



Economic Insight

How to finance higher defense spending?

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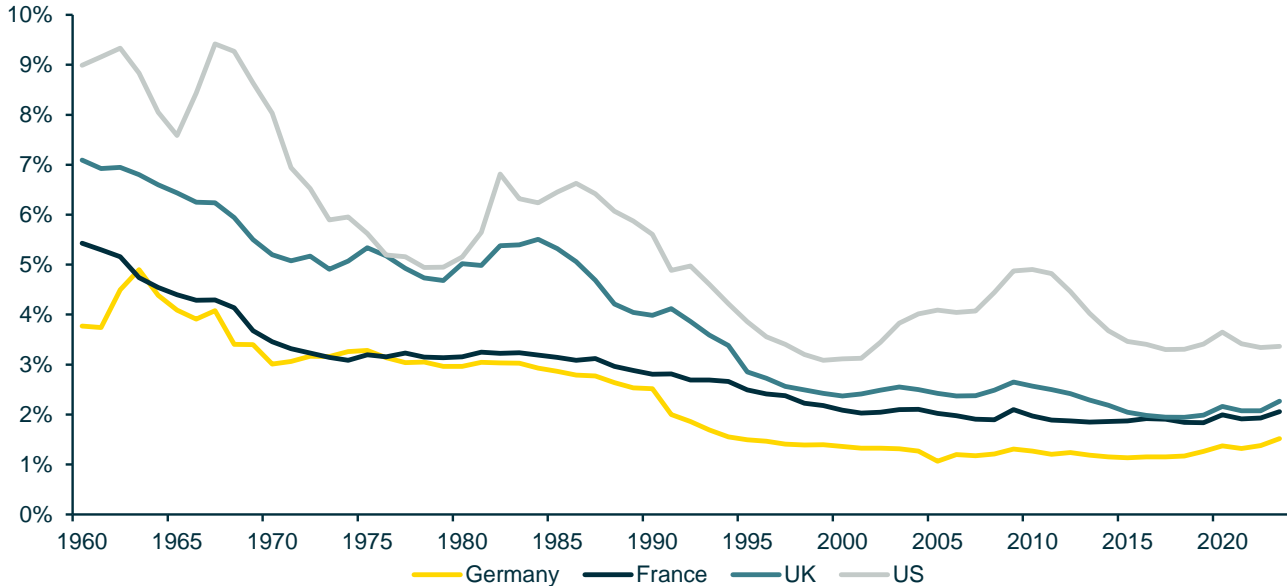
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Donald Trump is taking office today and has called for NATO countries to spend 5% of their GDP on defence. Even reaching 4% would be a major challenge – the scope of which most Germans do not understand. We have analysed the various options to finance higher defense spending.

Defence spending at the level demanded by Trump is not out of this world. On average, Germany spent 4% of its GDP on defence in the 1960s. Poland already achieves this ratio today (Chart 1).

Chart 1 - The West used to spend much more on defense

Defense expenditures in % of GDP



Source: SIPRI, Commerzbank Research

But Poland's economy is growing by around 3% a year after adjusting for inflation, and Germany even reached 4.4% in the 1960s. This helps to increase defence spending. Because if GDP grows faster than consumer prices, civilian government (i.e. non military)





spending can be increased in line with inflation and the remaining additional tax revenues can be used for national defence. This would be politically more feasible.

Today, Germany's growth is far too low

But Germany is only likely to grow by an average 0.5% in the coming years. It would then take 20 years for defence spending to reach 4% of GDP. In view of the military threat, such a delay would be irresponsible.

More defense spending can not be entirely financed by savings

Savings must therefore be made in other areas of the budget. But in order to close the gap solely through savings, federal civilian spending would have to be cut by almost 20% over the next 4 years. It is true that there is potential for savings in the area of social spending and in the overstuffed federal authorities, and a lot of money could also be saved in climate policy if the state was to focus on more efficient CO₂ pricing than on expensive subsidies. However, the additional expenditure on defence could not realistically be fully financed by savings.

Higher debt ...

Many are therefore calling for more debt. But if the additional military spending was financed entirely with debt, the general government budget deficit would rise from the current 2% to an estimated 4% of GDP. The European debt rules would be violated, as would Germany's constitutional debt brake, especially as core state tasks such as national defence should in the long run be included in the regular budget – and not financed through shadow funds as currently done.

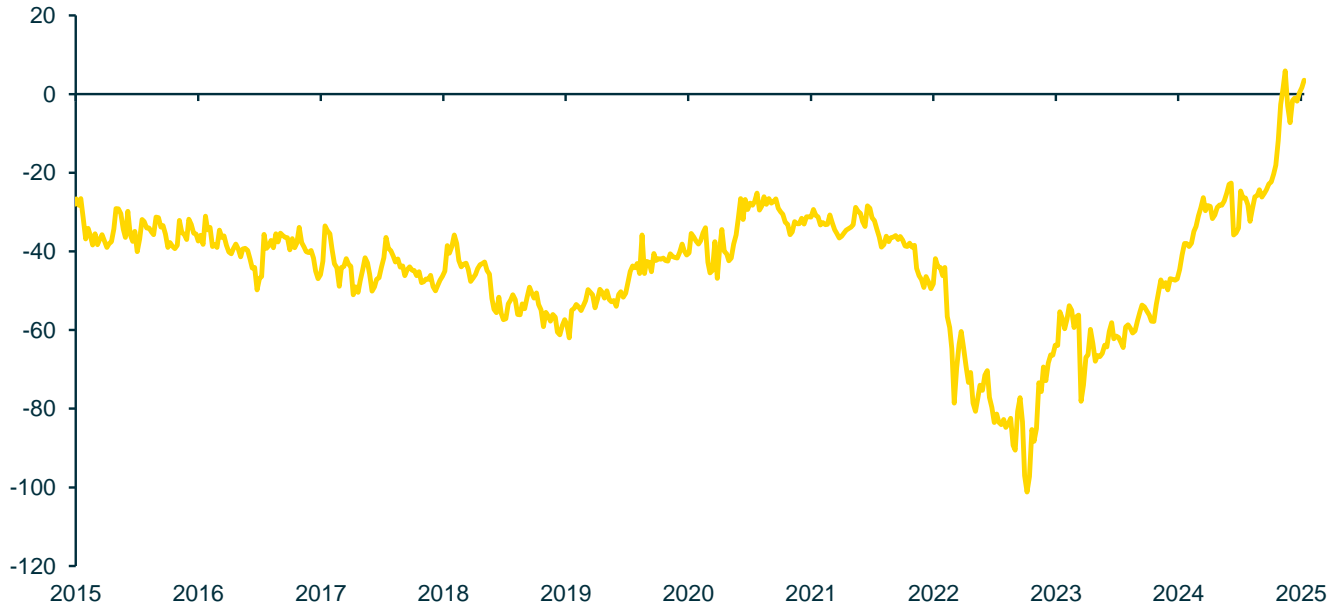
... requires structural reform

In addition, the risk premiums on German government bonds have already risen noticeably recently, also due to weak economic growth (Chart 2). In order to prevent financing costs from rising further despite higher levels of debt, it would be advisable to introduce far-reaching reforms to increase economic growth, tax revenues and thus the state's debt sustainability.



Chart 2 - Germany's credit quality has deteriorated somewhat

Yield spread of ten-year Bunds versus the swap curve, in basis points, weekly data



Source: Bloomberg, Commerzbank Research



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