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To the point!

Cross-Asset- and Strategy-Research

Germany’s federal spending spree

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From fiscal saint to sinner

Just this week, Chancellor Friedrich Merz’s new government presented its budget for the current year. To the best of my knowledge, no cabinet in the history of the Federal Republic of Germany has ever approved its draft budget this late in the year. With this step, the interim budgetary management under Article 111 of the German Constitution will soon come to an end. Under these emergency budgetary measures, the government is only authorized to cover existing payment obligations but cannot take on new financial commitments. Having looked at the budget—and particularly the medium-term financial planning through 2029—I have to admit: Rather regrettable, actually!

White smoke for the budget! But at what cost?

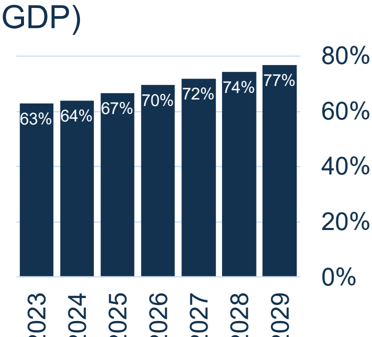
The fall of fiscal prudence

Regular readers of this column will know that I have been an advocate of reforming Germany’s debt brake. I believed that loosening it was necessary to modernize the country’s crumbling infrastructure and finance delayed investments in education, digitalization, and the energy transition.

However, when I examined the federal government’s medium-term financial plan this week, doubts crept in. Were the “debt brake hardliners” perhaps right in their concerns that giving politicians too much leeway over the budget would be risky? While Germany is not yet on the brink of runaway debt, the trend is alarming (see Figure 1).

Already in 2025, the federal government’s net new borrowing – including including special funds – is expected to climb to €143 billion. This would represent more than 3% of the country’s GDP. From next year onwards, net federal borrowing is projected to stabilize between 3.5% and 4% of GDP. Considering the expected deficits from states, municipalities, and social security

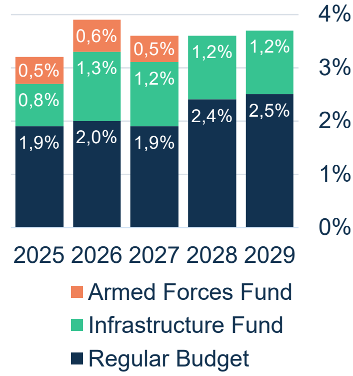
Fig. 1: Public debt (% of GDP)



Source: LBBW Research calculations based on data from the German Ministry of Finance (BMF) and the International Monetary Fund (IMF). Assumption: an annual deficit of 1% for states, municipalities, and social security systems.

systems, the nation's total public-sector shortfall will almost certainly be even higher. Habitual deficit offenders like Italy or France at least pretend to aim for the Maastricht deficit ceiling of 3% of GDP. In contrast, Germany is transitioning from being a fiscal saint to a sinner. The government's likely struggles to scale up planned investments and defense spending offer little consolation

Fig. 2: Net borrowing requirement federal government (% of GDP)



Source: Federal Ministry of Finance, IMF, LBBW Research

Defense spending drives the debt surge

The special funds for infrastructure investment are not the core issue. For this purpose, the federal government is borrowing a bit more than 1% of GDP each year (see Figure 2). Given the state of Germany's infrastructure, this is justifiable. Investments like these can enhance the economy's growth potential over the medium term, thereby increasing tax revenues to service the debt. The larger share of new debt, however, stems from the federal core budget, where much of the increase in defense spending is located (and from 2028 all of it). Defense expenditures are consumptive in nature: they do not generate cash flows that could be used to service these loans. Indeed, Germany's Federal Budget Code explicitly excludes military expenditures from being classified as investments. As I have argued before, debt-financed military spending is a misguided and generationally unfair approach.

Misusing the Climate and Transformation Fund (KTF)

It has become almost a footnote that German Finance Minister Lars Klingbeil now plans to fulfill his election promise of lowering natural gas prices through state subsidies drawn from a fund originally intended to support Germany's energy transition. This fund is now being used to subsidize a fossil fuel! The fiscal policies of the German conservative-social democrat coalition government have, so far, been profoundly disappointing.

Energy transition in reverse

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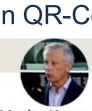

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