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# GERMAN REFORMS: SERIOUS PROGRESS

**A series of small steps can add up to major progress.** None of the many reforms on which the German government agreed last night will be ground-breaking on its own. But on top of the major pension reform proposal which the government had already endorsed ten days ago, the reform deal can make a real difference. If implemented, Germany can become a better place to invest and create jobs again. By supporting a rebound in private investment, the reforms may raise Germany's trend growth rate from the recent dismal 0.4% to 0.7% per year. With the fiscal stimulus unfolding over time, we expect German growth to accelerate from 0.3% this year to an above-trend pace of 0.9% in 2027 followed by a miniboom with 1.4% growth in 2028 (in calendar adjusted terms). Including a positive calendar effect, we expect Germany to achieve an expansion of 0.6% this year. For the economic outlook for Germany and Europe as a whole, German supply-side reforms matter more than the oft-discussed fiscal stimulus stemming for more German spending on defence and infrastructure. As Germany remains the major trading partner for most other European countries, a more dynamic German economy should be good news well beyond the country itself.

**Key elements of the reform deal**

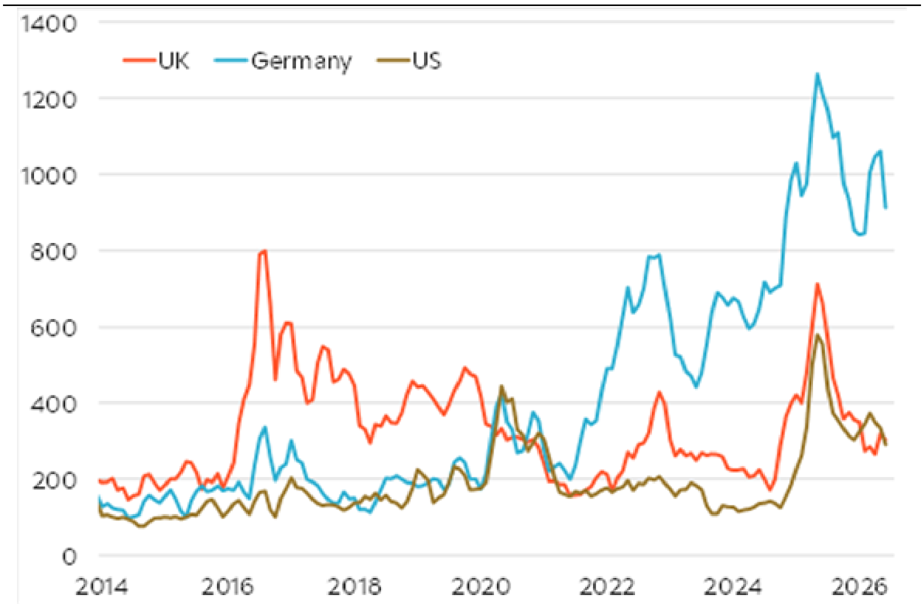
- A modest income tax reform with €10bn annual tax relief. Lower marginal tax rates for low- and middle-income earners will be financed partly by higher rates for top earners with a 45% rate for taxable income of more than €250k per year and 47% above €270k. According to Merz, the average family will get annual tax relief of €600. For low and middle-income earners, lower marginal tax rates increase the incentive to work more.
- Some cuts to red tape including faster approval procedures for infrastructure projects. Furthermore, various reporting and documentation requirements are to be abolished, and data protection will be reduced to the European minimum standard. The tax return process is also to be simplified.
- A federal programme to build more affordable homes.
- Relaxed dismissal protection rules for high earners. This will make the labour market a bit more flexible. It will encourage start-ups and companies offering high-end services such as finance to take more risks by hiring more people.
- A slight tightening of sick-leave rules.

**Other changes already in the pipeline:** the reform deal which coalition leaders presented this morning comes on top of the major overhaul of the public pension system which the government had already agreed ten days ago - see our note: Two cheers for new pro-growth reforms (22 June 2026). The pension reform will scale back early retirement schemes, introduce a Swedish-style statutory funded pension to complement the current pay-as-you-go system and modestly reduce the rate of pension increases after 2031. Together will small changes of the elderly-care system, the reform package including the pension reform should be discussed and passed by parliament in coming months to take effect in 2027. A separate law to make savings in the healthcare system might already be passed into law before the start of the parliamentary summer break on 10 July.

**Learning a lesson:** In addition to its substance, the reform deal can count as a significant success in a further respect: the Merz coalition is finally acting in a professional way. After a year of almost relentless bickering between and within the coalition parties, the centre-right CDU/CSU and the centre-left SPD, the coalition managed to agree on serious policy changes smoothly and on schedule. Since Friedrich Merz (CDU) took office as chancellor in May 2025, the deafening noise surrounding many decisions had obscured the fact that the government was already implementing some pro-growth reforms. As our chart shows, uncertainty about the course of economic policy has been unusually elevated in Germany ever since the final phase of the previous government. If the Merz government can now hammer out the details of the deal and pass the respective laws without too much noise, the impression that Berlin is finally getting its act together can boost consumer and business confidence und underpin stronger private sector spending. Over time, it may even help to dent support for the right-wing AfD and the left-wing Die Linke party.

**SPD endorses reforms:** The German reforms are a compromise between the centre right and the centre left. For Germany, that is not unusual. Even when the traditional major parties of the centre right (CDU/CSU) and centre left (SPD) were not governing Germany as a coalition, as they do now, they often formed a consensus on major reforms. A key example are the “Agenda 2010” reforms of 2003-2005, which turned Germany from the “sick man of Europe” into a European growth engine for the 15 years thereafter before complacency took its toll and the German economy descended into its current structural malaise. Back in March this year, SPD co-leader and finance minister Lars Klingbeil had paved the way for a reform consensus with a major speech already – see German reforms: Klingbeil makes his choice (26 March 2026). Even the initially hesitant other co-leader of the SPD, labour minister Bärbel Bas, has now endorsed the changes. That makes it likely that the reforms will pass both houses of parliament without being watered down decisively.

**A big part of the German problem: economic policy uncertainty**




*News-based economic policy uncertainty indices, 3-month moving averages. Sources: PolicyUncertainty.com, Haver Analytics*

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