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Germany's Post-Election Fiscal Future

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Germany: Will Political Volatility and the
Public Investment Challenge cloud the Sovereign Outlook?

Scope – FiFo Köln Webinar
September 9, 2021

Expenditure and revenue outlook for the 2020ies

Starting point 2022: Return to „normal“ from ca. 5% of GDP deficit and >70% of GDP debt

Budget outlook for general government in the medium-term:

Fiscal relief / decreasing burdens

- Low interest rates
- „Snowball effects“ (due to g > i)
- Unemployment benefits
- *Cutting subsidies…? (unlikely)*
- *Higher government efficiency…? (difficult)*

Additional tasks / increasing burdens

- Closing the investment gap
- Social security (pensions, health, care)
- Public servants’ pensions, health, care
- Climate: *much* more mitigation/adaptation
- Immigration (v. labour shortages)
- Education and LLL (v. labour shortages)
- External and cyber security (Europe, NATO)
- EU (post-Brexit, post-Covid)
- *… plus deals struck in a coalition agreement*

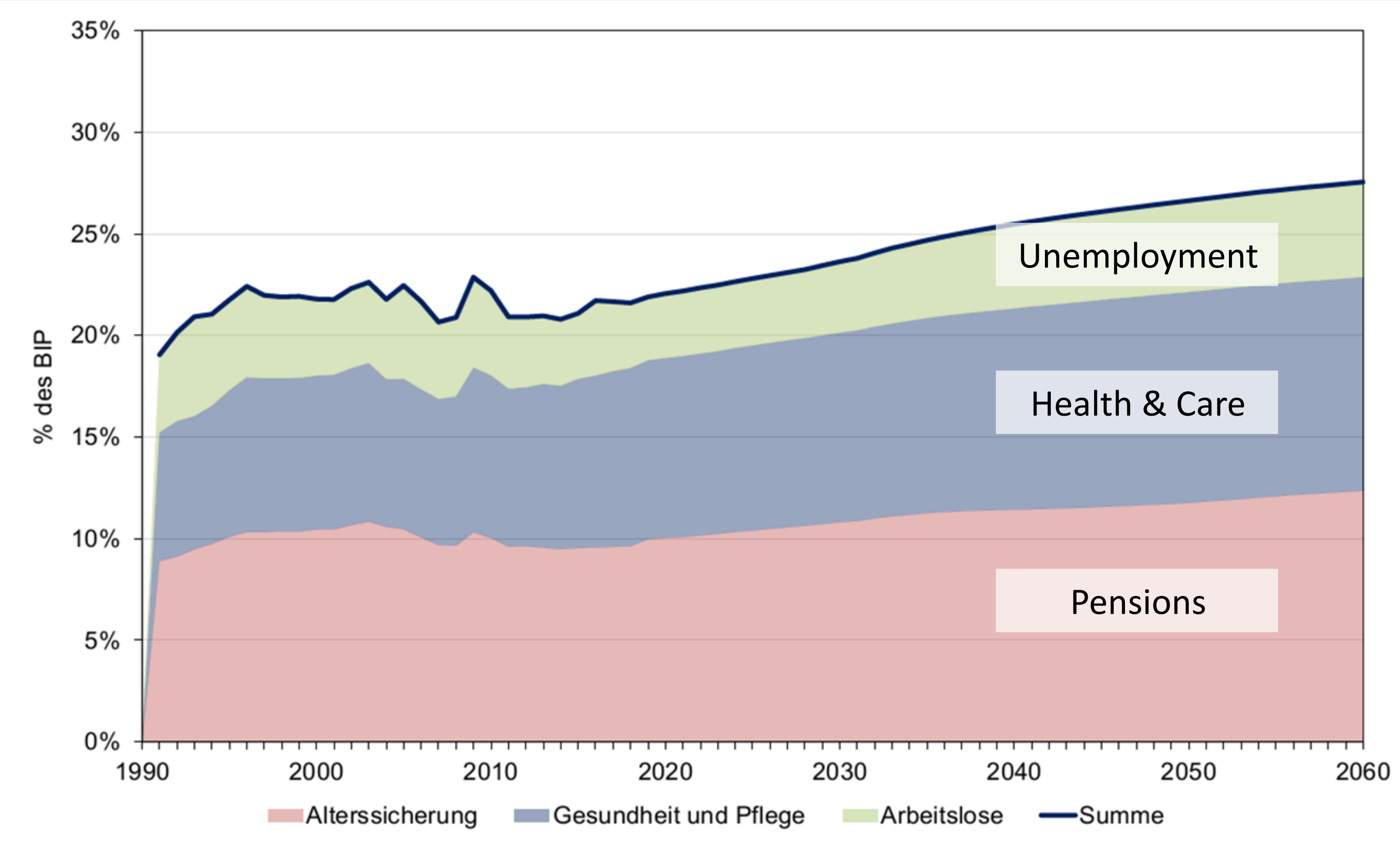
Revenue outlook:

Revenue: Little room to manoeuvre up (D already is a high-tax country), or down (see above).

Taxation: Possibly *structural* tax reforms: More green taxes with intense social compensation. Maybe some (small) reforms in corporate taxation and income tax. Wealth taxation unlikely.

A closer look:

Age-related expenditures in Germany are projected to increase by 10% of GDP between 2020 and 2060 (in a no-reform BAU scenario)



Source: M. Werding, B. Läpple (2020), „Finanzrisiken für den Bund durch die demographische Entwicklung in der Sozialversicherung“; FiFo-Berichte Nr. 29. https://t1p.de/y64h

So, fiscal discipline or new debt rules?

Unfortunately, that is not the question. To reach and maintain fiscal sustainability, Germany most likely needs **fiscal discipline and new debt rules**.

Four central criteria for a reformed constitutional debt-brake

A reformed debt rule must be…

1. ***Adaptable to EU*****:** Germany cannot establish different debt rules at the national level than it will demand from its European partners in a reformed Stability and Growth Pact.
2. ***Simple*** (at least, as simple as possible).
3. ***Compatible with democracy***: A debt rule and the corresponding budget system must leave decisions and accountability with the budget legislator. This link to the parliament is particularly important where investment expenditures are financed in a different way than current expenditures, i.e. where dividing lines are drawn. These dividing lines are "democracy compatible" when they are constructed *within* a common budget framework.
4. ***Robust***: Constitutional rules must not reflect only today's fiscal and/or macroeconomic circumstances. IF -- that is not a small "If" – the German *Grundgesetz* can be amended, the reformed debt-brake should, in principle, be applicable for decades.

Source: „Nachhaltige Finanzpolitik – Wie man in Zukunft investiert." Bericht des Finanzpolitischen Arbeitskreises 2021 der Heinrich-Böll-Stiftung; Berlin. https://t1p.de/cgt2

The Fiscal Rule of Three: Sound. Green. Investing.

FiFo Köln

Proposal brought forward by the Heinrich-Böll-Foundation's *Working Group on Public Finances*, June 2021.

INVESTING

Debt brake limits deficits to investment spending

Default: Net investment.
Catching up: Gross investment, whilst GDP growth > interest rate

GREEN

European climate protection via EU Green Bonds

Limited to highly effective climate protection.
Unlimited in fiscal terms

SOUND

Current budgets are always balanced

I.e. Structural zero debt.
With escape clauses for recessions and disasters

Source: „Nachhaltige Finanzpolitik – Wie man in Zukunft investiert." Bericht des Finanzpolitischen Arbeitskreises 2021 der Heinrich-Böll-Stiftung; Berlin. https://t1p.de/cgt2

Other solutions for the debt regime

<u>With</u> constitutional amendment of the *Grundgesetz*

- **Golden rule** with different design features
  - e.g. no „catch-up“ clause
  - e.g. no clause or broader clause for climate investments
- **Nominal expenditure targets** supplemented by a **debt ceiling**
  - Possibly combined with investment quotas / clauses
- **“Standards instead of rules”**. Softer, more flexible rules that are monitored by a strong and **independent fiscal council**.
- Theoretically: New, higher limits replace the current 0,35% of GDP (federal level) and 0,0% of GDP (Länder) structural deficits.

<u>Without</u> amendment of the *Grundgesetz*

- **Off-budget and “off-government” funds debt-finance investment**
  - Popular, but problematic idea. To comply with EU-law, such investment funds must not be controlled by government ("50% criterion"). That is not government anymore.
- **Expansion of EU fiscal capacity**
  - The “lack” of national debt opportunities increases the pressure to establish common EU debt as a permanent follow-up to the one-time *Next Generation EU* (NGEU).
  - Like it or not, common EU debt is going to be a new reality. Yet, a different question is whether Member States want to pressure themselves to concentrate fiscal space (and power) at the EU level by failing to reform national debt regimes and the SGP-rules.
- **No reform business-as-usual:** I.e. not facing future challenges or enacting fiscal austerity.

A closer look:

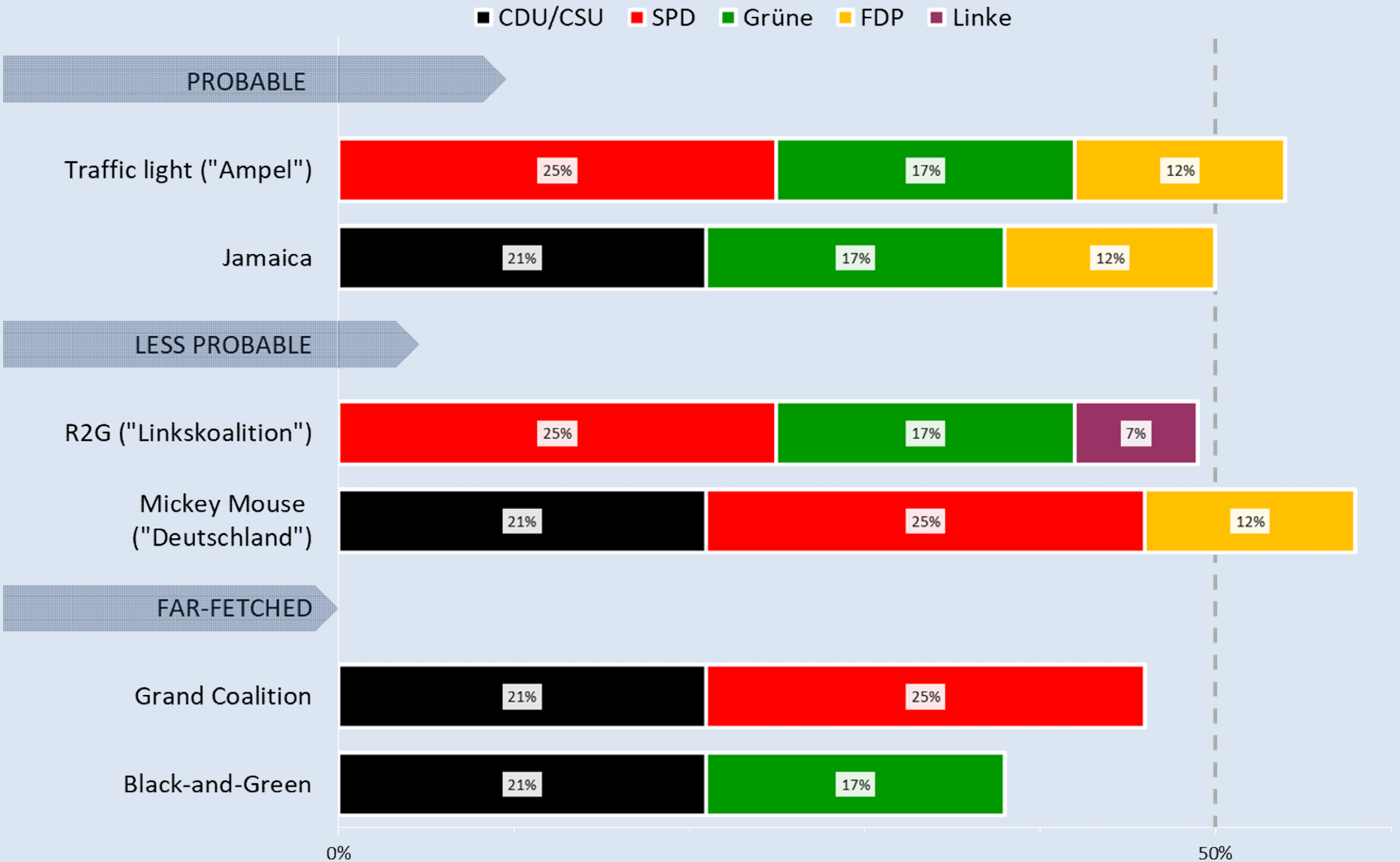
Amending the German *Grundgesetz* with a reformed debt-rule

- Changing Articles 109 and 115 GG in order to reform the debt-brake needs:
  - **2/3-supermajority** in the first chamber (*Bundestag*) plus
  - **2/3-supermajority** in the second chamber (*Bundesrat*).
- Upcoming elections on the federal level (i.e. the complete *Bundestag*) and in two of 16 Länder (7 of 69 votes in the *Bundesrat*) are not going to produce one of these supermajorities directly. [See next two slides.]
- Indeed, a **debt-brake reform seems unlikely.**

- Still, a **possible reform** would have to be designed **along two lines**:
  1. It would have to be **very attractive for most of the Länder**, regardless of "party colours". As the current debt-brake is poised to produce problems for almost all Länder in the 2020ies that should not be impossible.
  2. It would have to be **fiscally conservative in its own right** (like e.g. the golden rule) in order to bring aboard the conservatives and the liberals -- in coalition *and* in opposition. Friendly pleas from the Länder-level and additional logrolling on the federal level should be needed as well.

A closer look:

Coalitions in the future Bundestag and federal Government

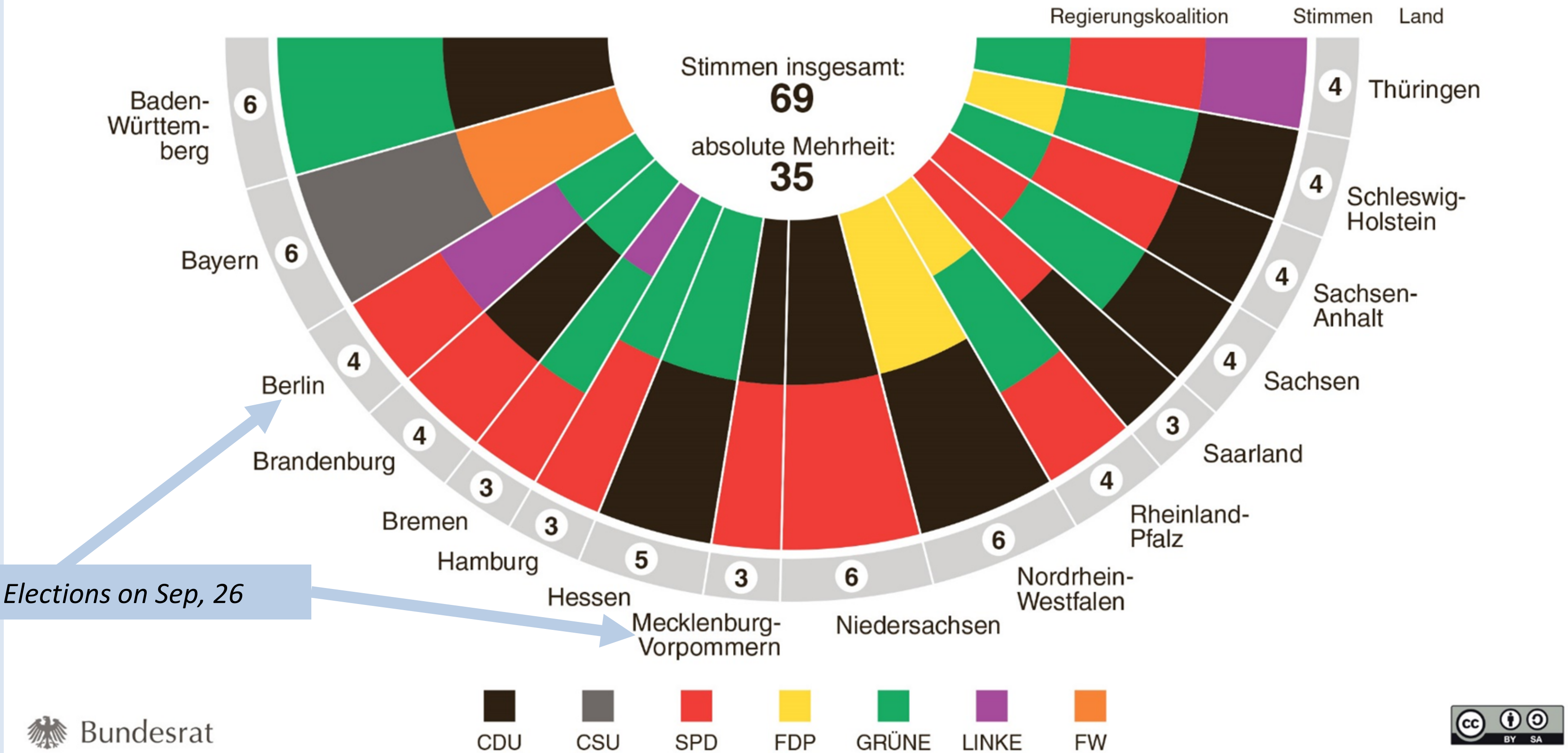


Average of current election polls (as of 8 Sep 2021).

Source: Der Spiegel, based on data compiled by wahlrecht.de. Own figure and assesment.

A closer look:
Composition of votes in the Bundesrat

No clear 2/3-supermajority. But no clear 1/3-veto block, either.



Elections on Sep, 26

Thank you!

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