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What to watch: The coalition government holds a mixed bag for Germany

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In summary

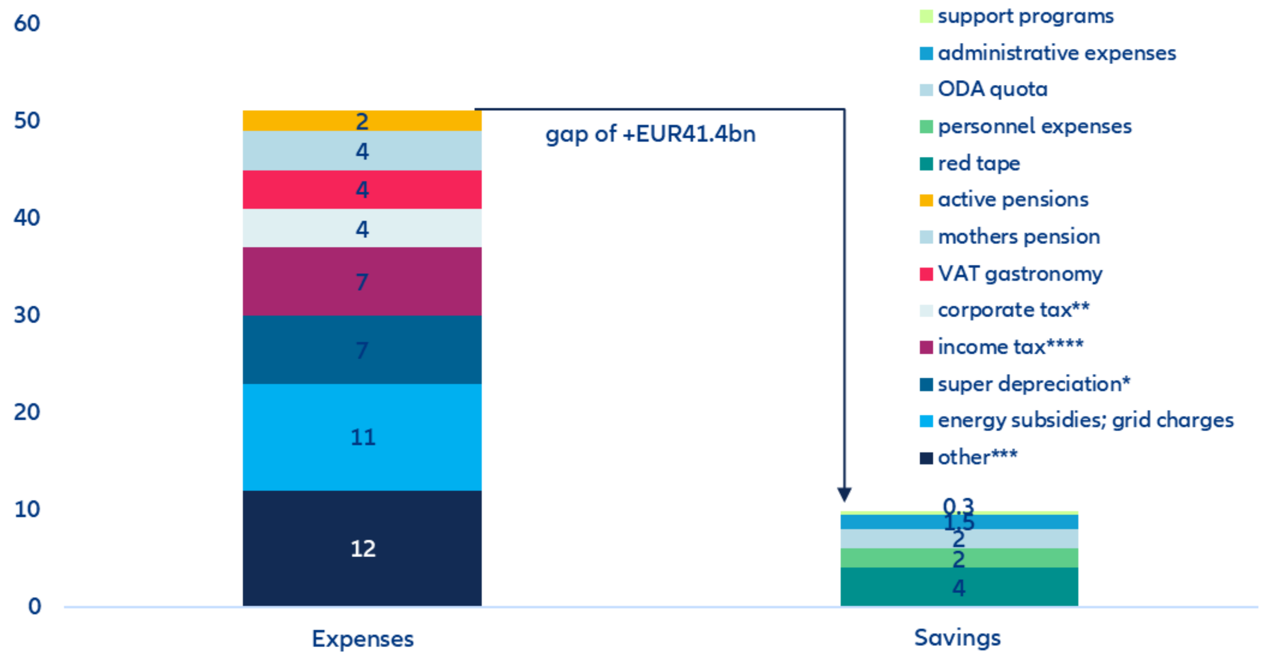
The coalition agreement holds a mixed bag for Germany. The EU's largest economy is on its way to a more stable government, with the election of Friedrich Merz as chancellor and the swearing in of cabinet members currently set for 7 May. But the coalition agreement is a mixed bag, without the sweeping new beginnings that many had hoped for. On the positive side, the coalition agreement focuses on pro-business reforms, including a proposed 30% super depreciation allowance for three years, lower corporate taxes from 2028 and the abolition of the Supply Chain Act. However, the plan lacks key structural reforms, particularly in the areas of pensions, work incentives and social security. With more than EUR50bn in estimated annual spending on the measures outlined in the treaty and only around EUR10bn in quantifiable identified savings, the program risks overpromising without a solid budgetary underpinning. The coalition's divergent views on the economy make real economic rebalancing and improved competitiveness unlikely without a shift in priorities.

The coalition agreement holds a mixed bag for Germany

No broad new beginning. Germany is on track to form a functioning government, with Friedrich Merz likely to be elected chancellor on 7 May. While the prospective coalition's program contains promising pro-business measures – such as a 30% super depreciation allowance for three years, lower corporate taxes from 2028, the abolition of the Supply Chain Act and a reduction in electricity costs – it lacks a coherent strategy. Key structural reforms, particularly in the areas of pensions, tax and social security, are missing. With over EUR50bn in planned annual spending but only EUR10bn in identified savings (Figure 1), the program overpromises without solid budgetary backing, making a real economic reset and restored competitiveness unlikely – especially in the face of global upheaval – unless priorities shift. Differing economic views within the future coalition further reduce the likelihood of a much-needed reset to halt Germany's decline in competitiveness.

Investment incentives and corporation tax: two strong signals with a few shortcomings. There is good news for German companies on the tax front. Two key measures stand out: First, an investment incentive offering 30% super depreciation on equipment purchases between 2026 and 2028. This temporary boost, costing around EUR7bn per year, could increase investment by +0.6% per year and boost GDP by +0.1pp per year. Although not a structural change, it encourages earlier and larger investments, with companies effectively repaying the relief through higher future tax revenues. Second, from 2028 onwards, corporate tax will be gradually reduced by 1pp per year over five years from the current 29.9% (2023). With an estimated annual fiscal cost of EUR4bn, this gradual reduction keeps costs manageable and sends a strong signal – although Germany will not reach a globally competitive tax level until 2032. One downside is the permanent extension of the reduced 7% VAT rate for restaurants, an economically unjustified EUR4bn annual subsidy.

Figure 1: Quantifiable expenses and savings of the coalition program, in EURbn annually



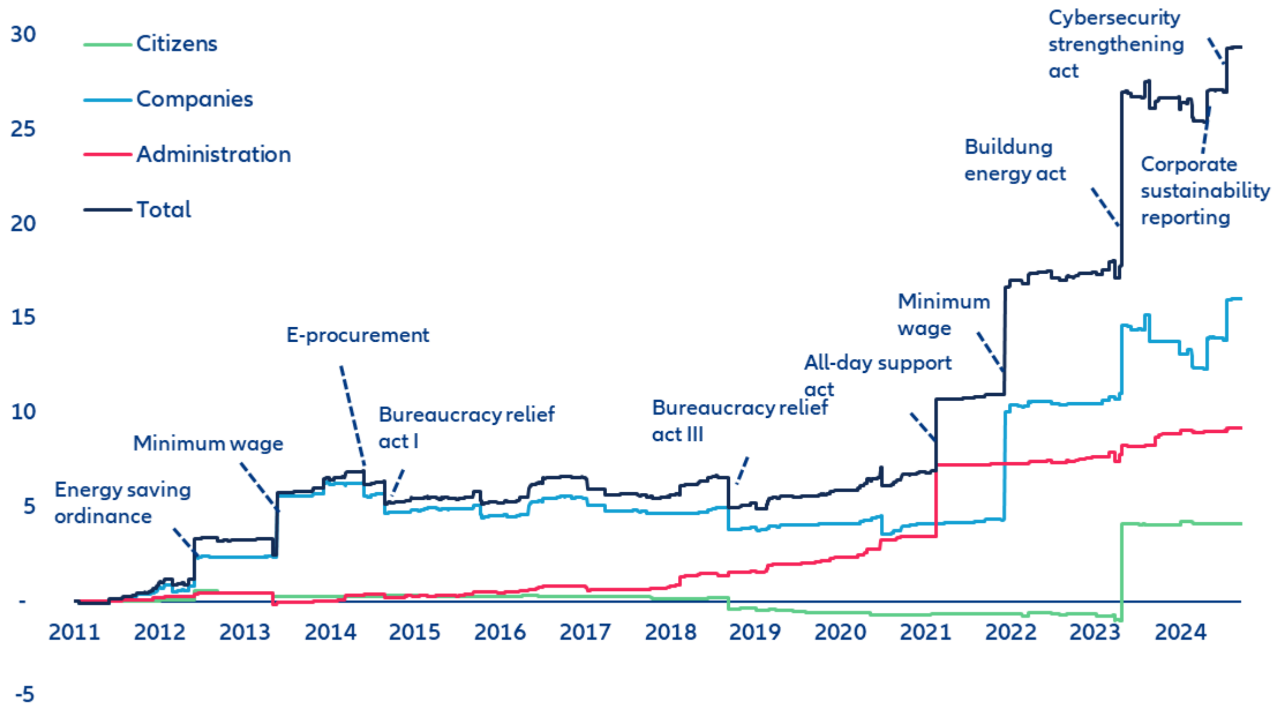
*Source: Allianz Research. Notes: *until 2028, ** from 2028, *** early retirement pension, a higher parental allowance, BAföG, the promotion of e-cars, the continuation of the Deutschlandticket, the subsidization of agricultural diesel and the reduction of air traffic tax, **** travel allowance, tax-free overtime, early retirement pension, single parents.*

Income tax: a missed opportunity apart from some simplification. Little remains of a comprehensive income tax reform. The plan to introduce broader changes mid-term is vague and unambitious, with no clear figures. However, targeted measures such as increased tax-free allowances for pensioners, single parents, volunteers and commuters, and tax-free overtime, will provide some EUR7bn in annual relief. A highlight is the new working day allowance. However, this will largely replace the commuter allowance, which will instead be raised to 38 cents per kilometer – an additional EUR2.3bn per year. In terms of working time incentives, the picture is mixed: tax-free income for work after retirement makes sense, but exempting overtime bonuses is unlikely to have a significant impact on working hours. Taken together with costly giveaways such as reduced VAT for restaurants and extended commuter tax relief, there is little fiscal room for meaningful tax reform. Meanwhile, costly pension measures are on the horizon, putting further pressure on the budget.

Energy cost measures bring some relief. German companies have long struggled with electricity costs more than 10 cents per kWh higher than the EU average, undermining competitiveness. The new coalition plans to ease this burden by halving the difference – around 5 cents per kWh – through reduced electricity tax and capped grid fees. Subsidized industrial electricity prices for energy-intensive companies will also be continued. While these broad measures lack economic precision, they send a supportive signal to industry. Taken together, these measures promise annual relief of EUR11bn, financed by the CO2 levy. However, to achieve a lasting improvement, Germany's lack of reliable baseload power must be addressed. To this end, the government plans to incentivize up to 20GW of new gas-fired power capacity by 2030, which could increase national power generation by around +6% based on current consumption. Notably, the reopening of nuclear power plants is not on the agenda.

Cutting red tape: promising steps, but many open questions. The new German government has announced an "immediate action program" to cut red tape, especially for small and medium-sized enterprises (SMEs), by the end of 2025, which has spiraled as bureaucratic costs amount to EUR146bn per year, with direct costs estimated at EUR65bn (Figure 2). The guiding principle is to move from control and regulation to trust. Planned measures include reducing the number of mandatory company representatives, easing training and documentation requirements and simplifying compliance burdens. The coalition also supports the EU's omnibus directive on sustainability, including the CSDDD, CSRD, taxonomy and CBAM – but insists on "unbureaucratic" implementation, especially for SMEs. At the national level, Germany's Corporate Supply Chain Act is to be repealed and replaced by the EU's CSDDD, although it remains to be seen whether this will really mean less red tape. Combined with other deregulatory efforts, such as the repeal of the Heating Act, the government aims to reduce bureaucracy by 25% over four years, providing an estimated EUR16bn relief to the economy. To modernize public administration, a one-stop digital platform for citizens and businesses will be launched, allowing companies to be set up within 24 hours. By 2029, the staff of ministries and federal agencies will be reduced by -8% after they increased by more than 30% over the last decade, potentially saving EUR2bn a year. A new Ministry of Digital Affairs will lead this "digital by default" transformation. Infrastructure approvals are also intended to be speeded up under a new law providing faster access to the EUR500bn infrastructure fund for projects such as roads, railways and schools. These projects will be declared of "overriding public interest" to cut down on legal challenges. To really make approvals for infrastructure faster and to actually be able to use the EUR500bn of the special infrastructure fund to be ultimately spent primarily on roads, bridges, railways and schools, the new federal government intends to speed up the planning and approval procedures as part of a future infrastructure bill. These projects are to be in the 'overriding public interest', which shortens legal disputes. But it is not clear whether the excessive rights of environmental organizations to participate and take legal action will actually be limited in the end. There is no explicit commitment to this in the coalition agreement.

Figure 2: Development of current compliance costs since 2011, in EUR bn



Sources: Normenkontrollrat, Allianz Research

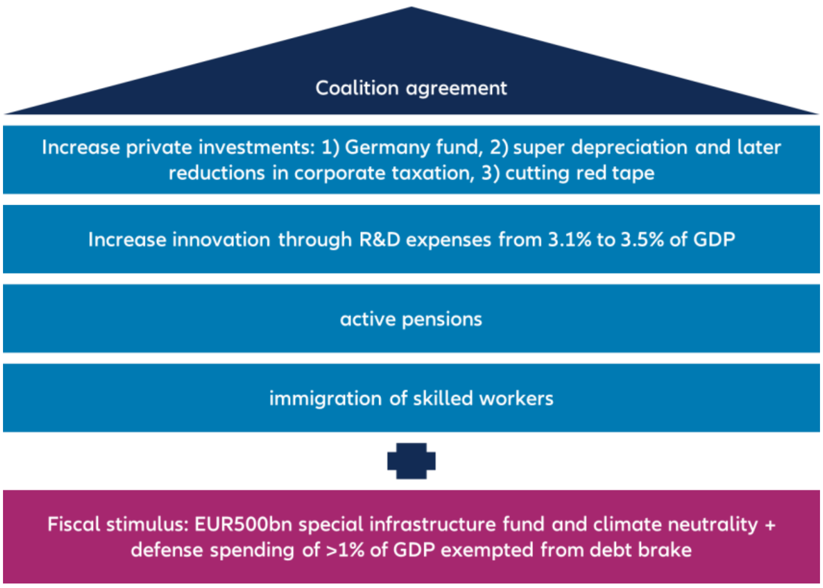
Rising non-wage labor costs amid limited pension reform. Germany's ageing population continues to put pressure on its social security system, with non-wage labor costs rising significantly. Since Q1 2021, total labor costs have risen by +20%, with non-wage labor costs up by a third, outpacing wage growth. With nearly 5mn people expected to retire by 2029, further increases are likely. Despite this, the coalition plans to maintain the current pension level of 48% until 2031, with a reassessment in 2029, and to continue to allow full retirement after 45 years of contributions. New subsidies such as an "active pension" (tax-free income of up to EUR2,000 per month after retirement, with costs of EUR2.2bn annually) and the costly mothers' pension (EUR4bn per year) will further burden the system. A comprehensive reform is lacking, but several constructive initiatives stand out: the promotion of occupational pensions, especially for SMEs and low-income earners; a planned Riester reform; increased employee share ownership and a new "pension starter kit" ("Frühstartrente") for children aged 6-18, with state contributions of EUR10/month. While the latter is a promising step to encourage early saving habits, its long-term effectiveness will depend on strong incentives to continue contributions beyond the age of 18. Overall, costs continue to rise while structural solutions remain limited.

Few structural changes in labor policy, but major concessions. While the coalition agreement includes some initiatives in social and labor policy, it lacks major structural reforms. Key proposals include the reform of citizen's income into a new form of basic security, the creation of a "Work & Stay" agency to support better integration into the labor market and a tougher stance on migration by introducing border controls, rejecting irregular migration and tightening citizenship rules, with naturalization only possible after five years. But these steps are incremental rather than transformative. On the contrary, one significant step could have a major impact on the labor market: the planned increase in the minimum wage to EUR15 by 2026. This would represent a jump of +17% – well above the expected overall wage growth of +5.2% in 2024 and +2.8% in 2025 and +2.7% in 2026. While this signals strong support for low-income workers, it may pose challenges for companies, especially in low-wage sectors.

Mixed signals on climate policy, social spending and security plans. On climate policy, the program takes a step backwards by continuing subsidies for agricultural diesel – costing EUR0.5bn a year – and offering tax breaks for electric company cars, a costly and inefficient way to reduce CO_2 emissions. These measures largely benefit the car industry rather than driving real change. However, the expansion of the EV charging network is a welcome and sensible infrastructure investment. In addition, many smaller commitments, such as early retirement, higher parental benefits, extended BAföG, EV incentives, the "Deutschlandticket" and reduced air travel tax, add up to around EUR12bn per year. The coalition agreement entails many more good points. For instance, on defense and security, it plans to further develop a Federal Security Council, national situation center and crisis team within the Chancellery and increase spending on defense (no specific amount mentioned) besides accelerating planning and procurement law for the Bundeswehr while thinking about expanding compulsory military service on a voluntary basis (for now!) following the Swedish model. On the sectoral level, the coalition wants to provide more support for start-ups and high-tech industries.

The bottom line is that the coalition's plan includes more than EUR50bn in spending, with only about EUR10bn in quantifiable savings. While growth from some initiatives could boost government revenues, it is unlikely to fully offset the costs, and the implementation of many intended measures will only be possible if the debt brake is loosened further. This means the coalition will have to be selective about which reforms and promises to prioritize. The cornerstones to put Germany on a higher potential growth path are set (Figure 3), but in the end the government needs to choose the right measures to boost German growth and strengthen the economy.

Figure 3: Cornerstones of the coalition contract for higher potential growth in the longer-term



Sources: Allianz Research

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