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Allianz Research

Germany – quo vadis?

Executive Summary


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Over the past 25 years, megatrends such as demographics, climate change, and artificial intelligence (AI) advancements have reshaped global economies. Poised at the crossroads of these transformations, Germany faces challenges distinct from its earlier struggles as the "sick man of Europe", raising doubts about its economic model. To navigate these complexities, Germany requires a "2030 Leitbild" – a strategic vision that strengthens growth foundations and charts a path to future prosperity. Ten priority areas emerge as crucial to restarting Germany's growth engine:

1 Liberation from fiscal self-restraint: Germany's federal budget shortfall, driven by rising defense and investment costs, demands a comprehensive strategy. Public investments in decarbonization, transport, education and defense require reforms such as a dynamic debt brake and „golden rule plus" based on investments. Raising the structural deficit ceiling to 0.5-1% of GDP could support critical investments, but structural reforms remain essential.

2 Transition to a green energy system to secure competitiveness: Short-sightedness has delayed Germany's energy transition, leading to higher costs, slower decarbonization, and infrastructure development that lags the growth of renewable energy. Achieving long-term sustainability requires EUR1tr in investments by 2035, equally divided between upgrading energy infrastructure and expanding renewable capacity.

3 Rebuilding public infrastructure after years of neglect: German public investments have plummeted from 1% of GDP in the 1990s to zero. Rebuilding capital stock will require an additional EUR600bn over the next decade. Critical priorities include infrastructure, education, housing, and green energy while fostering public-private partnerships to enhance financing and job creation.

4 Unleashing labor supply to close the demographic gap: Germany's working-age population is projected to decline from 52mn to 43mn by 2050. Proactive labor market policies must increase workforce participation among women, older workers, and immigrants. Strategies include removing barriers to work and reducing discrimination, while implementing incentives such as tax breaks and integration programs.

5 Ensuring generationally fair pensions: Germany's old-age dependency ratio is expected to increase from 34% to 51% by 2050, demanding balanced pension policies. Reforms should curb cost increases, incentivize later retirement and expand capital-funded options like occupational pensions, especially for low-income groups, while addressing double taxation of retirement income.

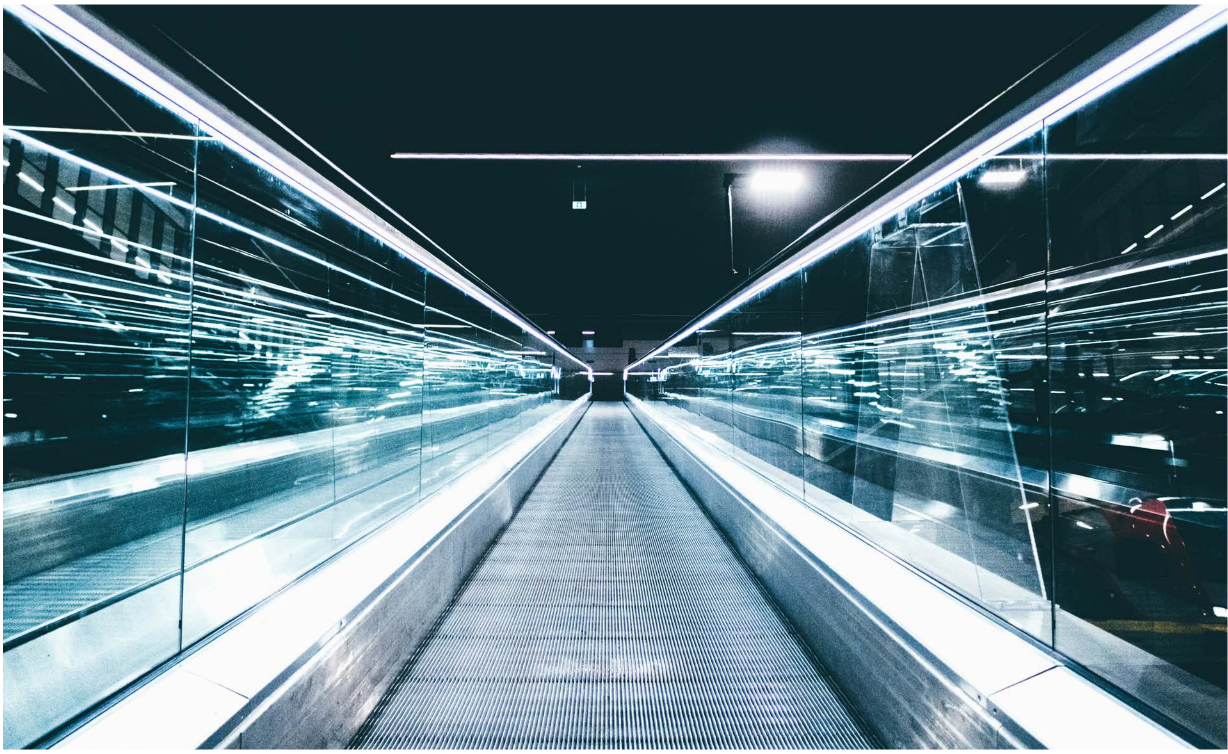
6 Reforming the tax system to boost motivation and incentivize work: Germany's current tax system places a high burden on labor, with an effective personal income tax at 29% and corporate tax at 29.9% in 2023, while taxing wealth at only 0.4%. To enhance competitiveness and encourage economic participation, reforms should focus on eliminating the solidarity surcharge, simplifying income tax brackets, and reducing corporate taxes to 25%. These changes would create a more balanced system that supports growth and incentivizes productivity.

7 Revitalizing innovation: German R&D investments of 3.1% of GDP are insufficient to stake leadership claims in future technologies industries such as AI, robotics, quantum and green technologies. Doubling R&D investment to 6% of GDP through tax breaks and strategic institutional support is critical for innovation and competitiveness.

8 Reducing regulatory hurdles: Despite progress, bureaucratic costs in Germany amount to EUR146bn annually, with direct costs estimated at EUR65bn. Reducing red tape by 25% over four years, digitalizing procedures, and streamlining EU negotiations are key to enhancing efficiency and competitiveness.

9 Strengthening European leadership: A strong Franco-German partnership is vital for the EU's success, yet recent internal conflicts – Germany's internal coalition conflicts and French political turmoil – have weakened collaboration. A new EU Commission and German government offer a fresh start. Germany must reinvigorate its role by supporting common debt mechanisms, deepening the Capital Markets Union (CMU), promoting equity market growth, incentivizing savings reorientation, and simplifying regulations.

10 Engagement for fair trade relations: Germany's export-led model, with exports at 43% of GDP, is under strain as globalization wanes. Declining exports to China, now at 6% of the German total, are partially offset by gains to the US, but trade tensions loom. Germany must pivot its value chains towards Europe, negotiate for free trade agreements, and focus on internal growth and industrial policy standardization.



Then and now – what a difference a quarter of a century makes

A quarter of a century can feel like both a lifetime and a fleeting moment. In 2000, the EU launched its Lisbon Strategy to become the world's most competitive region. Its focus? Digital literacy and technological innovation; structural reforms and reducing regulatory burdens; increasing energy efficiency and promoting renewable energy sources. This sounds depressingly familiar. A generation later, the Draghi Report echoes similar themes. In 1999, The Economist labelled Germany the "sick man of Europe". Fast-forward to today and history appears to be repeating itself.

However, these déjà vu experiences should not obscure how much the world has changed. In 2000, the spirit of the "end of history" still lingered. The future seemed to belong to a rule-based, open, liberal world order. Democracy's triumph felt unstoppable. Today, no one believes that anymore. The "fragmented world" we now inhabit reflects the uncertainty of a transitional period. The old order is unraveling, and whether something new will emerge remains an open question. Meanwhile, megatrends such as demographics, climate, and AI – only just on the horizon back then – are now reshaping economies and societies.

This means Germany's "sickness" is fundamentally different. In 1999, the solution was straightforward: revitalize existing strengths. The German economic model – export-driven growth, industrial prowess, and technology leadership – was unquestioned. After necessary adjustments, this model delivered strong results for years. But now? Every pillar of that model faces uncertainty:

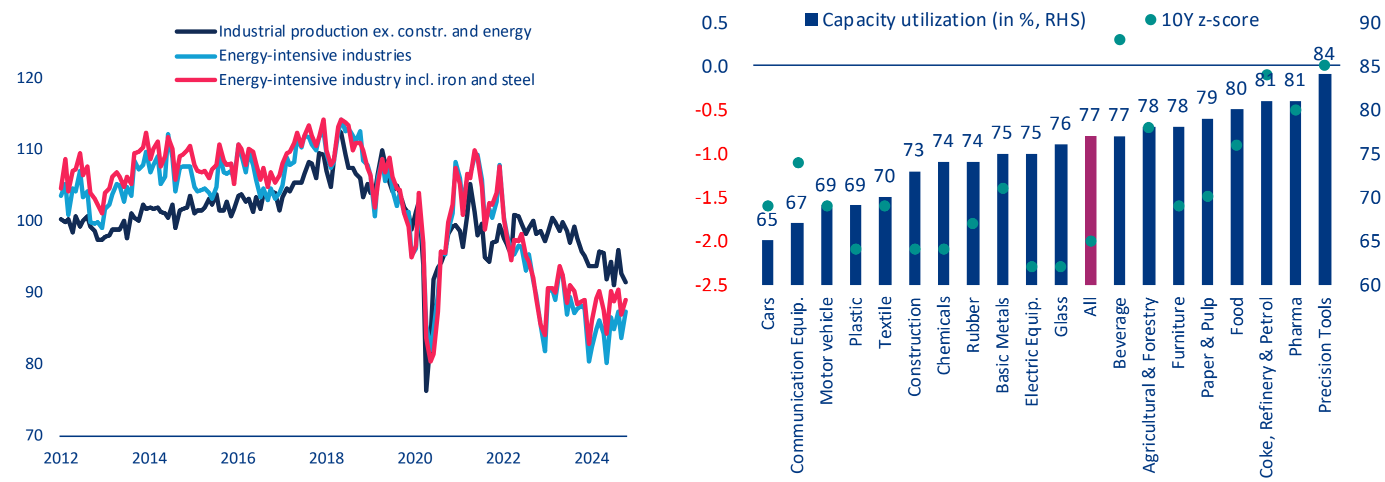
- Export orientation struggles in a time of rising protectionism.
- Engineering prowess is being eclipsed by the importance of data and software in shaping our daily lives.
- Technological leadership has eroded, with dominance shifting to competitors like the Chinese and advancements in AI.
- Industrial strength is under pressure from the costly energy transition.
- Immigration, a potential solution to the demographic gap, is fueling political populism.

Germany's automotive industry epitomizes this perfect storm. Tariff threats from the US, evolving customer expectations for connected cars, gaps in electronic vehicles (EV) technology, and huge cost disadvantages make Germany a less competitive production hub.

Beyond the auto sector, the outlook is also bleak: Over a third of industrial companies in Germany are cutting investments in core processes due to high energy costs. Two-thirds report that their competitiveness is at risk. Critical sectors such as chemicals and machinery are particularly affected, grappling with high energy costs and shifting global demand. Manufacturing is battling declining orders for cyclical goods and a pivot toward service-driven growth. This has resulted in steeper production declines compared to other sectors (Figure 1, left) and underutilized capacity (Figure 1, right). The consequence? A wave of job cuts across industries, with major companies announcing layoffs on an unprecedented scale (Table 1).

Incremental changes – like minor tax adjustments or additional subsidies – will not suffice for the new government. Germany needs a genuine fresh start: a bold, forward-looking economic model that can continue the country's success story. This requires a "2030 Leitbild" – a strategic vision outlining where Germany can generate future growth and prosperity.

Figure 1: Industrial production, Feb 2022 = 100 (left) and capacity utilization, in % and z-score (right)



Sources: LSGE Datastream, Allianz Research. Note: Energy-intensive industries include chemicals, metals, glass, paper, coking & refining.

No political party currently has such a blueprint – and neither do we. The task for the months ahead is to collaboratively draft this master plan, bringing together insights from politics, business, and science. This is not about adopting a rigid, centrally planned approach akin to a Chinese five-year plan. Instead, it calls for a unifying idea of how and where Germany should deploy its (limited) resources and, crucially, where it should refrain. The plan must also address how to support this transformation effectively, ensuring its feasibility and long-term success.

Table 1: Announced job cuts in 2024

	Company	Sector	Layoffs (Germany)	Staff ratio (Germany)
Automotive	Robert Bosch	Auto supplier	3800	3%
Automotive	Schaeffler	Auto supplier	2800	3%
Automotive	LEONI	Auto supplier	4500	5%
Automotive	ZF Friedrichshafen	Auto supplier	11000-14000	20-26%
Automotive	HELLA	Auto supplier	420	5%
Automotive	Continental	Tyre	2860	6%
Other industries	Baywa	Agricultural	1300	16%
Other industries	Luftthansa	Airline	400	20% of administrative jobs
Other industries	Deutsche Bank	Banks	3500*	4%*
Other industries	Evonik	Chemicals	2000	6%
Other industries	Miele	Domestic Appliances	1300	11%
Other industries	SMA Solar	Energy	1100	25%
Other industries	Siemens Energy	Energy	4100*	15%*
Other industries	SAP	Software	3500	Early retirement program (14% of German staff)
Other industries	Infineon	Software	Hundred of persons	3-10%
Other industries	Thyssenkrupp	Steel	11000	40%

Sources: Reuters, AFP, Allianz Research

While envisioning a new economic model is crucial, it does not relieve Germany from the hard work of strengthening the foundations of growth. Even the best navigation system is useless if the engine is not running. For two decades, essential maintenance of Germany's growth engine has been neglected, necessitating an urgent overhaul. Yet the reverse is also true: a purring engine is of little value without clarity on direction. This paper aims to kickstart the discussion on how to restart Germany's growth engine and determine its economy's direction. In our view, ten fields of action are critical:

- Liberation from fiscal restraint
- Transition to a green energy system
- Rebuilding public infrastructure after years of neglect
- Unleashing labor supply to close the demographic gap
- Ensuring generationally fair pensions
- Reforming the tax system to boost motivation and incentivize work
- Revitalizing innovation
- Reducing regulatory hurdles
- Strengthening European leadership
- Engagement for fair trade relations.

Ten priority areas to restart Germany´s growth engine

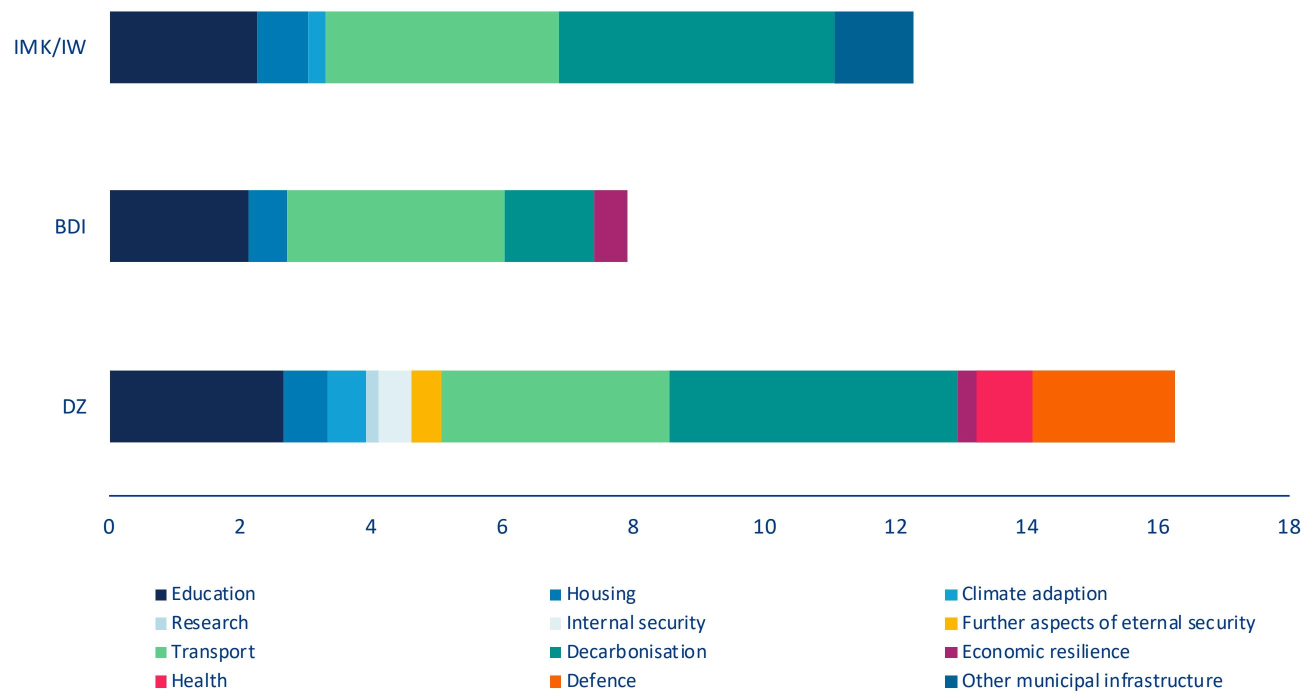
1 Liberation from fiscal self-restraint

Germany faces significant fiscal challenges that demand an overarching strategy. Social spending, accounting for nearly half of government spending, remains controversial in public debates about budget cuts. With spending blocks like interest rates, defense, and public investment being either fixed or high priority, curbing government spending without touching social spending is difficult.

And the financial strain is set to intensify. The 2025 federal budget faces a shortfall of EUR12bn – but the actual gap is closer to EUR28bn. Between 2026 and 2028, an additional EUR135bn will be needed. And tax revenues are shrinking due to slower economic growth, compounding the issue.

At the same time, Germany requires substantial public investments. These are estimated at 9-18% of GDP over the next five to ten years, addressing pressing needs in decarbonization, transport, education, and defense (Figure 2). Closing this gap will require a comprehensive strategy that balances fiscal responsibility with the need for transformative investments to secure long-term growth.

Figure 2: Estimates of public financing needs, % of GDP



Sources: Dezernat Zukunft, BDI, IMK/IW (right), Allianz Research. Note: Internal security includes measures to strengthen disaster response and civil protection by investing in infrastructure to warn the population, protect the public with bunkers and similar shelters, build national reserves, digitalize crisis management, and strengthen relevant authorities and institutions. Further aspects of external security include intelligence services, diplomacy, humanitarian aid, development cooperation and support for strategic partner countries. The Dezernat Zukunft estimates are for 2025-30; the BDI and IMK/IW estimates stretch over 10 years.

The new direction

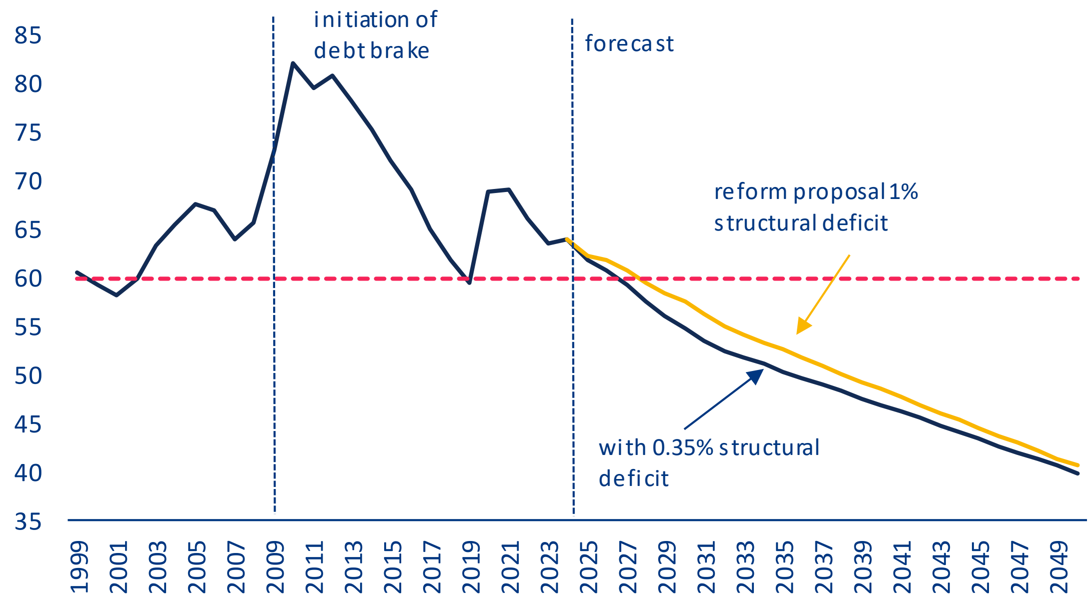
A dynamic debt brake could address concerns about excessive debt, while a „golden rule plus" would ensure sufficient financial leeway for critical investments. Reform proposals by the Bundesbank and the Council of Economic Advisors show promise, offering a pathway to maintain a clear downward trajectory for German government debt. These proposals include:

- Extending the activation of the emergency clause beyond the immediate aftermath of a crisis.
- Allowing a slightly larger structural deficit when debt has moved below 60% of GDP.
- Introducing an investment rule to prioritize growth-enhancing spending.
- Modifying the method for cyclical adjustments to reflect economic realities more effectively.

The „golden rule plus" is based on net investments. It thus addresses limitations of the previous fiscal framework by distinguishing between productive investments and operational expenditures. However, these reforms could also impose additional burdens on future generations, who already face significant implicit debt due to subdued growth prospects.

The tricky electoral arithmetic for a fiscal policy shift. A shift to a more expansionary fiscal policy after the next election will hinge on political will, particularly whether the Conservatives are willing to support relaxed borrowing limits. As things stand, significant loosening of fiscal spending seems unlikely. Post-election reforms are expected to be modest and remain stricter than current EU fiscal rules. Raising the structural deficit ceiling to 0.5-1% of GDP could provide room for investment spending while keeping debt below 60% of GDP (Figure 3 and Table 2). However, this alone will not be enough. Achieving sustainable growth will require meaningful structural reforms alongside these fiscal measures.

Figure 3: Government debt simulation, % of nominal GDP and 60% Maastricht limit



Sources: LSEG Datastream, Allianz Research. Notes: Fiscal multiplier of 0.8 applies based on Dezernat für Zukunft, "What is the fiscal multiplier and why is it so controversial?" 2024.

Table 2: Scenarios for Germany on the debt brake

	Baseline: deficit ceiling at 0.35% of GDP		Middle: deficit ceiling at 0.5% of GDP		Upside: deficit ceiling at 1% of GDP	
Impact on...	**2025**	**2026**	**2025**	**2026**	**2025**	**2026**
General balance in % of GDP	-0.35	-0.35	-0.5	-0.5	-1	-1
Debt-to GDP	61.8	60.8	61.9	60.9	62.3	61.6
GDP growth	0.4	0.9	0.5	1	0.7	1.4
10y gov. bond yields	2	2	2.1	2.1	2.4	2.4
DAX 40	6%	7%	8%	10%	11%	12%
EURUSD	1.05	1.08	1.05	1.08	1.07	1.1

Source: Allianz Research

Lifting Germany's debt brake would result in higher yields, a steeper curve, a stronger Euro, and narrower swap spreads – but the effects would be modest. Here's a closer look:

- **Higher bond supply and economic growth:** Loosening the debt brake would mechanically increase bond supply, driving higher long-term yields. Concurrently, fiscal flexibility could stimulate economic growth, further attracting capital inflows and strengthening the Euro. Returns from the Eurozone's largest economy would become more attractive, contributing to these trends.
- **Yield curve steepening:** Long-term yields would rise due to higher bond supply and growth expectations, but short-term yields would likely remain anchored to the European Central Bank's (ECB). The divergence would steepen the yield curve. Though the ECB's stance might adjust to fiscal policy changes, such shifts would be less pronounced.
- **Tax cuts and amplified effect:** If fiscal reforms include tax cuts, the impact on economic growth and inflation could be magnified, providing an additional tailwind to long-term rates and the Euro.
- **Narrowing EUR swap spreads:** Increased bond supply would cheapen government bonds, increasing their yields. However, EUR swap rates, unaffected by supply dynamics, would remain stable, narrowing swap spreads. For instance, the ten-year EUR swap rate and the ten-year German government bond yield would tighten.
- **Impact on risky assets:** Similarly, German risky assets, including equities, would only see modest improvement. While fiscal easing would provide a minor boost to our earnings per share (EPS) and equity performance forecasts, the overall impact would remain limited, reflecting the measured scale of fiscal changes.

While the direction of fiscal policy may seem clear, the magnitude of potential market impacts remains limited. Our baseline forecast assumes the debt brake will remain in place. Even under alternative scenarios, we do not foresee Germany becoming a significant fiscal spender (Table 2).

- **Limited impact on bond supply:** The increase in German government bond supply would likely remain negligible if the debt brake allows a deficit of 0.35%, 0.5%, or even 1.0% of GDP. Germany's conservative fiscal policy stance means its government bond market would still be undersized compared to other major economies.
- **Broader economic effects:** A higher deficit ceiling, such as 1.0% of GDP, would likely impact rates and the Euro more significantly through secondary effects. Increased fiscal spending could drive higher economic growth and inflation across the Eurozone. This could lead to a comparatively more hawkish stance from the ECB, pushing yields and the Euro higher.
- **Historical context of German yields:** German ten-year yields have been on a downward trajectory since 2000 (Figure 4), driven primarily by demographic trends and lower policy rates. Notably, introducing the debt brake after the 2009 financial crisis did not cause a significant deviation in this trend. Similarly, a modest loosening of the debt brake is unlikely to reverse the trajectory in any meaningful way.
- **Swap spreads and scarcity effects:** Between 2015 and 2019, swap spreads widened – a pattern typically seen during recessions due to the safe-haven demand for German bunds. However, attributing this only to the debt brake is misleading. This period coincided with the ECB's large-scale quantitative easing (QE) program, which reduced the availability of German bunds in the market, driving yields lower and widening swap spreads.

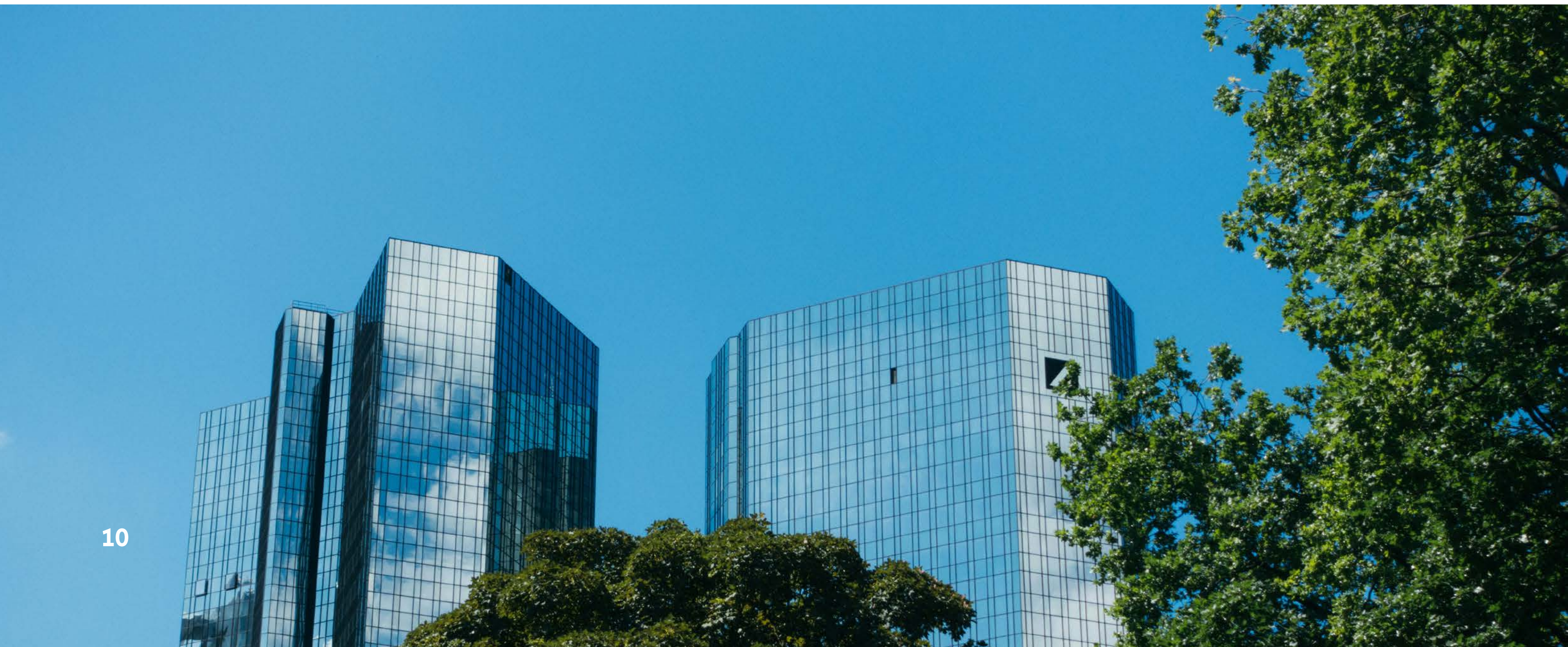
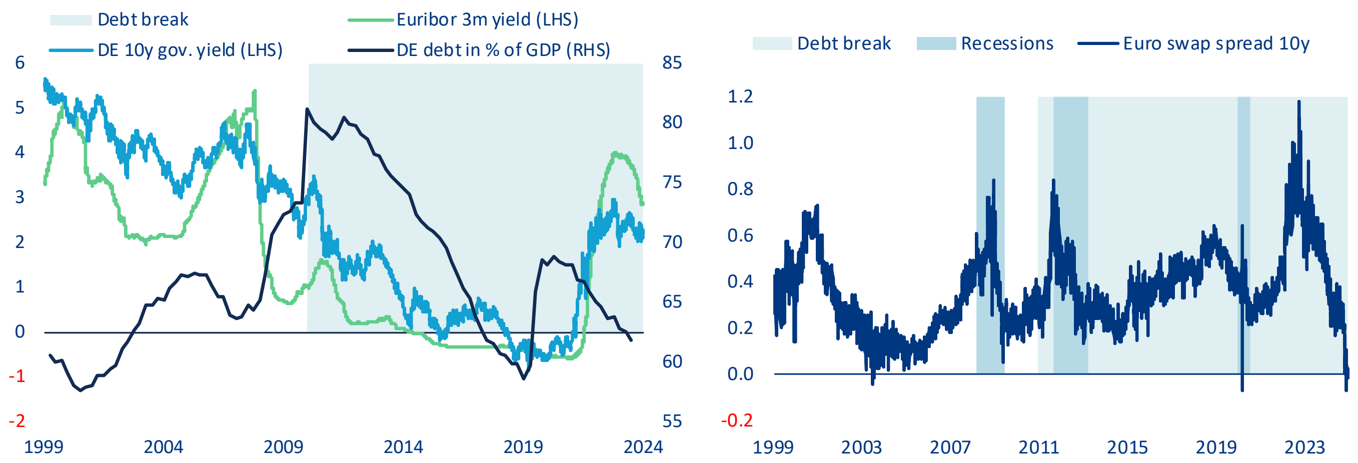


Figure 4: German 10-year government bond yields, Euribor 3-month and debt in % of GDP (left) and swap spread (Euro 10-year swap – DE 10-year gov bond), pp (right)



Sources: LSEG Workspace/Datastream, Allianz Research

2 Transition to a green energy system to secure competitiveness

Germany's energy transition has been hampered by myopia, delaying essential structural reforms and leading to higher energy costs and slower decarbonization. The nuclear phase-out increased short-term reliance on fossil fuels, leaving the country vulnerable during the energy crisis. While coal consumption has fallen by 45% since 2014 thanks to significant renewable energy growth, natural gas usage remained steady until 2021. This reliance left Germany more exposed than other European countries to energy price shocks and sustained high costs due to LNG imports.

A second challenge is the misalignment between the rapid expansion of renewable energy capacity and the lagging grid and storage infrastructure development. Despite a 12.4% annual growth rate in renewable capacity over the past 23 years, infrastructure development is trailing by seven years. This mismatch forces renewable generation shutdowns during surplus hours and contributes to supply shortfalls during peak demand. This supply-demand imbalance has increasingly led to greater price volatility in the wholesale market, with adverse effects on consumers and industrial production.

The new direction

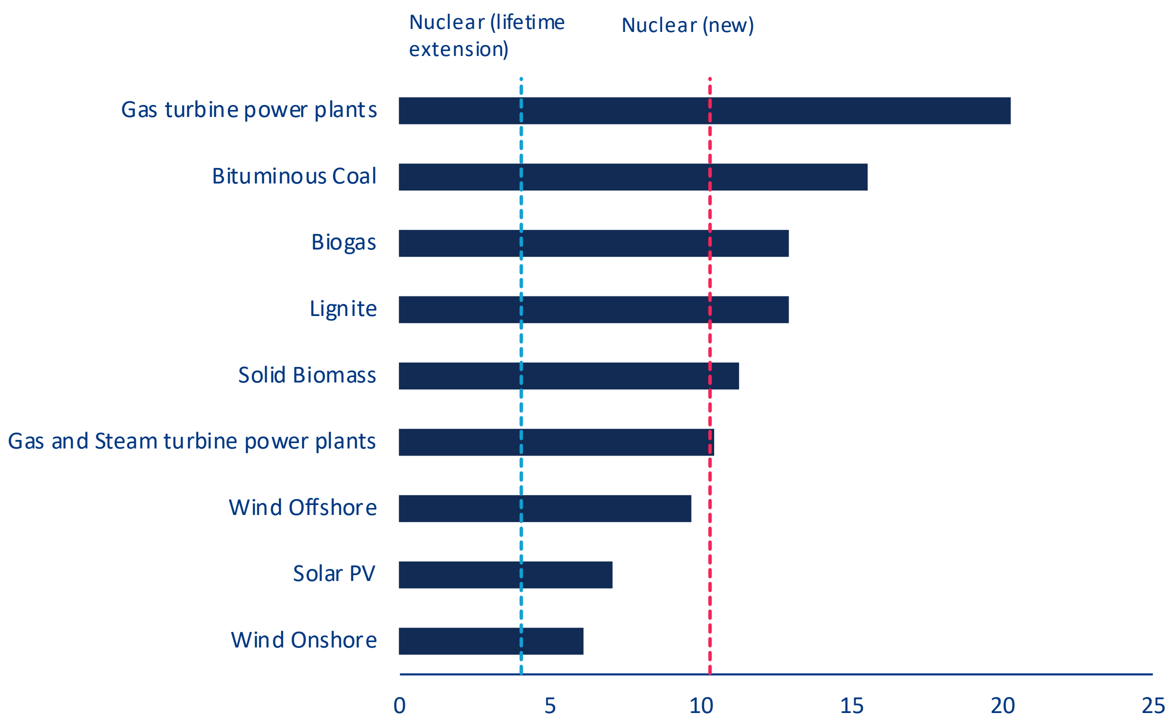
To secure a sustainable energy future, Germany needs investments totaling EUR1,000bn by 2035. These investments must focus on modernizing the energy market and upgrading energy infrastructure. Contrary to claims that decarbonization undermines industrial growth, the green transition – coupled with deeper European energy market integration – presents Germany with the best opportunity to drive economic growth and restore competitiveness.

More than half of the required investments are needed to upgrade energy infrastructure. By 2035, an estimated EUR372bn will be required for transmission and distribution grids. Furthermore, approximately EUR122bn will be required for storage solutions, while EUR58bn are needed within the next decade to expand Germany's district heating network.

Investments in renewable generation capacity will require EUR466bn by 2035. The priority should be on existing, cost-efficient, low-carbon options like wind and solar, as geothermal and nuclear roll-out times are too slow to meet immediate needs.

- **Solar energy:** Falling panel costs and the growth of rooftop photovoltaic systems in German states make achieving the target of 215 GW installed solar power by 2030 feasible. Investment need: EUR131bn by 2035.
- **Wind energy:** Despite efforts to streamline permitting, wind power still falls short of the 2030 targets. A significant challenge continues to be local acceptance and the willingness of states to accelerate expansion efforts. Additionally, supply chain disruptions and limited ship availability constrain offshore development. Plans aim to double offshore capacity within just two years by the end of this decade, targeting 15 GW in both 2029 and 2030. Investment need: EUR316bn by 2035.
- **Hydrogen:** While hydrogen projects and international partnerships are growing, uncertain long-term demand discourages full-scale investment. Investment need: EUR19bn (for domestic capacity only) until 2035.
- **Geothermal energy:** Geothermal could be promising mid- to long-term (2035 onwards) if costs decline consistently. Traditional nuclear power is likely too expensive for future energy markets (Figure 5), though small modular reactors may have niche applications, but recent cost explosions demand cautiousness.
- **Nuclear fusion technology:** Nuclear fusion is still in its infancy and these technologies are unlikely to play a role in the green transition. Despite 900m in investments slated for 2024 – 50% from public sources – it remains unclear when and if the technology will become cost-competitive with established renewables.

Figure 5: Levelized cost of electricity, cent/kWh

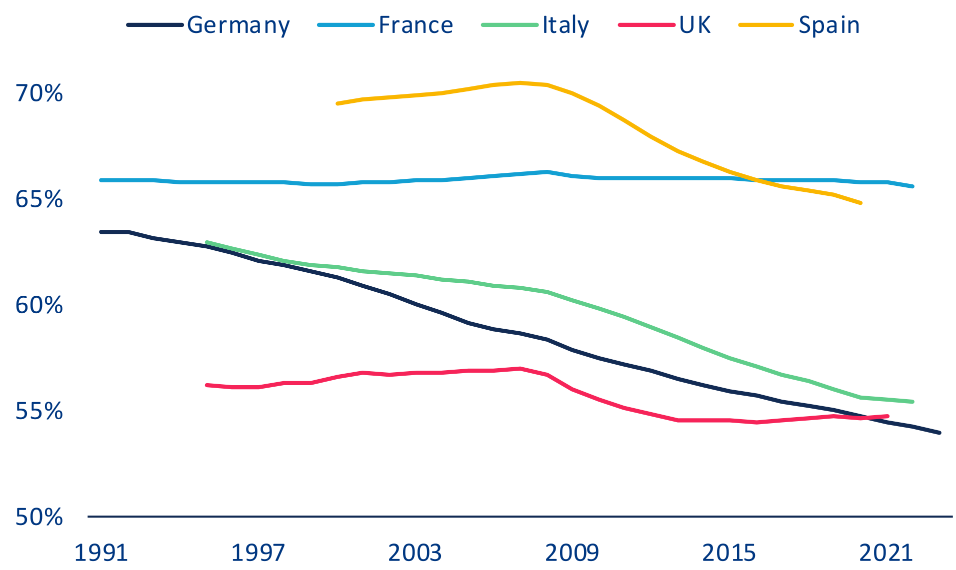


Sources: Fraunhofer ISE, IEA, Allianz Research

3 Rebuilding public infrastructure after years of neglect

Germany's public investments have steadily declined since 2004, compounded by economic uncertainty and a downturn that has dampened private sector contributions. Annual net public investment has fallen from 1% of GDP in the early 1990s to zero, with Germany's capital stock declining by -10pps over the past decade (Figure 6). The underinvestment has been particularly pronounced in public infrastructure – railways, highways, and waterways – with a peak loss of -EUR22bn recorded in 2023, exacerbating the deterioration.

Figure 6: Share of net/gross fixed capital stock, in %



Sources: OECD, Allianz Research

Germany faces a moral hazard issue in its approach to infrastructure investments, especially in railway infrastructure maintenance. The Federal Railways Expansion Act (BSWAG) historically required the federal government to finance replacement investments while Deutsche Bahn AG (DB AG) handled maintenance. This misalignment of responsibilities led to delays and neglect, with economically efficient maintenance sometimes deferred until only full replacements became unavoidable. The BSWAG is being revised to allow the federal government to fund maintenance costs. This partially resolves the incentive problem but shifts financial burdens onto the federal government without resolving oversight concerns surrounding the DB AG meeting its maintenance obligations.

Similar incentive issues affect road infrastructure. Local or state-owned public infrastructure may not be regularly maintained with the anticipation of receiving federal grants for large-scale repairs or constructions. Shared responsibilities can create inefficiencies, as local entities may underinvest in regular upkeep while waiting for federal funding.

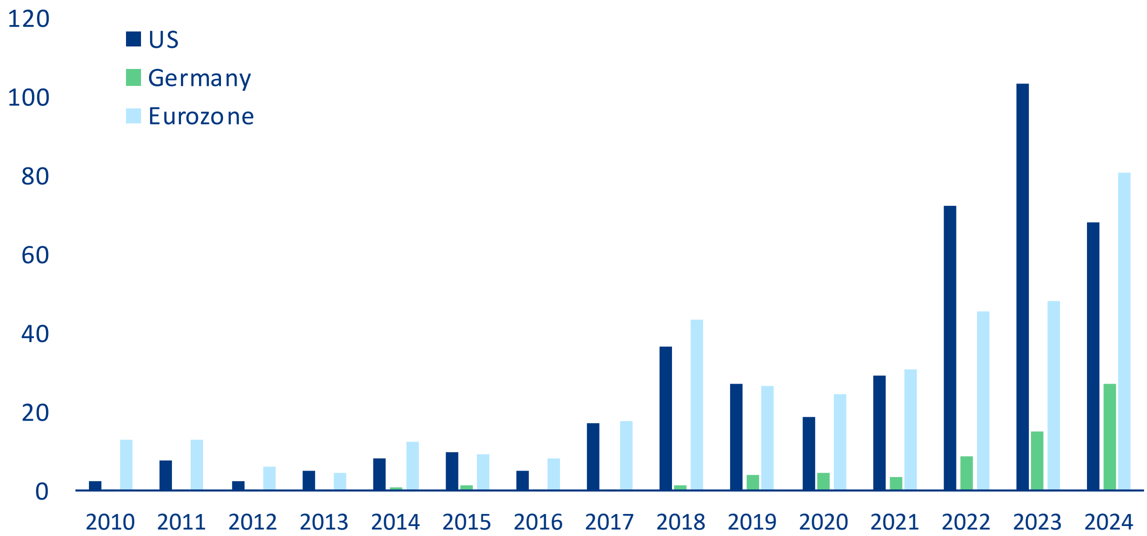
The new direction

To address years of underinvestment and rejuvenate economic growth, Germany needs an additional EUR600 billion in public investments over the next decade – equivalent to 1.2% of GDP annually. This far exceeds current plans, with public investments of EUR53bn in 2024, and a preliminary allocation of EUR57bn for 2025. Revitalizing Germany's aging capital stock will require bolder measures and a targeted approach:

- **Infrastructure:** EUR208bn is needed for projects such as transportation upgrades and green energy systems.
- **Education:** EUR41bn to modernize facilities and enhance workforce competitiveness.
- **Housing:** EUR37bn to address shortages and improve affordability.
- **Supra-regional infrastructure:** EUR99bn to enhance connectivity and logistics.
- **Climate protection and adaptation:** EUR213bn to align with decarbonization goals and increase resilience.

The new government should prioritize infrastructure investments in green energy, digital infrastructure, and transportation, aligning with broader decarbonization and technological modernization goals. Increased public-private partnerships (PPPs) and streamlined regulatory frameworks could unlock additional funding and accelerate project timelines. These measures would bolster economic growth, create jobs, and position Germany as a leader in sustainable and innovative infrastructure development (Figure 7).

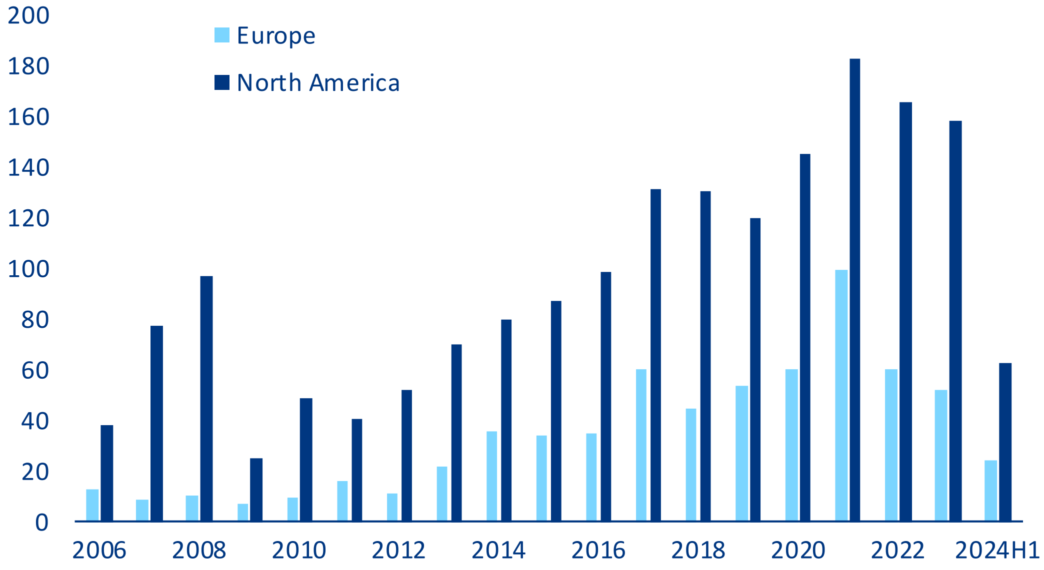
Figure 7: Infrastructure projects investments by country, in EUR bn



Sources: Workspace Infra 360, Allianz Research

Beyond infrastructure, the broader private debt asset class in Europe – particularly Germany – could experience a resurgence in 2025, fueled by a more business-friendly policy environment under a new German government. As political stability improves and fiscal policies shift toward supporting economic growth, private debt may benefit from increased corporate demand for alternative financing options as bank lending standards remain tight. Sectors such as renewable energy and small-to-medium enterprises (SMEs) could attract heightened interest from private debt investors, leveraging Germany's strong industrial base and Europe's focus on sustainable development. These factors position private debt as a key player in addressing Europe's evolving capital needs. Tailwinds for this asset class could drive significant growth in the coming years (Figure 8).

Figure 8: Private Debt capital raised by region, in USD bn



Sources: Pitchbook, Allianz Research

4 Unleashing labor supply to close the demographic gap

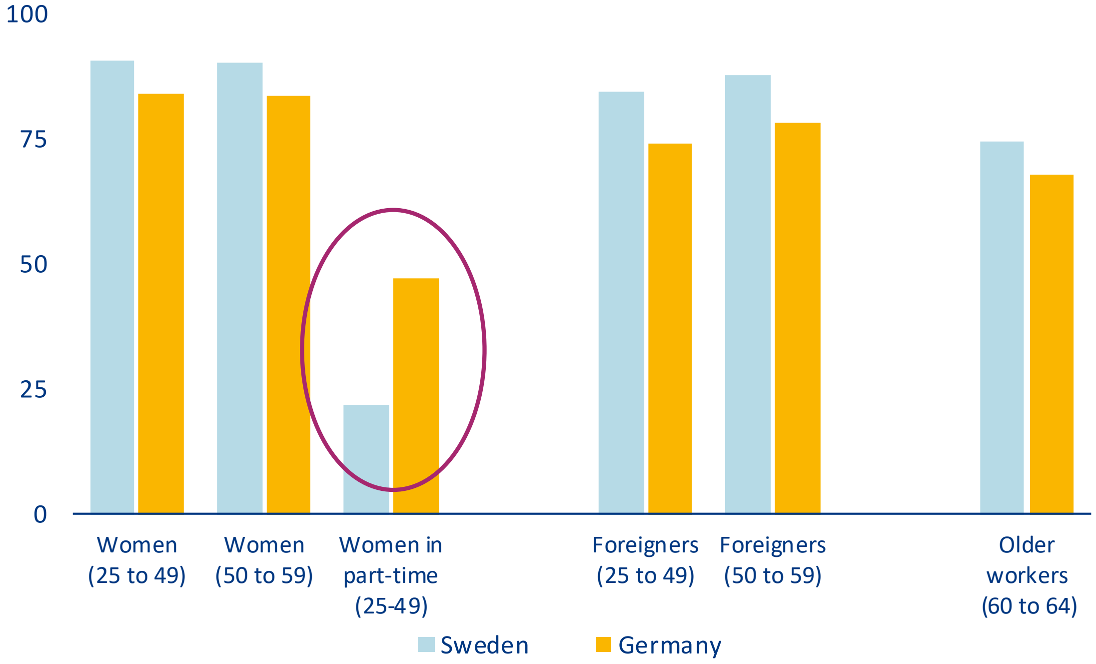
Germany's working-age population is set to decline from around 52mn today to 43mn in 2050. While high immigration has helped offset the ageing workforce in recent years, this inflow is set to decline. Therefore, mobilizing untapped labor reserves is increasingly urgent. This requires boosting activity rates among women, older workers, and the unemployed. Efforts must focus on reducing part-time work (currently 47% of women are employed part-time), incentivizing delayed retirement, and increasing average hours worked. Meanwhile, the number of unemployed – measured broadly, including those in qualification programs – stands at around four million.

However, an effective education system is the backbone of a flexible labor market that can adapt to transformative changes. While Germany's dual vocational and tertiary education is in good shape, the school system is underperforming. The latest PISA results are Germany's poorest on record. Pandemic-related school closures and insufficient early language support for students with a migrant background only partially explain the decline. Comprehensive reforms are needed, particularly in digital infrastructure, with a clear focus on the quality of teaching and student motivation. Too many students leave school without adequate qualifications, a loss Germany can ill afford.

The new direction

To cushion the labor market effects of demographic decline, Germany needs a more active labor market policy that increases the participation of women, older workers and immigrants. A two-pronged approach includes removing negative incentives (barriers to working more) and the creation of positive incentives. Furthermore, comprehensive education reforms are critical to lowering the share of young people leaving school without formal qualifications. As a benchmark, Germany could look to Sweden, where the labor force activity rates of women, foreigners, and older workers are significantly higher (Figure 9).

Figure 9: Activity rates, in %



Sources: Eurostat, Allianz Research

Removing negative incentives

- **Investments in care facilities:** Expanding childcare and ambulant or daycare for elderlies could help address the fact that one in three working-age women cites caregiving responsibilities as the reason for working part-time.
- **Overhauling taxes and social contributions:** Current arrangements, such as free health co-insurance for spouses and "Ehegattensplitting" (spousal income splitting) discourage labor force participation.
- **Fighting against age discrimination:** Workers aged 50 and older still face significantly higher risks of long-term unemployment than their younger peers.
- **Abolishment of "Rente63" (Retirement at 63):** Allowing early retirement at age 63 is counterproductive. It depletes the workforce of experienced employees and sends counterproductive signals to employers, effectively labeling older workers as no longer worth further training.
- **Reform "Bürgergeld" (Citizen's income):** The focus should shift toward building competencies and strengthening employability rather than short-term support.

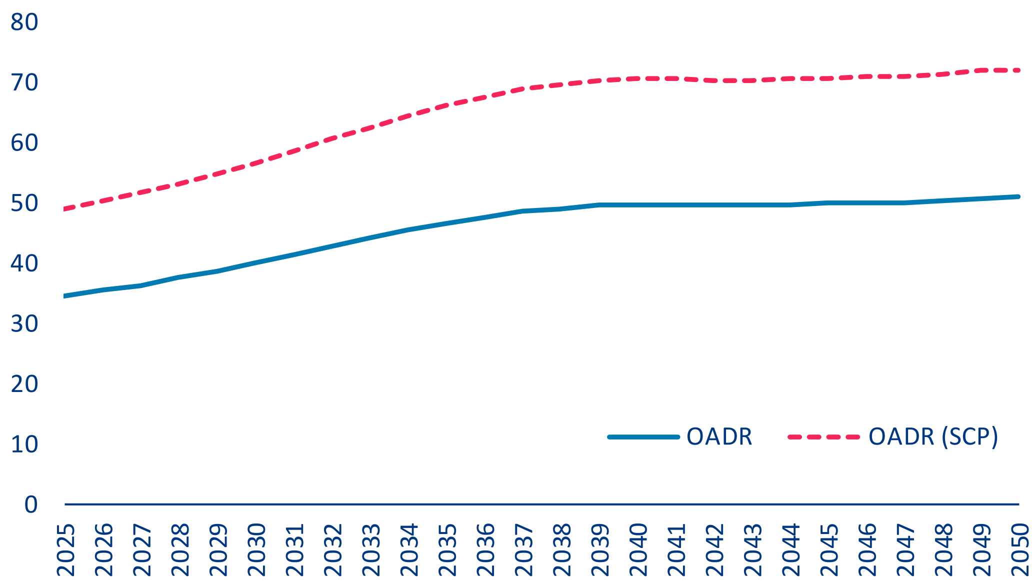
Creating positive incentives

- **Easing tax and contribution burdens:** Adjust the tax brackets to shift higher rates to wealthier income classes and lower the upper contribution assessment limits. Staggered contribution rates for lower incomes to smooth the transition from mini- and midi-jobs to full-time work could increase the income gap between paid work and social assistance and make sustained employment more attractive.
- **Tax breaks for post-retirement work:** Introducing tax-free allowances for earned income beyond retirement age (up to a certain amount) could encourage older workers to remain employed ("Aktivrente").
- **Improving immigrant labor market integration:** In 2024, only 29% of the immigrants from Ukraine and 45% of those from asylum countries were in employment, compared to 64% of immigrants from EU member countries. Enhanced support, such as targeted skills training and language programs, is essential.

5 Ensuring generationally fair pensions

The German old-age dependency ratio is set to increase from 34% today to 51% by 2050. However, the actual ratio of retirees per contributor may already be closer to 50% as not all individuals in the workforce are subject to social security contributions. If the share of the working-age population contributing to social security remains constant, the ratio of pension recipients to contributors is set to increase to 70% (Figure 10).

Figure 10: Old-age-dependency ratios, in %



OADR: Old-age dependency ratio
OADR (SCP): Old-age dependency ratio, based on social security contributors

Sources: UN Population Division, Bundesagentur für Arbeit, Allianz Research

The new direction

Pension policy must balance two competing objectives: ensuring a decent living standard in old age while avoiding excessive burdens on the working-age population. Historically, pension policy was skewed to the first objective. Although some reforms were introduced a quarter of a century ago, such as the demographic factor (a formula to dampen the rise of pensions) and the "Riester-Rente", the past two decades have largely prioritized pensioners' interests. This is no longer sustainable. Two things are required: avoiding measures that increase costs and strengthening capital-funded provisions.

Avoiding cost drivers

- **Scrapping Rentenpaket II (Heil-Plan):** Stabilizing mechanisms in the pension formula must be preserved and applied. These adjustments do not cut pensions but slow their growth. In contrast, implementing the proposed reform to stabilize the pension level at 48% would significantly increase contribution rates and pension expenditures.
- **Flexibilize the statutory retirement age in light of rising life expectancy:** While raising the retirement age may be politically unfeasible, introducing an age corridor with incentives to postpone retirement – similar to Sweden's model – could effectively increase the actual retirement age.
- **Shift financing of extra-insurance benefits to taxes:** Benefits unrelated in the narrower sense to direct pension contributions ("versicherungsfremde Leistungen" – non-contributory benefits) such as the "Mütterrente" (mothers' pension) or parts of pensions to recipients in the "Neue Bundesländer" (the eastern states that joined the Federal Republic of Germany after reunification in 1990), should be tax-financed rather than borne by a segment of the working-age population.

Strengthening capital-funded provisions

- **Riester II:** Reform of the Riester-Rente is long overdue. A new product should adhere to five principles: reduced bureaucracy, lower guarantees, increased subsidies, greater standardization, and a clear focus on low-income groups.
- **Expanded occupational pensions:** Similar principles should guide the expansion of occupational pensions – more tax exemptions, better access for SMEs, reduced red tape, lower guarantees, and a focus on middle- and high-income groups.
- **Avoid double taxation of retirement income:** Addressing double taxation is essential to increase public acceptance of private pension provisions.

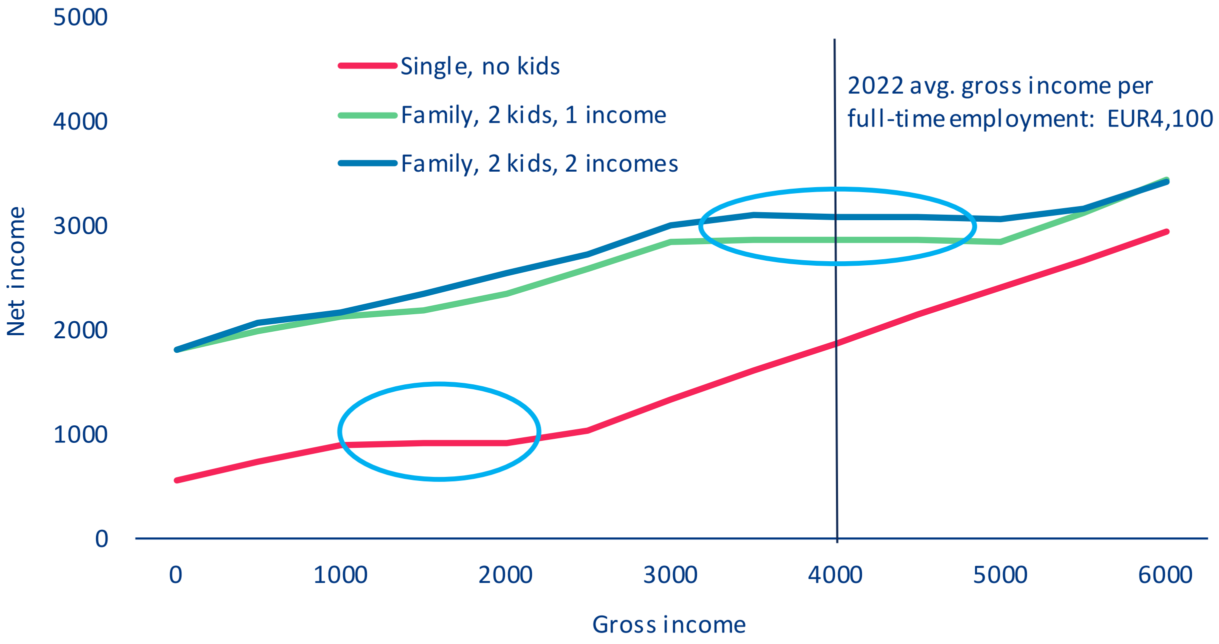
6 Reforming the tax system to boost motivation and incentivize work

Germany has one of the lowest tax burdens on wealth and one of the highest on labor amongst advanced economies. In 2023, wealth-related tax revenue amounted to EUR40bn, or just under 1% of GDP, translating to a mere 0.4% tax burden on total private wealth. This is significantly lower than nations like Canada, France, the United Kingdom and the United States, which levy three to four times higher taxes on private assets. If Germany aligned its wealth taxation with these nations, it could generate an additional EUR80 to 120bn annually. In contrast, Germany's effective personal income tax rate in Germany was 29% in 2023 – significantly higher than Italy (19%) and France (15%). The progressive income tax system ranges from 14% to 45%, with the 42% rate applying to incomes over EUR66,761. The top rate of 45% is for those exceeding EUR277,826.

However, this system offers low- and middle-income earners minimal incentives to increase their gross income. For instance, a married couple with two children earning an extra EUR 3,000 to EUR 5,000 annually would see less than EUR 100 more in disposable income (Figure 11).

Germany's corporate tax rate is also relatively high at 29.94%, with no major reform since 2008. This includes a local business tax that accounts for about half the total corporate tax burden but is problematic due to its dependence on economic cycles. Reforming this tax is politically challenging, as it requires restructuring municipal finances.

Figure 11: Disposable income for HH constellations, net versus gross income per month in EUR



Sources: ifo Mikrosimulationsmodell, Destatis, Allianz Research

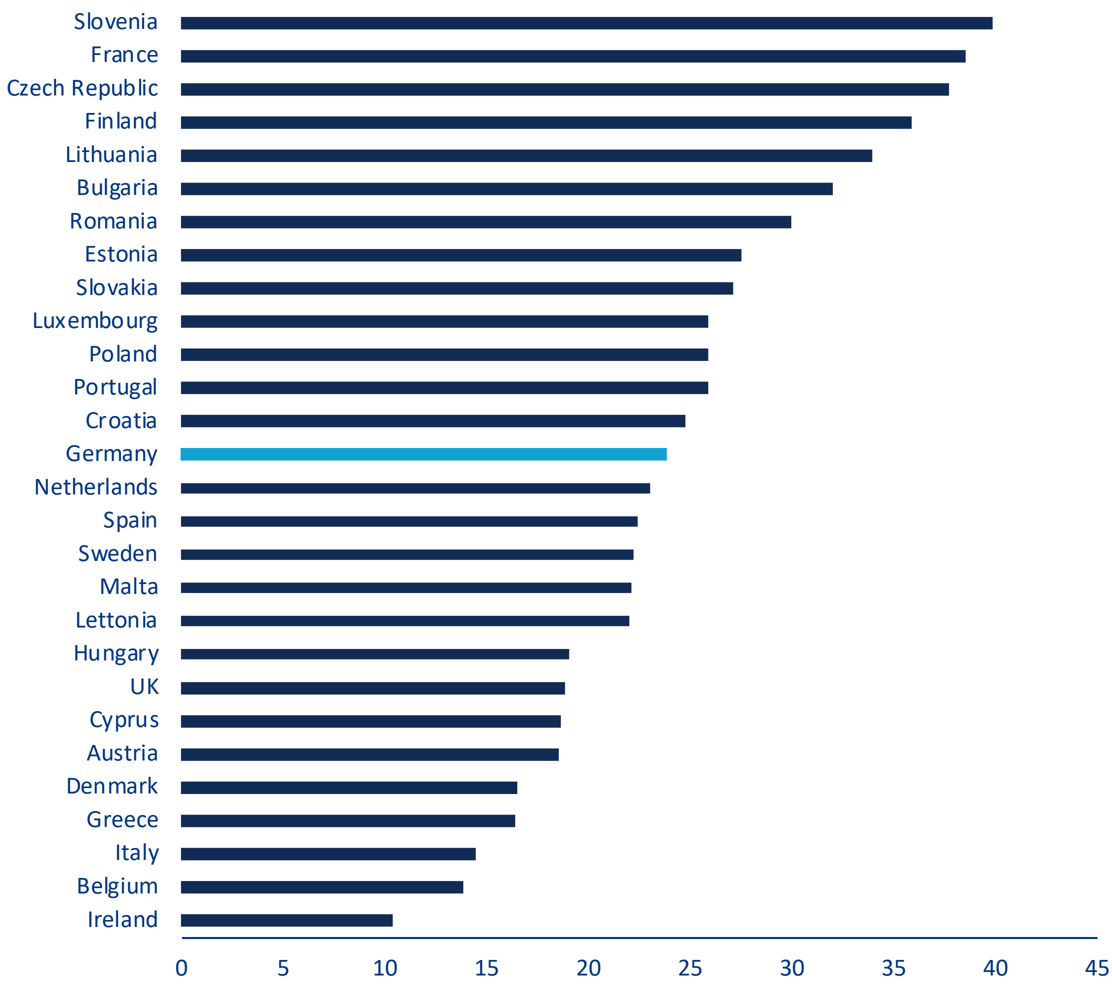
The new direction

Proposals for tax reforms

- **Personal income tax:** Abolish the solidarity surcharge for all taxpayers and undertake a comprehensive reform of the income tax system. This would involve implementing a „tariff on wheels" to automatically address cold progression and reducing deductible business expenses to facilitate digitally pre-filled tax forms. To offset these changes, lower the overall income tax rates to enhance work incentives and encourage labor force participation.
- **Corporate taxation:** Replace the trade tax with a corporate or income tax surcharge, ensuring municipalities maintain their revenue base. Reduce the corporate tax rate to 25% and ease restrictions on loss offsetting to improve business resilience during downturns.
- **Standardize VAT at 16.5%:** Replace the current VAT rates to increase efficiency and reduce bureaucracy.

Expanding value-sharing schemes could bolster workers' purchasing power, incentivize employees to contribute to company growth, and foster higher productivity. Germany lags other nations in using profit-sharing schemes as a widespread economic tool (Figure 12). Increasing tax incentives and simplifying administrative processes could make these schemes more attractive to employees and employers alike.

Figure 12: Share of firms with profit-sharing schemes, % in 2019



Sources: ECS, French Treasury, Allianz Research

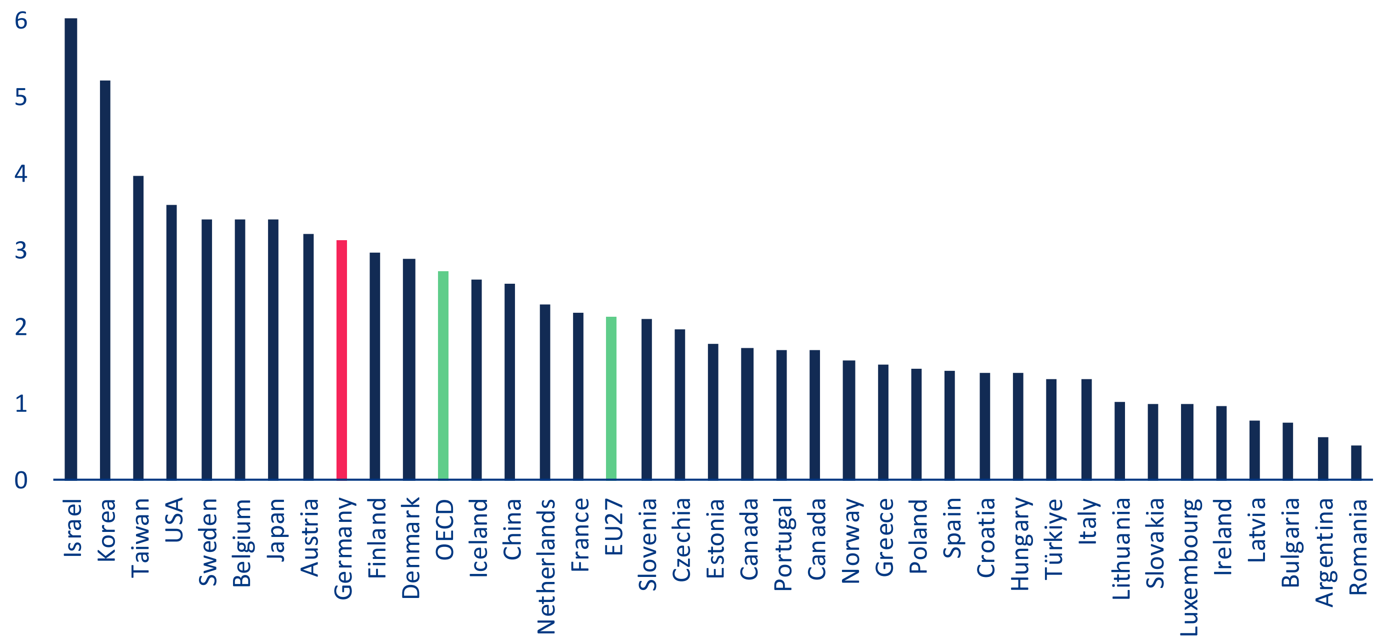
7 Revitalizing innovation

Germany's economic weakness predates recent geopolitical and economic shocks and is rooted in long-standing structural problems. For years, companies underinvested in research and development (R&D) despite research indicating that every dollar spent on R&D generates five times the economic output. In 2022, Germany's investment in R&D stood at 3.1% of GDP, lagging the US at 3.6% and 5.2% in South Korea (Figure 13). While Germany ranks among the top three countries for patent applications in 22 out of 58 future technologies, it risks losing its status as an innovation hub due to structural weaknesses, particularly in critical digital sectors. Despite its basic research and engineering strengths, Germany has struggled to come to grips with new tech.

The new direction

Germany must double its R&D investment to 6% of GDP to fully harness its innovative potential. Achieving this target requires effective measures, including tax breaks for R&D activities. Germany's renowned universities and institutions, such as the Max Planck Institutes and the Fraunhofer Society, provide a robust foundation for fostering innovation. Increased investment could unlock even greater achievements in fostering innovation and maintaining Germany's competitive edge. Additionally, Germany must develop two to four important future industries in areas such as artificial intelligence, robotics, quantum technology and green technologies.

Figure 13: R&D in % of GDP in 2022



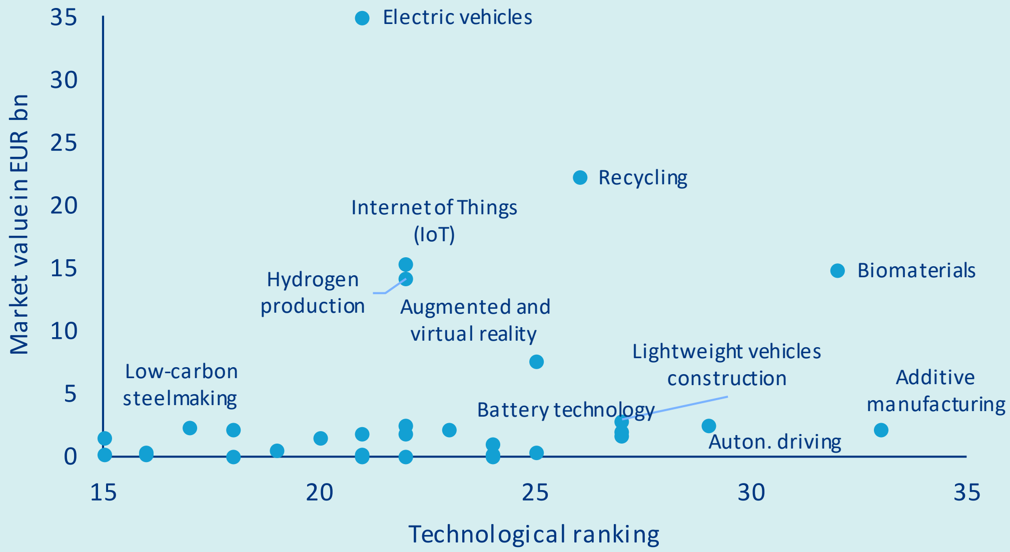
Sources: OECD, Allianz Research

A clear strategy for future industries could be transformative

Germany already possesses diverse strengths in emerging technologies but lags in others that are increasingly critical. Today, Germany excels in automotive technologies, particularly hybrid electric mobility, electric traction motors, and lightweight automotive construction. These strengths are rooted in traditional German expertise, but innovative research is needed to enhance capabilities in electric mobility. Beyond the automotive sector, Germany also excels in production technologies, environmental and climate technologies, and medical technologies. However, it faces significant challenges in information technologies, which are crucial for digitalization and increasingly impact sectors like automotive and mechanical engineering. Germany's standing in information technology is mid-tier compared to global competitors, making it unrealistic to expect rapid advancements through increased R&D alone. Instead, the focus should be on enhancing application skills within manufacturing technologies.

While Germany's technological and economic strengths often align, there are notable exceptions. For instance, hybrid electric vehicles and recycling boast significant market value but lack the technological importance of additive manufacturing, biomaterials, or autonomous driving. Conversely, these high-ranking technological fields have yet to achieve comparable economic impact (Figure 14).

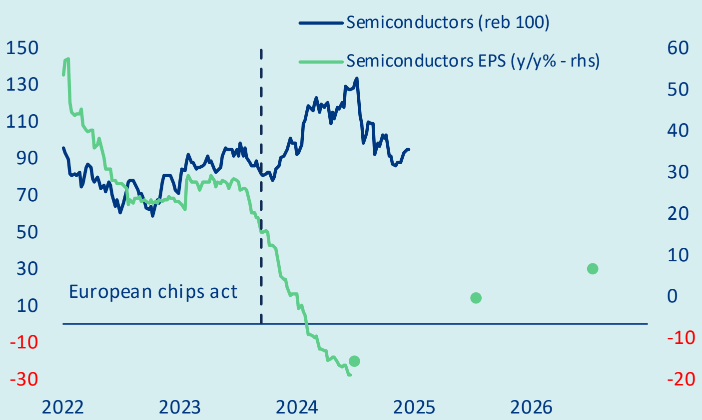
Figure 14: Future technologies market relevance in EUR bn versus technological ranking, 2020

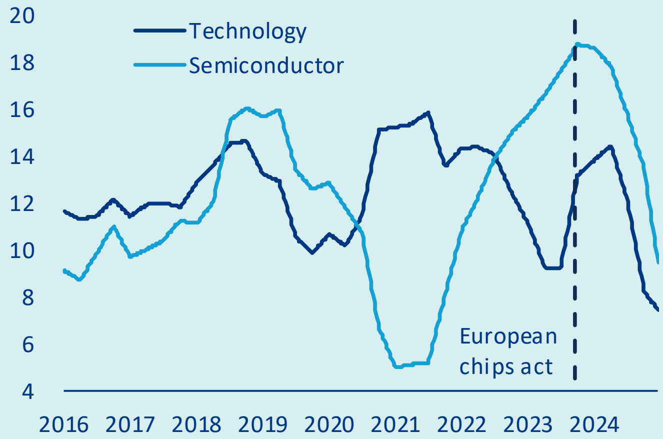


Sources: Schmoch et al. (2021), Allianz Research

Germany must prioritize key sectors such as technology and semiconductors to safeguard its competitive edge. As a global manufacturing and innovation hub, Germany relies on semiconductors for critical industries, including automotive, industrial automation, and renewable energy. Recent global supply chain disruptions and increasing competition from regions like Asia and the US highlight the urgent need to bolster domestic chip production and innovation. Investments in this sector are essential to ensure resilience against supply shortages, drive technological leadership, secure high-value jobs, and reinforce Germany's position as a frontrunner in the digital and green transitions (Figure 15). While current expectations for revenue, earnings and profit margins in the semiconductor sector are unfavorable, an improvement is anticipated in the near future.

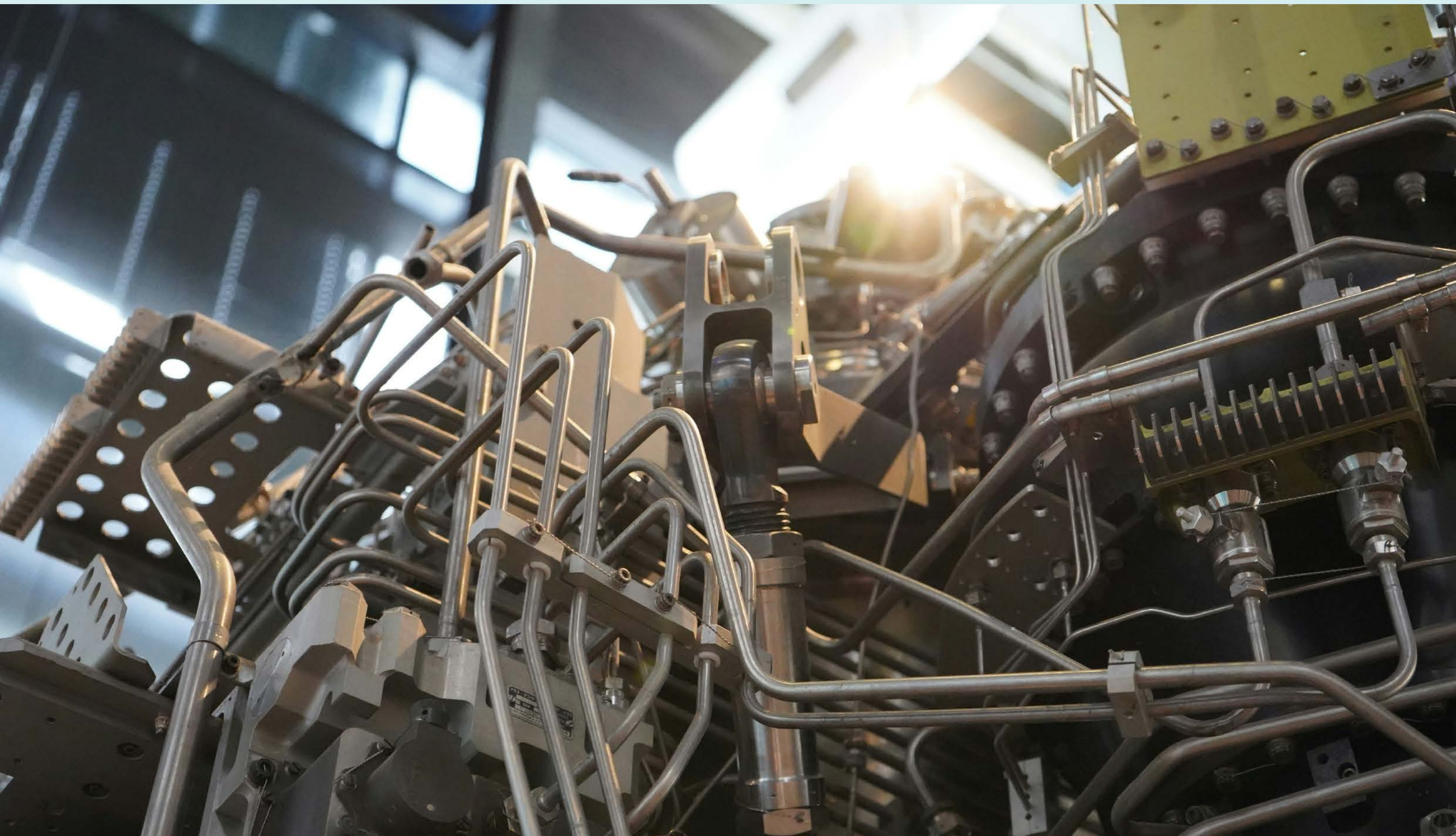
Figure 15: European semiconductor price and EPS growth (left) and German technology and semiconductor net profit margin (right)





Sources: OECD, Allianz Research

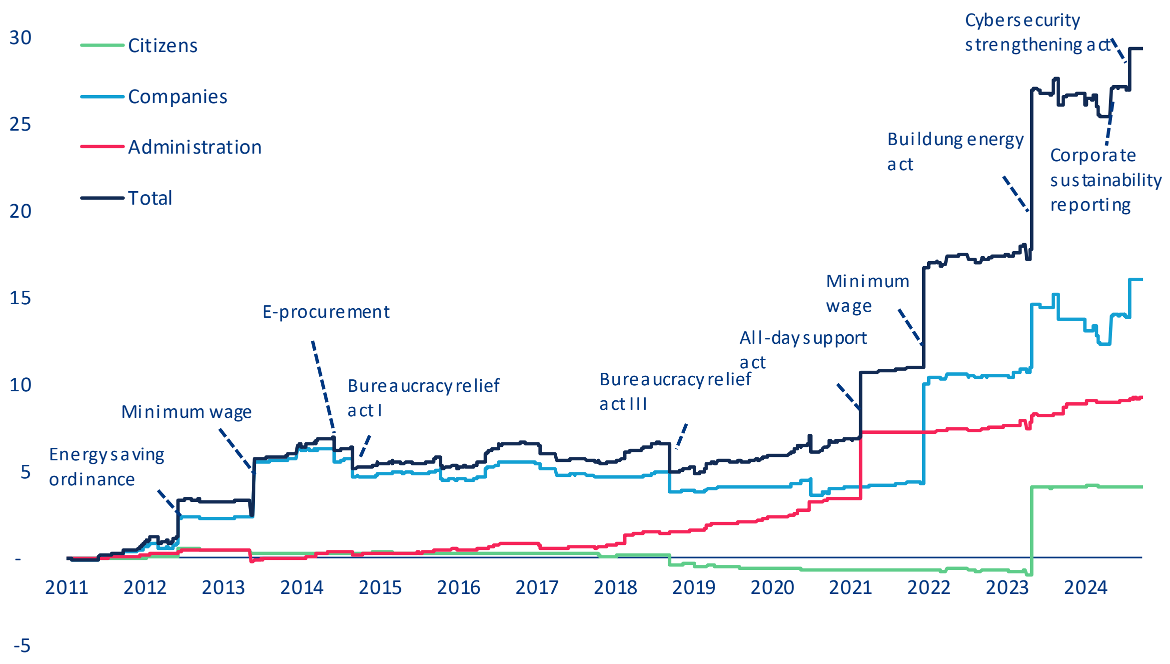
Focusing on industrial technology and innovation could shape the future of the German economy. With a diverse technological profile, Germany is witnessing significant growth in its digital economy, particularly in AI and quantum technologies. Over the past year, AI start-ups in Germany surged by +35%, driven by global interest, public funding, and venture capital investments. Notably, 95% of these start-ups focus on tailored B2B solutions rather than consumer-facing applications like chatbots. In line with this trend, German companies have launched DataHub Europe, a platform aimed at providing high-quality, secure data for training AI models. This initiative reinforces Germany's ambition to lead in AI technology. Similarly, Germany is recognized as a pioneer in quantum technologies. Germany needs a long-term strategy to advance in these high-tech fields to sustain this momentum and prevent talent migration abroad. This must include enhanced public and private investment in research and practical applications. Moreover, building on existing strengths in the automotive sector and manufacturing while addressing challenges related to electric drivetrains and information technology is crucial. A targeted approach to fostering critical future technologies will be vital for sustained progress.



8 Reducing regulatory hurdles

Laments over red tape are widespread. While Germany has significantly reduced the bureaucratic burden on companies since 2012, recent developments have reversed some gains. The implementation of the Corporate Sustainability Reporting Directive (CSRD) in 2024 increased the bureaucratic burden on companies by +2.6% between March and September. The costs of bureaucracy in Germany are substantial, with lost economic output amounting to approximately EUR146bn annually. According to the German Regulatory Control Council, direct costs are estimated at EUR65bn annually, with compliance costs alone accounting for EUR29bn. These compliance costs break down as follows: EUR4bn for citizens, EUR16bn for firms and EUR9bn for public administration (Figure 16). However, the indirect economic costs of bureaucracy more than double the direct bureaucracy costs.

Figure 16: Development of current compliance costs since 2011, in EUR bn



Sources: Normenkontrollrat, Allianz Research

The new direction

To effectively reduce red tape, Germany must:

- **Systematic reduction target:** Transform bureaucracy from a selective exception into a systematic rule, aiming for a -25% reduction in compliance and bureaucratic costs within four years. This includes eliminating exceptions to the „one in, one out“ rule, fully incorporating EU directives, and considering citizen and administrative costs.
- **Practical checks:** Implement rigorous practical checks during the legislative process to identify solutions early and weigh up alternatives.
- **Digitalizing procedures:** Digitalizing legislative procedures will streamline operations, reduce delays and improve transparency.
- **Stakeholder engagement:** Launch a bureaucracy relief project to actively engage stakeholders, fostering collaboration and practical solutions for reducing administrative burdens.
- **Enhance efficiency:** Improve state and administrative efficiency by bundling tasks and establishing clear, uniform standards are essential.
- **Unified voice in Europe:** Ensure the German government speaks with a unified voice in European negotiations, factoring in cost implications from the outset.

9 Strengthening European leadership

The EU only functions with a strong Franco-German engine. In recent years, this partnership has faltered. Furthermore, the "German vote" became proverbial in Brussels as coalition disagreements in Berlin led to repeated abstentions on critical votes. However, the simultaneous launch of the new EU Commission – set to unveil an ambitious reform program based on the Draghi Report – and a new government in Berlin presents an opportunity for a fresh start. That said, France's role might remain uncertain due to its ongoing political instability.

The new direction

Germany must constructively advance two critical EU issues: the question of common debt and the completion of the Capital Markets Union (CMU). Germany's traditional resistance to joint debt is no longer appropriate given the enormous defense efforts that Europe must undertake. Joint debt can serve as leverage to establish joint EU military spending and to foster integration in the European defense industry. This instrument is also suitable for a common European energy market.

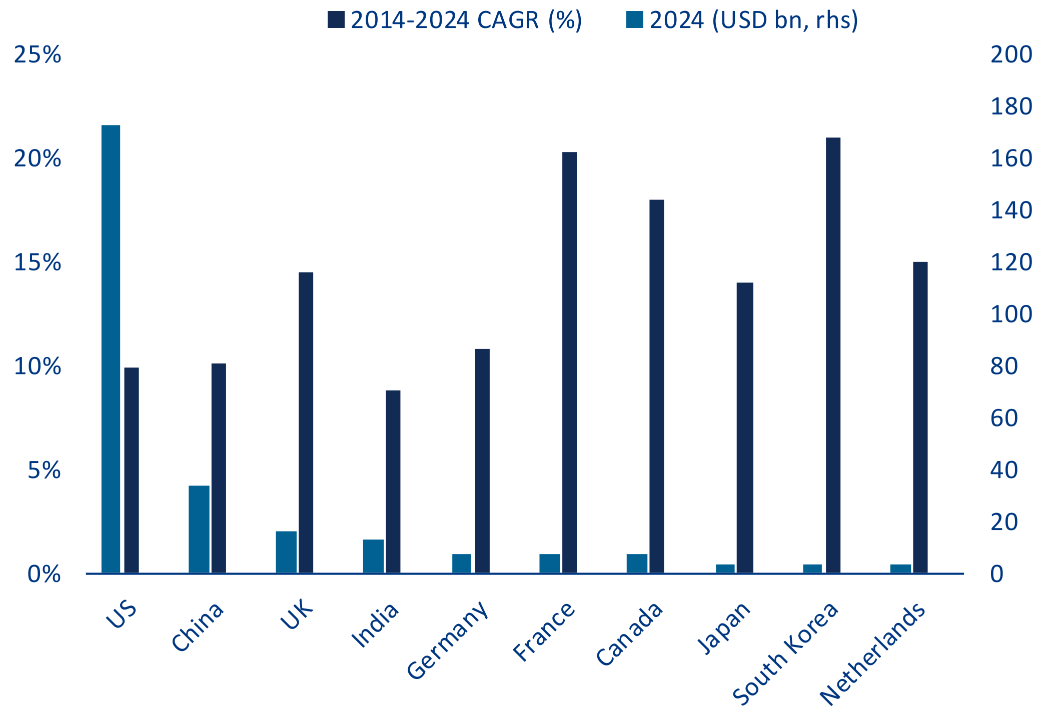
Completing the CMU is essential for boosting EU competitiveness and unlocking greater funding opportunities for businesses. However, not all proposals on the table are equally beneficial:

- **Centralized supervision:** While supervisory convergence is crucial to achieve CMU goals, consolidating supervision at the EU level is unnecessary. The banking sector shows that a single supervisor is not per se conducive to market integration. A focus on a „single supervisor" model risks diverting significant political attention from more important initiatives.
- **Securitization:** While further growth and diversification in securitization are welcome, they do not address the primary weakness of European capital markets: over-reliance on debt financing. Europe needs more equity, not bank loans.

At the core of the CMU should be the revitalization of EU equity markets, particularly venture capital (VC) and private equity (PE) – where Europe trails the US by a wide distance (Figure 17). Achieving this requires reorientating savings and investment behaviors. However, it is hard to see how a pan-EU label could change this. For instance, investment funds are already very "European" – UCITS is the de-facto international fund standard, and most are domiciled in Luxembourg – but this had so far limited impact on equity culture.

Incentives like tax breaks to encourage private savers to invest in equity markets, alongside strengthening capital-funded pensions to reorient institutional investors towards equity, are crucial. However, the responsibility for fostering an equity culture lies with the national states. Germany, in particular, must address its weak equity culture by, for instance, introducing robust capital-funded pillars in its pension system. Further initiatives the new German government should back to enhance the CMU include simplified regulation (also for IPOs) and reporting rules, particularly in sustainable finance; increasing VC funding by scaling up the European Investment Fund (EIF); and fostering convergence of insolvency frameworks via a harmonized "28th regime."

Figure 17: VC Investments by country



Sources: Dealroom, Allianz Research

Mobilizing the German savings pool

German households hold EUR8.8trn in financial assets (June 2024), of which EUR3.3trn are in bank deposits, including EUR2.1trn in sight deposits. With deposits accounting for 41% of financial assets (end-2023), Germany has one of the highest deposit shares in Europe, significantly outpacing countries like France (30%) and Italy (28%).

If German households reduced their deposit share to 30% over the next decade, they could "free up" at least EUR800bn (EUR80bn p.a.). Beyond reshuffling the stock, fresh savings (flows) should also be redirected. In 2024, German households are on course to purchase EU300bn in financial assets; half of this is likely to end up in bank deposits. Reducing the deposit share in fresh savings to 30% could unlock an additional EUR60bn for long-term savings and green investments. This simple calculation shows that German households have the potential to invest at least EUR100bn annually in capital market products, which is theoretically enough to finance the energy transition.

Such a shift is achievable. The decisive response of German savers to the recent interest rate turnaround – buying bonds and shifting money from sight into term deposits – shows their adaptability to changing incentives. Given Germany's strong aversion to tax, bold measures like abolishing capital gains could redirect savings into green investments.

However, financial assets in Germany are unequally distributed. While the average financial asset is EUR 77,900, the median is only EUR 25,900. The poorest 20% hold, on average, EUR 3,400 in financial assets, whereas the richest 10% hold EUR 332,800.[1] To enable low-income households to save and benefit from the green transformation, the proposed "Klimageld" (climate money) initiative, which aims to redistribute revenues from carbon pricing directly to citizens, could be used. This scheme could channel funds (in full or in part) into private „climate financial products", with the government doubling the amount that households save on energy costs. Such a „climate dividend" would serve a dual-purpose: securing the social acceptance of the green transformation (as it would be no longer a project only of the wealthy) and reducing social inequality by enabling low-income earners to build savings.

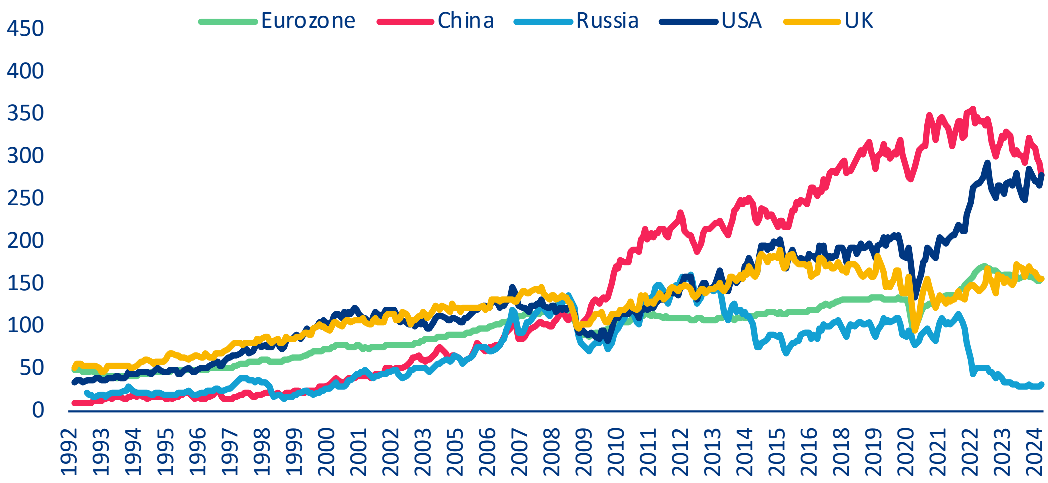
[1] Deutsche Bundesbank (2023), Monatsbericht April.

10 Engagement for fair trade relations

Germany's export-led growth model has left it exposed as globalization recedes. With 43% of its GDP derived from exports, Germany faces increasing pressure on its export-oriented model. Over the past 15 years, exports outside the EU have risen from 17% to 22%, initially boosting profits and treasury revenue. However, reliance on China has diminished since 2022, with Chinese exports now comprising only 6% of Germany's total exports.

The challenge extends beyond export dependence. China's domestic market struggles to absorb the excess production of state-subsidized manufacturers, leading to an expanded trade surplus that pressures German firms both domestically and internationally. While exports to the US have partially offset declining exports to China (Figure 18), looming tariffs and restrictions threaten German manufacturers dependent on Chinese inputs. This competition intensifies as Chinese exporters seek alternative markets, including Europe. Simultaneously, China is pivoting away from an export-driven economy towards domestic consumption and self-sufficiency, positioning itself more as a competitor rather than a customer. In response, German companies are relocating production abroad, with key sectors increasingly thriving in the US and East Asia, spurred by subsidies and tax incentives.

Figure 18: German exports, 2009 = 100



Sources: LSEG Datastream, Allianz Research

The new direction

As globalization evolves, Germany must reduce dependencies by restructuring its value chains towards Europe. The EU must support its companies and export industries by negotiating free trade agreements (FTAs) to counter rising global protectionism. The recent FTA with Mercosur, the South American trade bloc, represents a significant step forward. Prioritizing FTAs with resource-rich countries like Australia and high-growth regions such as ASEAN is essential to secure critical resources and tap into emerging markets.

Equally important is fostering prosperity within Europe. This requires streamlining regulations, standardizing industrial policies across member states, consolidating capital markets and financial systems, and investing in future-focused sectors. Embracing a more European perspective will enable better collective responses to shared challenges in an increasingly fragmented global landscape. For Germany, this transition requires transitioning from its traditional globalization-dependent economic model toward one centered on regional cooperation and self-reliance. Germany must build a coalition of willing partners to spearhead this change and articulate a compelling vision for Europe's future.

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