FOCAL POINT

German fiscal woes to drag on 2024 outlook

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Our Focal Point series explores topical issues on macro, markets and investment

- **In its ruling from Nov 15 the German Constitutional Court (GCC) stated that the transfer of € 60bn from Covid-related means into the so-called climate and transformation funds (CTF) was illegal implying a gap of € 18.5bn or 0.5% of GDP in the 2024 budget.**
- **Possible reactions are suspending the debt brake again, cutting expenditures, or increasing taxes. Each of these alternatives is either legally (debt brake), politically (where to cut), or economically (tax hikes) problematic. Time is pressing as on December 15 the budget needs to be sent to the upper house for the council's second consultations and the vote in the lower house is now scheduled for December 13.**
- **We think that ultimately a compromise on the 2024 budget consisting of expenditure cuts will be found. The effect on growth depends on the extent and timing of consolidation and the strength of amplifying sentiment effects. We deem a range of -0.3% to -0.5% sensible and have adjusted the 2024 GDP forecast to 0.1%.**
- **That said, the implications of this ruling are far-reaching as there exist currently 29 CTF-like vehicles with a volume of €869 bn. It will also trigger a discussion about the debt brake. Politically, the tensions in the governing three-party coalition increased. A government collapse remains unlikely, but risks rose.**

Usually, German fiscal policy is associated with the call for sound consolidation measures. This time is different. Some sort of creative fiscal accounting was detected by the German Constitutional Court (GCC) that completely screw up the budget planning. For 2023 the government fixed implied problems by passing a supplementary budget on November 27. This was easy as the debt brake is still suspended this year. More challenging is the year 2024 for which the government needs to finance a net gap of €18.5 bn according to our calculation. It is not yet clear how the issue will be solved but the resulting shockwaves increase tensions within the three-party coalition and more generally triggered a discussion about the debt brake.

GCC ruling forbids circumventing the debt brake

In the autumn of last year, the governing coalition passed a law transferring €60 bn of credits initially designated for the pandemic to the so-called Climate and Transformation Funds (CTF) that shall support the green transition. The idea was that the €60 bn of debt would be booked for the year 2022 when the national debt break was still suspended. This would have enabled the government to present a 2024 budget that respects the debt brake again. However, the GCC ruled that there are three conditions for exceptions from the debt brake (see box next page):

First, *"in the event of natural disasters or exceptional emergency situations beyond the control of the state and significantly affecting the state's financial situation* [...]". This requires a decision by a majority of the members of the Bundestag ('Chancellor majority').

Second, there must be a causation between the declared emergency and the exceeding of the debt ceiling. However, the GCC also stated that the government's discretionary room for manoeuvre becomes smaller the further away this event and its consequences are, the longer the crisis lasts, and the more extensive these means were used. Concretely, the pandemic-related means were not fully deployed.

Third, the court made clear that the approved volume of credits is to be determined according to years (*Jährlichkeit*) and that credits taken in a certain year shall be used in that year (*Jährigkeit*). Hence it is not allowed to take credits in one year and spend the means only in the year after or to book credits in the year they were granted. The government's seemingly smart action was illegal.

The Climate and Transformation Fund

	2024	2025	2026	2027
Scheduled expenditures (bn EUR)	57.60	57.00	49.70	47.50
Revenues from emission trade (bn EUR)	19.10	23.60	29.20	34.70
Excess revenues (bn EUR)	9.30	5.20	5.20	5.20
Funding gap (bn EUR)	29.20	28.20	15.30	7.60
~% of 2022 nominal	0.75	0.73	0.40	0.20

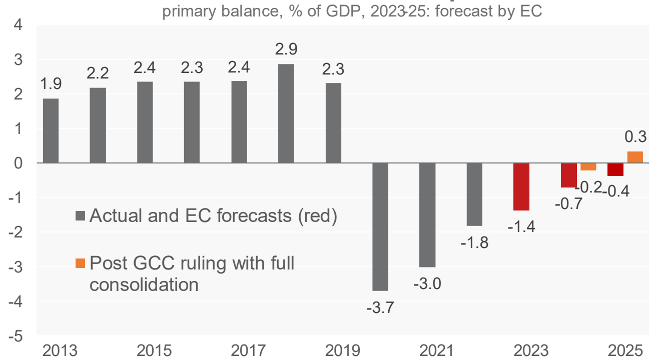
Source: Deutscher Bundestag, GIAM

Implications for the budget 2024

The GCC's ruling has immediate consequences for the budget 2024. In autumn 2022, the lower house voted (with support from the coalition) for a reallocation of €60 bn (1.5% of GDP) of initially pandemic-related spending to the CTF in 2024. As the (conservative) opposition successfully sued this practice a huge gap has opened. In 2024, the government had planned to spend €57.6 bn of these means according to the budget proposal. However, the fund has annual revenues

German consolidation paths

primary balance, % of GDP, 2023-25: forecast by EC



Source:EC autumn 2023 forecast, GIAM

Box 1: The German debt brake

It entered into force in 2011 as a substitute for the so far eligible constitutional "Golden Rule" that new debt must not exceed investment expenditures, with measures to fight disturbances of the economic equilibrium being exempted. This rule proved ineffective. It was in the past frequently offset by declaring a disturbance of the economic equilibrium or using shadow budgets and did not prevent the debt ratio from advancing. The new rule follows the spirit of the Stability and Growth Pact according to which budgets shall be balanced or in surplus over the medium term.

Following an adjustment period, since 2016 the debt brake allows for a federal structural budget deficit of 0.35% of GDP over the medium term. In 2020, the debt brake also became binding for the regions (*Länder*) which must exhibit always a balanced structural budget. The definition of the key variables is in line with the EU methodology. Key is a so-called control account which captures all non-cyclically caused deviations. Hence, a worse than expected economic activity has no impact (this would be captured by automatic stabilizers) but a wrong assessment of for instance a tax reform has an impact. If the medium-term structural deficit ceiling is not reached it is left available for future use. In case the cumulated balance of the control account exceeds 1.5% of GDP, it is to be reduced. This reduction shall take place only in recovery phases and is limited to annual steps of 0.35% of GDP. Because this stretches the deficit reduction, the effective legal regulation already foresees a reduction of the structural deficit if the 1% threshold is reached.

Exceptions are possible in emergency situations (natural disasters or exceptional emergencies beyond the government's control). They need to be approved by an absolute majority of lower house (Bundestag) parliamentary members and require a binding redemption plan.

from the European and national emission trade. Moreover, there are scheduled excess revenues also contributing to the reduction of the funding gap (see table above).

However, towards the end of 2023, the CTF is expected to have €70.7 bn of reserves. Deducting the unconstitutional €60 bn reduces these reserves to €10.7 bn. If used for the mitigation of the funding gap the shortfall would be merely €18.5 bn or 0.5% of GDP. Assuming that these reserves would then be fully depleted, in the years 2025 to 2027 the funding gap would need to be fully financed by expenditure cuts or tax increases lifting the German primary balance accordingly. As a result, fiscal headwinds would mount. For the euro area, this would translate into an additional fiscal headwind of up to 0.15 pp in 2024.

Fixing the 2024 budget not yet clear

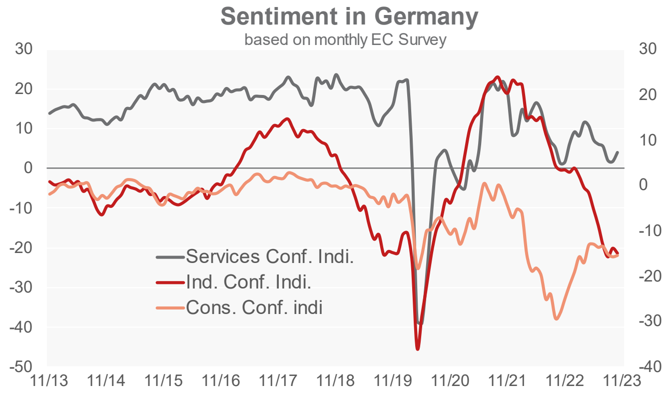
The government was shocked by the GCC ruling and is under great pressure to fix the issue. The intended vote in the lower house for November 24 was cancelled. The upper house is scheduled to pass it on December 15 and the lower house shall do so on December 13.

The 2024 funding gap could be closed by tax increases, expenditure cuts, or higher debt. Politically, tax increases are viewed as inappropriate given the weak current German activity and the liberal Minister of Finance (Mr Lindner) has ruled this out. Higher debt could be engineered by another suspension of the debt brake. It would require only a simple majority in parliament. However, the reasoning would not be very convincing as the state of emergency was self-induced by breaking the rules. Hence, as it seems now expenditure cuts appear inevitable.

The political arm-twisting and horse-trading are in full swing. The Liberals opt for savings in social security, at odds with the preferences of the Social Democrats. The Greens seek to prevent cutting money for greening the economy and mastering climate change. In a government policy statement on Nov 28, the Chancellor remained vague and only announced that the energy price support measures shall already expire by year-end 2023. But quite interestingly, an expert who gave his opinion on the issue before the budget committee hinted at some possibilities to get liquidity by other means:

- The EU peace facility enables governments to refinance the delivery of weapons to Ukraine by the fund. Germany has used this opportunity only reluctantly so far.
- Making use of the NGEU credit potential: Germany so far has not taken NGEU credits. They are not considered in the calculation of the budget deficit but increase public debt. They should hence not be considered by the debt brake calculations.
- The debt brake could to a certain degree also be circumvented by making favourable assumptions when deriving the feasible volume of credit as the production potential could be increased.

If these possibilities would be at least party exploited, the above derived needed improvement of the primary balance would be reduced somewhat.



Source: Datastream

German growth to suffer from fiscal woes

For the already rattled German economy, these fiscal woes come at a time when there are some tentative signs of stabilizing activity. Sentiment indicators like the ifo index have just started to improve from low levels. With inflation having embarked on a downward trajectory amid a solid labour market uncertainties and concerns about the fallout from additional consolidation needs will likely dampen confidence and let firms and consumers become more reluctant to spend. We do not expect the full tightening potential to be exploited and it is uncertain from which quarters onwards these extra-tightening measures will become effective. In contrast, negative sentiment effects will amplify the headwinds. All in all, we deem it likely that German growth in 2024 will be reduced by 0.4 pp to just 0.1%, after -0.2% in 2023. Thereby Germany will again underperform the euro area average for which we see growth at 0.5% in 2024. For the euro area, the fiscal drag due to Germany would increase by -0.15 pp in 2024.

GCC ruling will trigger fundamental discussions

The importance of the GCC's ruling goes far beyond the 2024 budget as it affects German off-balance sheet issues in general. There are currently 29 special vehicles (*Sondervermögen*) with a volume of € 869bn. The ruling implies that sooner or later they will need to be included in the normal budget. For 2023 the net credit requirement would be € 192.8 bn instead of the officially stated €45.6 bn. This would Germany hardly leave any needed fiscal leeway to master the green transition and to invest in its much too low stock of public capital. Against this backdrop, it does not come as a surprise that also fiscally conservative politicians have started to openly discuss a reform of the debt brake. However, polls show that the debt brake is popular among Germans so its scrapping or complete watering down seems unlikely. Also, the conservative opposition in parliament strongly opposes this. And a two-thirds majority would be needed to change it. Ultimately the GCC ruling might also be a chance to get rid of inefficient spending. The Institute for the World Economy for instance found in its 2020 subsidy report that 22.3% of all subsidies over €100 mn could be abolished without replacement from a macroeconomic perspective.

Political risks increased

The need to consolidate increased the tensions within the three-party coalition. In the latest polls, all parties have lost compared to the 2021 election outcome with the Social Democrats being most severely affected (-9.5 pp to 16%), followed by the Liberals (-5.5 pp to 6%) and the Greens (-3 pp to 12%). As they would no longer have a majority of seats in the Parliament there is an incentive to compromise for all of them. However, sacrifices in fields essential to each of these parties (e.g. welfare, no tax increases, greening) might be needed increasing resistance within these parties. While a government collapse is not our base case, the risks of it have increased.

Imprint

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