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Reforming the debt brake: Now or never!

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The German federal election has dramatically altered the landscape

The political center is eroding alarmingly

Germany has cast its vote, and the results have made one thing very clear: the political center is crumbling. The Social Democrats (SPD) have recorded the worst result in their post-war history, the conservative Union parties (CSU in Bavaria and CDU in the rest of Germany) the second worst, and the liberal Free Democrats (FDP) have even failed to cross the electoral threshold and will have no MPs at all. The situation is so dire that only one viable coalition option remains: a tie-up between CDU/CSU and SPD. A coalition of the largest and third-largest factions, as the second-strongest force is the far-right AfD, with which the centrist parties have ruled out to cooperate. CDU/CSU and SPD together hold only a thin majority in the parliament.

The window for constitutional changes is closing rapidly

Another dramatic outcome of the election is that the remaining centrist parties (CDU/CSU, SPD, and Greens) no longer command a two-thirds majority. In Germany, a two-thirds majority is required to amend the constitution. In the new parliament, constitutional amendments will only be possible with the consent of the parties at the extreme ends of the spectrum, the AfD mentioned above or the Left Party. Both are likely to attach conditions to their approval that will be unacceptable to the centrist parties.

Last chance for a reform of the debt brake

This also affects the creation of special funds or a reform of the debt brake. This is why Berlin is currently humming with chatter on whether the special fund for the armed forces should be increased in the remaining time of the old Bundestag (German lower house). The clock is ticking! The new Bundestag must constitute itself no later than 30 days after the election. Even so, in normal times big decisions being taken by a lame-duck parliament is not considered proper parliamentary practice.

The debt brake should be reformed quickly

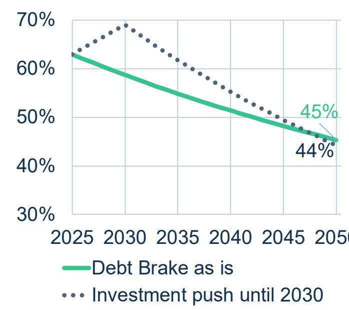
Alas, these times are anything but normal. I consider deviating from established custom not only as justifiable but as urgently necessary. And defense is not the only issue. A further deterioration of German railways, roads, and schools is likely to play into the hands of the political extremes in the future and block growth. If Germany does not reform the debt brake now, it is uncertain when the next opportunity will come. The debt brake is a fiscal rule enshrined in the constitution that limits the federal government's structural deficit to a maximum of 0.35% of GDP annually.

No need to fear an escalating public debt burden

At the end of 2023, I made a concrete proposal in this column on how to reform the debt brake, which I would like to repeat here in an updated form. If the debt brake were modified to allow a deficit of 2.5% until 2030 instead of the current 0.35%, which must be invested in capital projects, the debt ratio would rise from the current 63% to a moderate 69% of GDP by 2030, even in the event of continuous economic stagnation (dotted line). Furthermore, assuming that real economic growth is 0.25% annually due to the investments (instead of 0%), the debt ratio would return to the level that would have been reached with an unchanged debt brake by 2046. The only difference: the economy would grow more dynamically. The stability of public finances would not be even remotely jeopardized at any point. And if other reforms let the economy rise from its stagnation sick-bed as the chancellor in waiting seems to believe (I remain skeptical) then the debt ratio would decline faster than shown in the chart. Even better. Either way, it is high time for forward-looking pragmatism.

Extraordinary times call for extraordinary measures

Government debt ratio (% of GDP, 2025-2050)



Source: LBBW Research
Assumptions:
Scenario 1: Nominal GDP growth = 2% p.a., deficit = 0.35%
Scenario 2: Nominal GDP growth = 2% p.a. until 2030, then 2.25%, deficit = 2.5% of GDP until 2030, then no more deficits.

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