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My proposal on the German debt brake

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A purposeful and temporary reform could boost public investment

Since the German Federal Constitutional Court ruled on the federal budget in mid-November, the coalition government has definitively entered crisis mode. Suddenly the state is short of money on all fronts. Any remaining political leeway seems to have evaporated overnight. The debt brake is now at the heart of the debate. And rightly so.

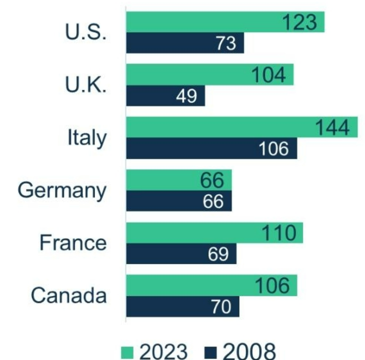
I have argued previously that the debt brake has become a brake on growth for Germany. This is because the country urgently needs extensive investment in infrastructure, digitalization, education and the transformation of the economy. The public sector will have to finance a significant proportion of this. But the coffers are empty. And they are getting even emptier year after year. With the end of the zero-interest rate regime, the expenditure for the national debt is going to continue to inflate. At the same time, expenditure on the rapidly ageing population is increasing.

The debt brake served us well in the past

Although I am in favor of reforming the debt brake, I would like to put on record that the debt brake was a positive element of German fiscal policy until recently. With interest rates at rock-bottom, the interest burden on the public sector in Germany fell by 2% of GDP since the financial crisis until 2021. This is why Mario Draghi, the previous president of the ECB, contributed mire to Germany's budget consolidation than Federal Finance Minister Wolfgang Schäuble. But what Schäuble did is that he resisted the temptation to immediately spend this reduced interest expenditure on popular election gifts. The debt brake was a valuable anchor. Other countries had no anchor on board. Their debts shot up accordingly (see illustration on this page).

Germany's public debt is moderate

General government debt ratios 2008 and 2023 (% of GDP)



Source: IMF, LBBW Research

The debt brake has become a brake on growth

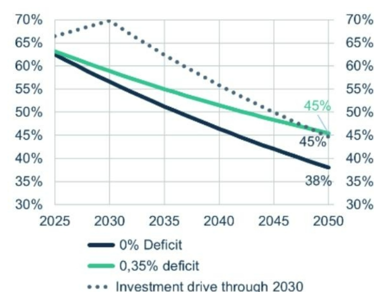
When budgets are balanced year in, year out, the debt ratio (as a proportion of GDP) tends towards zero in the very long term. This is because the underlying economy continues to grow (at least in nominal terms due to inflation). Is that the right approach?

Let's take a look at the stylized simulations in the chart on this page. With an annual zero deficit, the German government debt ratio would fall to a mere 38% by the middle of the century (black line). Assumption: 2% inflation and permanent stagnation of the economy. If 1% annual growth were assumed, the ratio would fall to an even lower 29% by 2050. Even if the maximum annual deficit of 0.35% of GDP permitted under the debt brake is used every year (green line), the debt ratio would fall to 45% of GDP with zero growth (and 36% of GDP with 1% growth).

You can go ahead and do that. But I think it makes more sense to use Germany's strong fiscal position to make the necessary investments possible. If the debt brake were to be modified in a way that until 2030 a 2% of GDP deficit is permitted, which must be invested in real investment projects, the debt ratio would climb moderately from the current 66% to 70% of GDP by 2030 (dotted line). If we furthermore assume that the real economy grows by 0.25% per year (instead of zero) due to the public investments made, the debt burden would return to the level that would have been achieved even with austerity (green line). The only difference? The economy would grow a little more dynamically. The stability of public finances would not be jeopardized at any time. The strategic choice shouldn't be hard to make.

That is why forward-looking pragmatism is now called for. Insisting on yesterday's concepts unnecessarily puts boulders in the way of our economy. Austerity in a recession does little good.

Public debt (% of GDP) under different scenarios



Source: LBBW Research

Assumptions:

- Scenarios 1 and 2: annual nominal GDP growth of 2%,
- Scenario 3: 2% annual growth until 2030, then 2.25%, deficit 2% of GDP until 2030, then 0.35%.

Pragmatism instead of dogmatism

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