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Germany's creative accounting hits a brick wall

A tremendous setback for the coalition

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Summary

- The top court in Karlsruhe has now overruled the German government on relabelling EUR60bln in covid funds, which directly puts projects championed by the coalition at risk.
- There are risks to the survival of the 'Traffic light'-coalition, but we expect them to survive.
- The ruling could call other funds, particularly the WSF, into question as well
- The court ruling could restart about discussion on the debt brake, although abolition is unlikely.

Creative accounting

The Germans have a rather strange relationship with their fiscal rules. On the one hand, there is the debt brake, which caps the annual fiscal deficit that the government can run at 0.35 percent of GDP. This is a strong form of self-control, which is deeply ingrained in German culture and which can only be suspended during times of extreme crisis. On the other hand, the German government has repeatedly used off-balance-sheet vehicles to avoid their self-imposed fiscal straightjacket, particularly on issues requiring vast sums of money, such as the energy transition or rebuilding the military.

This strategy now has potentially hit a brick wall. On November 15 Germany's top court in Karlsruhe ruled that EUR 60bn in unspent covid-funds (that were approved under a temporary suspension of the debt brake) were unconstitutionally relocated to a climate action fund. This is a painful blow to the coalition led by Olaf Scholz as it came less than 24 hours before the Bundestag would finally approve a painfully negotiated budget. Moreover, it leaves a gaping hole in the budget for next year and forces the German government to immediately stop doling out subsidies from its Climate and Transition Fund (KTF), which will put many of the projects championed by the coalition at direct risk. Politicians from CDU/CSU have also threatened to file a similar suit against the legality of the Economy Stabilization Fund (WSF, about which more later).

But the worries are bigger than the financing of the government budget in the short term. It also raises the question whether the use of special funds is still advisable after the Karlsruhe ruling. And the sums of money involved are considerable. The *Bundesrechnungshof* (Federal Court of Auditors) published a list of 29 special funds in August that sum up to EUR869bln[1], or over a fifth of GDP. Christian Duerr, parliamentary caucus leader of the co-governing FDP even went so far as to state that the number of off-balance sheet funds should be drastically reduced and that Germany's federal budget was due for a complete overhaul in the medium term.

In this report we will try to answer three questions: i) What does the ruling imply for the survival of the coalition?; ii) What does it mean for off-balance sheet funds?; And iii) Will the debt brake be called into question again?

[1] The EUR100bln fund for the German military is likely safe as it was enshrined into the constitution last June.

A lame duck or a new government?

Scholz's "Traffic light" coalition was always a bit of a strange combination because the parties' ambitions differ considerably. Finding compromises hasn't worked out well for the coalition partners. In the polls, the liberals (FDP) are barely above the electoral threshold of 5%, while the SPD has lost more than a third of its voters since the elections in 2021. The Greens are still holding up quite well. Still, it would give coalition members every incentive not to call new elections, but the question is whether they can work it out together.

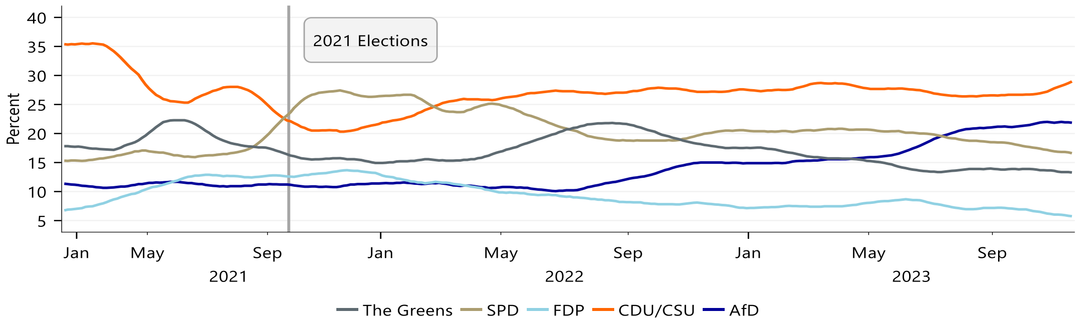
After the news broke, Germany's cabinet promptly vowed that they would find a way to fill the funding gap left by the Karlsruhe ruling. But, unfortunately, there are no simple solutions. The government is constrained by the debt brake (more on that later), which means the gap would have to be filled by raising taxes or cutting spending elsewhere. Luckily, the amount of EUR60bn was to be spent over several years, but the court ruled that any money that is already committed must be "*compensated for through other means*". Estimates are that the Finance Minister Christian Lindner would still have to find EUR 37bn (1% of GDP) in a revised 2023 federal budget. Consequently, the German government decided to temporarily suspend the debt brake to plug the hole in the budget. This is particularly painful for the finance minister's fiscally conservative pro-business party (FDP), which was proud to reinstate the debt brake earlier this year.

The outlook is less certain for the remainder of the 60 billion euros (roughly equal to 3% of the annual budget) as the debt brake is not suspended for 2024. Given that the coalition is already divided, reaching an agreement will be difficult. Significant tax increases are likely to be vetoed by the finance minister's liberal pro-business party (FDP), while Scholz' SPD and the Greens are unlikely to accept significant cuts in spending on social welfare or climate projects within the budget. Failing to find a solution to this problem would put the coalition at risk, however. Relabelling the EUR60bln in unspent covid funds as climate funds was the silver bullet to sway the Greens, whilst simultaneously reassuring the liberals' fiscally conservative voters the no additional debt would be issued.

Consequently, there is some speculation with respect to the survival of the coalition. There is even the rumour that Scholz' SPD might ditch the Greens and Liberals to form a new coalition with the CDU/CSU. This would allow the SPD to continue to govern and hopefully end their term on a positive note, whilst it would give CDU/CSU leader Friedrich Merz an opportunity to gain experience in a ministerial role before heading into the elections. Given the lead of the CDU/CSU in the polls we don't think this is a likely outcome, however, as CDU/CSU has more to gain from a new round of elections.

The most likely outcome is that the current coalition will survive, perhaps by stretching up the rules of the debt brake (by tinkering with the cyclical component for example) albeit with their hands tied. A solution likely entails a combination of lower government spending, as well as sacrificing any room for unplanned fiscal initiatives, which isn't exactly a great place to be in now that the economy is slowing down and given the many challenges ahead.

Figure 1: Life hasn't been too kind for the governing parties



Source: Macrobond, Wahlrecht

Will the ruling threaten the use of special funds?

The use of special funds by German governments dates back to a bill passed in 1924 that allowed the *Reichsbahn* (railway) and *Reichspost* (mail service) to issue their own bonds. Since then, there have been numerous special funds established to accommodate investments for long-term projects, such as rebuilding the economy after WWII or the reunification in the 1990s. These special funds are distinct entities that exist solely to carry out a specific task and are managed separately from other federal assets. They are also an exception to the constitutional principle of fiscal unity, so the debt brake has no effect on them. Only transfers to or withdrawals from special funds have to be included in the federal budget.

The *Bundesrechnungshof*, in collaboration with the Bundestag and Bundesrat (lower and upper houses), is in charge of overseeing the special funds. The former has recently expressed some serious misgivings about the use of those funds. In a report published in August they argued that the use of special funds should be reduced because it conceals the federal government's true net borrowing. According to the *Bundesrechnungshof*, only one-tenth of funds are actually directly co-financed by the government, with the rest being loan-financed by the entity itself (with the implicit backing of the government). This means that the funds effectively act as outsourced debt with the potential for new debt dwarfing the federal budget.

The part of the report that most startled policymakers was the assertion by the *Bundesrechnungshof* that existing funds should be evaluated on a regular basis and their continuation must be well justified. This could be a major issue, particularly for the Economy Stabilization Fund (WSF). The EUR 200 billion fund was established in 2020 to assist households and businesses in dealing with the pandemic and was later expanded to provide support for higher energy prices. The *Bundesrechnungshof* now argues that the WSF's credit authorization was only valid in 2022, but that the Ministry of Finance used financial trickery to fully exhaust the borrowing capacities of the fund without any actual borrowing, so that it can spend the money in 2023-2024. Given the fact that only EUR 30bn has been spent so far, there's still a lot of firepower left in the fund (4.5% of GDP). Since the debt brake was reinstated earlier this year, this was at direct odds with constitution (although the debt brake has just been temporarily suspended again).

Given the fact that one of the supervisors of special funds has already laid the groundwork for a suit and the fact that the CDU/CSU already communicated that they intend to act on it, we see it as a probable risk that the coalition will have to face another major budget setback. We don't expect the coalition to survive another setback, however.

Will the debt brake come into question again?

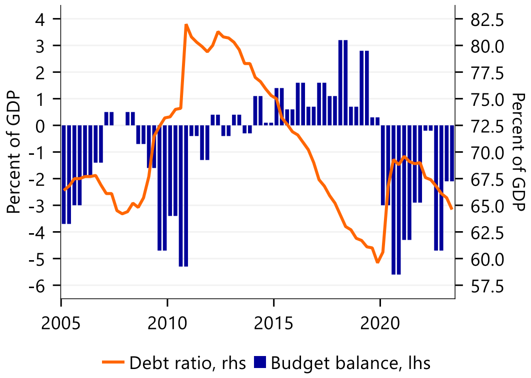
The debt brake has been a source of contention since its implementation in 2009. The debt brake's supporters argue that, given Germany's demographic outlook, it would be unwise to burden future generations with too much debt and that abolishing it would undermine Germany's position as a fiscal role model in Europe. Critics (including the author of this report) argue that the debt brake places an unnecessary constraint on government finances, that has resulted in structural underinvestment in public goods such as (digital) infrastructure during an era of ultra-low interest rates (also see this report from 2019).

Whatever side you are on, it is a fact that it will limit the government's ability to plug a potential budget hole. This especially holds given the sheer size of these funds (the WSF still had 4.5% of GDP in funds left for 2023-2024). Furthermore, if the court's ruling is extended to cover more off-balance-sheet funds set up over the years, it could severely constrain the German government, as all investments would have to be paid for from the current budget. As a result, this limitation may reignite the debate over the debt brake.

Economy Minister Robert Habeck (Greens) kicked off the debate by saying the debt brake is "*inflexible*" and that the ruling will have "*massive implications*" for Germany's transition to a renewable economy. However, we doubt that a permanent abolition of the debt brake is on the table. Since it is enshrined in the constitution, a two-thirds majority in the Bundestag and Bundesrat is required. That is a number of seats that the coalition lacks, even if the FDP were to back such a proposal (which is unlikely). Furthermore, support from non-governing parties, such as the CDU/CSU, appears unlikely, given that they filed the complaint at the Karlsruhe court in the first place and the fact that they are fierce supporters of the debt brake.

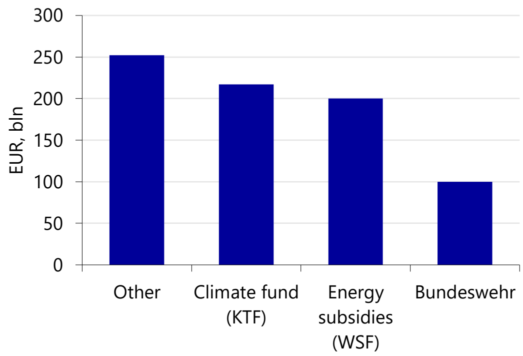
However, much remains unknown in the medium to long term. If, as the FDP's Christian Duerr pointed out, the German budget is due for a complete overhaul, it is critical that it include a mechanism for financing capital-intensive multiyear projects. Especially now, when German companies are struggling to compete on a global scale due to high energy prices and are less likely to make the required investments themselves.

Figure 2: The debt brake was quite effective until continuing crises struck in 2020.



Source: Macrobond, Destatis

Figure 3: Recent funds account for the lion share of total special funds



Source: Bundesrechnungshof

Conclusion

While the ruling is a clear setback for the 'Traffic Light'-coalition's agenda, we expect them to survive for the time being. It is likely to require painful concessions from the ruling parties and significantly reduce the government's flexibility, but the alternative (elections) is simply too painful for the coalition. It will be a test nonetheless, and we doubt whether the coalition could survive another budgetary setback.

More structurally, the ruling puts a bomb under the German fiscal framework. With so many challenges ahead (energy transition, geopolitical tensions, digitalization just to name a few) this poses a serious risk to Germany’s ability to solve them in a coherent manner.

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