

# Germany's grand coalition leaves big choices to its successor

Blog post by Senior Practice Lead Thomas Gratowski, 24 September 2021

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Germany's grand coalition of Christian and Social Democrats will soon be history. Despite its comfortable majority - the next government may be jealous - there is a sense that Chancellor Merkel's fourth government has deferred big policy choices to its successor. Even in the few areas where it has set a new policy direction, in part to deal with the pandemic, major choices still need to be made. In a sense, the legacy of Merkel's last government will be determined by whoever follows. Big choices are particularly acute in four areas.

## Digitalising industry - and the state

Digitalisation is not only an enormous challenge for German industry. The pandemic has showed that Germany still lags in digital infrastructure, public services and administration. The grand coalition offered billions of euros in support of digitalising schools and rolling out fast internet, but implementation has been slow. There is little doubt that the rollout of digital infrastructure and e-government services will be a priority of the next government. The key question however is how this can be achieved more quickly than in the past. CDU/CSU and the liberal FDP have proposed a separate digital ministry to coordinate all government efforts and avoid the common inter-ministerial conflicts. SPD and Greens want legally enshrined guarantees for fast internet access to accelerate its rollout.

## Walking the talk on climate

Perhaps more important, the grand coalition rushed through a new climate law in May after the constitutional court had ruled that the cost of climate change needs to be spread across generations more evenly. The law set the CO2 reduction target for 2030 to 65% - up from 55% - and brought forward to 2045 the date by which Germany aims to achieve "net zero". The coalition parties passed the law swiftly due to electoral considerations but left it largely to the new government to put concrete measures in place.

There is a consensus that both climate targets won't be achieved without a further dramatic expansion of renewable energy production. The next government will also up its support for green hydrogen technologies as these will play a critical role in decarbonising energy intensive sectors such as heavy industry. The choice is largely about the energy mix within sectors - and to what extent electrification should be the default objective. The planned coal exit as well as carbon taxes and the future of the internal combustion engine - issues that will ultimately be decided at the EU level - will also be up for re-negotiation in this process. The Greens have made the boldest - and perhaps costliest - proposals in all three areas, for instance by demanding to bring forward the end date for coal from 2038 to 2030 and to prohibit new registrations of diesel and gasoline cars by the same year.

## Who pays for pensions?

Pension reform didn't play an important role in the campaign, which is hardly surprising. The roughly 21 million pensioners are an important group of voters. A few more million baby boomers will leave the workforce this decade, so bad news for this constituency ahead of the election could have a decisive impact on its result. But fact is, the federal government spends roughly a quarter of its budget - more than on any other expenditure item - on subsidising the public pension system. That is in addition to the mandatory contributions paid by employees and employers. Experts from the economy ministry have repeatedly warned that the current pension model is only sustainable at increasingly high fiscal costs.

The grand coalition decided in 2018 to maintain the general pension level at 48% of the average salary until 2025 and to cap pension contributions at no more than 20% of gross salaries. The next government will need to decide quickly what it wants to do beyond 2025 - when the fiscal cost of this policy would be much greater. This is why CDU/CSU candidate for chancellor, Armin Laschet, has indicated there should be a cross-party pension reform after the election. His bloc and the FDP have floated various proposals for a government subsidised, capital markets-based pension for young generations. The SPD and Greens are open to reforming the framework for private pensions but want to prioritise maintaining or even expanding the benefits through the public system. Any farther-reaching pension reform would have a major impact on Germany's room for discretionary spending in areas such as defence and investment.

## Fiscal prudence, or deficits and debt sharing

Germany's debt break and the EU's fiscal rules have been suspended during the pandemic. The former is a constitutional requirement which the next government may be forced to comply with after 2022. The law also requires a detailed debt repayment schedule, which will further narrow the government's fiscal space. Changes to the debt break would need to be approved by a two-third majority - but both CDU/CSU and FDP are keen to return to fiscal prudence. Nonetheless, the debate about the right fiscal policy mix appears almost inevitable with growing mandatory spending commitments that narrow the room for investment in areas such as digital and energy. This will have reverberations in the EU, which is discussing reforms to the fiscal rules of the Stability and Growth Pact that after pandemic related debts appears more outdated than ever.

The debate about fiscal rules will be conflated with a key question about EU integration and governance. The EU's €672.5 bn recovery fund - Merkel's boldest move in the past four years - has been set up as a temporary mechanism to cope with the economic fallout from the pandemic. For the first time, it allowed the European Commission to borrow on capital markets despite earlier resistance in Northern Europe to debt mutualisation. The fund expires at the end of 2026, so there will be a choice to make about whether the EU needs a permanent arrangement to channel investment from richer to poorer member states. SPD and Greens appear open to such ideas - which could unlock a much wider debate about euro zone governance that Merkel has skilfully managed to avoid. Both CDU/CSU and FDP remain opposed to debt pooling, of course until events may force them to re-consider.