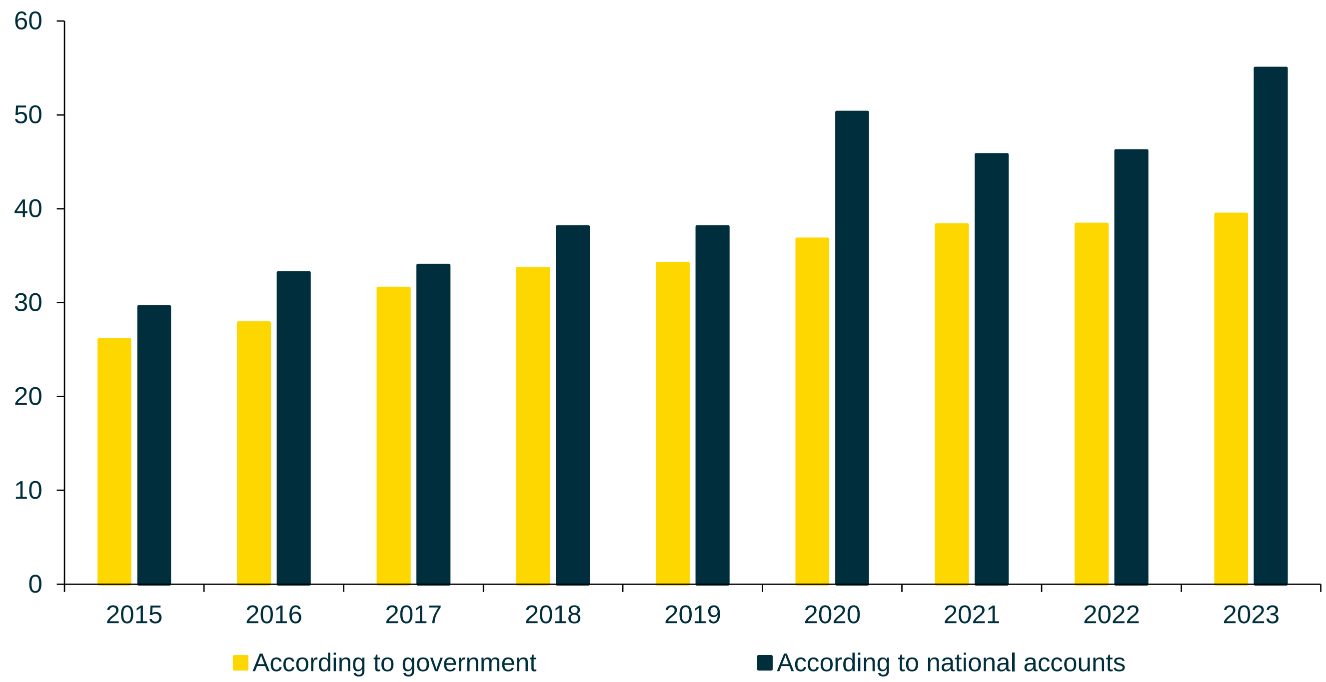
Another proposal that is heard time and again is to create further "special funds" by amending the constitution, for which the debt brake – as with special fund for the German armed forces – does not apply. Volumes of EUR 500 billion or more are mentioned, which could be used to pay for investments in infrastructure, digitalization and the decarbonization of the economy or additional expenditure for the Bundeswehr.

However, it is more likely that expenditure for certain (or all) investments will continue to be covered by the federal budget in future, but that this will not be taken into account when calculating the net borrowing relevant to the debt brake. Such a change would increase the scope for new debt in two ways. Firstly, unlimited additional loans could be taken out for additional investments. Secondly, if the upper limit for new structural debt were not lowered at the same time from the current 0.35% of GDP, the budget funds currently used for investments could be used for other expenditure.

How large the funds "freed up" by this would be depends on various factors. One of the most important is the definition of "investments". The "investment expenditure" reported in the federal budget does not correspond to the definition in the national accounts. For example, the provisional result for the 2023 federal budget shows investment expenditure of €55 billion, while the national accounts only show €38 billion, and compared to the period before the pandemic, investment expenditure according to the government's definition has increased significantly more than the national accounts figures (Chart 2). This can be explained to a considerable extent by the fact that the federal budget – in contrast to the national accounts – also counts many grants for investment projects by the states, municipalities or private individuals as investments. Overall, there would of course be an incentive for politicians to treat further expenditure as investment. After all, there is always talk of *investment* in education and *investment* in social cohesion. Many people are also likely to see spending on the Bundeswehr as an investment in security. If such an amendment to the debt brake does not clearly define the concept of investment in the constitution, the debt brake would largely lose its effect.[6]

Chart 2 - Budget figures show a stronger increase in investments than national accounts

Public inverdstment on the federal level according to the budget figures and the national accounts, in billion Euro



Source: Federal ministry for Finance, Destatis, Commerzbank Research

It would also be important to determine whether total (gross) investment or only net investment (i.e. less depreciation) should be deducted from the deficit.[7] After all, gross investment in recent years has corresponded to between 0.8% and 1.1% of GDP (i.e. currently around EUR 32 to 44 billion) on the basis of national accounts figures, while net investment by the federal government since reunification has corresponded to less than 0.3% of GDP (i.e. EUR 12 billion) (Chart 3). [8] Particularly when net investments are taken into account, the additional scope for additional non-investment spending is therefore likely to be significantly lower than some advocates of this change would probably hope for. For this reason, such a change to the debt brake is unlikely to end the discussion about relaxing it unless the concept of investment is interpreted very generally at the same time.

Chart 3 - Federal govenment reduced share of public investments on GDP

Public investment on the federal level, in percent of GDP

European regulations argue against a major relaxation of fiscal policy

However, even if the debt brake were to be relaxed to a large extent, the rules at European level would present a further obstacle to the noticeable relaxation of fiscal policy that many are calling for. Following their final revision in the spring, these rules stipulate that member states must limit their structural budget deficit to 1.5% of gross domestic product in the medium term and further reduce their debt ratio. In principle, investments are treated no differently to consumer spending.

The new German government may hope that the EU Commission will be very “flexible” in its interpretation of these rules. However, many euro countries, which currently have to reduce their deficits because of these rules, would certainly interpret a significant relaxation of German fiscal policy as a signal to show less ambition in these efforts. As a consequence, the rise in the already high level of public debt in the eurozone would probably speed up further.

Box: The debt brake

The foundations of the debt brake are laid down in Articles 109 and 115 of the German constitution. It consists of two regulations:

- Federal government expenditure may not exceed its revenue by more than 0.35% of GDP, with this upper limit decreasing or increasing depending on the cyclical situation. The effects of "financial transactions", i.e. expenditure from the acquisition or income from the sale of assets, are not taken into account in revenue and expenditure. Adjusted for the cyclical effect, the states may not incur any new debt at all.
- In "emergency situations", the Bundestag may suspend the debt brake. However, the additional debt incurred in this case must be repaid within a "reasonable" period of time.

In addition, there are various regulations that have been laid down either in the law on the debt brake [9] or by statutory order. (back to text)

[1] This Economic Insight is an update of a publication from April 2024 entitled “Debt brake as a bone of contention”. (back to text)

[2] According to the current planning, 9.2 billion of the emergency loans taken out directly via the federal budget are to be repaid each year from 2028 (until 2058). From 2031 (until 2061), an additional EUR 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, the loans taken out for the Bundeswehr Special Fund are to be repaid within a “reasonable period of time” from 2031 at the latest, according to the corresponding law. We assume that these repayments will be made as late as possible and – as with the “emergency loans” – will be spread over 31 years, resulting in further repayments of EUR 3.2 billion per year from 2031. (back to text)

[3] When calculating the maximum permissible net borrowing (NKA), the repayment obligations existing in the respective year are deducted. (back to text)

[4] A relaxation would only really be called into question if the FDP, its staunchest opponent, were once again part of the governing coalition, as defending the debt brake has now become a kind of trademark of the party, which it would hardly want to give up. However, the current polls speak against the party's renewed participation in government. (back to text)

[5] In this procedure, the economy's production potential is estimated first. If this is below the GDP, the economy is operating at above-average capacity so that lower net borrowing is permitted. If the GDP is below potential, additional new debt is permitted. The exact amount of the cyclical component is then calculated by multiplying the (expected) deviation in GDP and the so-called “budget elasticity”. This is currently set at 0.203, meaning that a 1 billion increase in gross domestic product reduces the upper limit for new borrowing by EUR 203 million. This value is also likely to be reviewed when the procedure is revised. (back to text)

[6] The Scientific Advisory Council to the Federal Ministry of Economics proposes the establishment of an “independent expert committee” for this purpose. However, it is questionable whether this could prevent a “creative interpretation” of the concept of investment in the long term. (back to text)

[7] Excluding all gross investments would bring us back closer to the regulation before the introduction of the debt brake. At that time, Article 115 of the constitution stipulated: “Revenues from loans may not exceed the sum of the budgeted expenditure for investments.” (back to text)

[8] The figures for depreciation used in such a calculation would be somewhat lower if they were calculated on the basis of purchase prices, as is customary in corporate accounting. In contrast, depreciation in the national accounts is calculated on the basis of the – usually higher – replacement costs. The additional scope for financial policy resulting from such a change would therefore be somewhat greater than shown here, although the differences are likely to be limited. (back to text)

[9] See **here** (only in German). (back to text)

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