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Public Finance and Economic Affairs Directorate

Deficit Rule Reform Team*

Reforming the Constitutional Budget Rules in Germany

1 Introduction

To modernise the financial relations between the Federation and the *Länder*, the Bundestag and Bundesrat (the two houses of parliament) gave their approval in late May/early June 2009 to the second stage of federalism reform in Germany – a project which started nearly 4 years ago. By making this historical change to the German Basic Law (so called "Grundgesetz (GG)", Germany's constitution), the Federation and *Länder* have significantly changed and improved the legal and institutional basis for meeting the challenges of the economic and fiscal future (ageing, globalization, climate change) in Germany. The most important element of the reform comprises new constitutional rules to limit net borrowing by the Federation and the *Länder*. These rules are based on a proposal presented last year by the Federal Minister of Finance Peer Steinbrück.[1]

The focus of the following paper is on the federal rule (Article 115 GG), more specific steps to implement the reform on the *Länder* level (besides the general principles in Article 109 GG) still have to be defined in the legislation of the *Länder*. Section 2 puts the reform in context. This provides a starting-point for deriving the

[1] Closely tied in with this is assistance for budget consolidation, which was also given approval. This relief is designed to ease the transition of individual *Länder* with particularly poor finances to a level where they can meet the new budget rule. In return, these *Länder* must pursue a strict path towards consolidation, and have their progress monitored by a new body, the Stability Council (*Stabilitätsrat*). An early warning system to avoid future budgetary crises will be introduced at the same time as the new budget rule. The second stage in the reform of the federal system furthermore comprises, in particular, measures to raise the efficiency and effectiveness of tax collection, rules on cooperation between the Federation and the *Länder* in the field of IT, and a basis for comparing the performance of public administrations.

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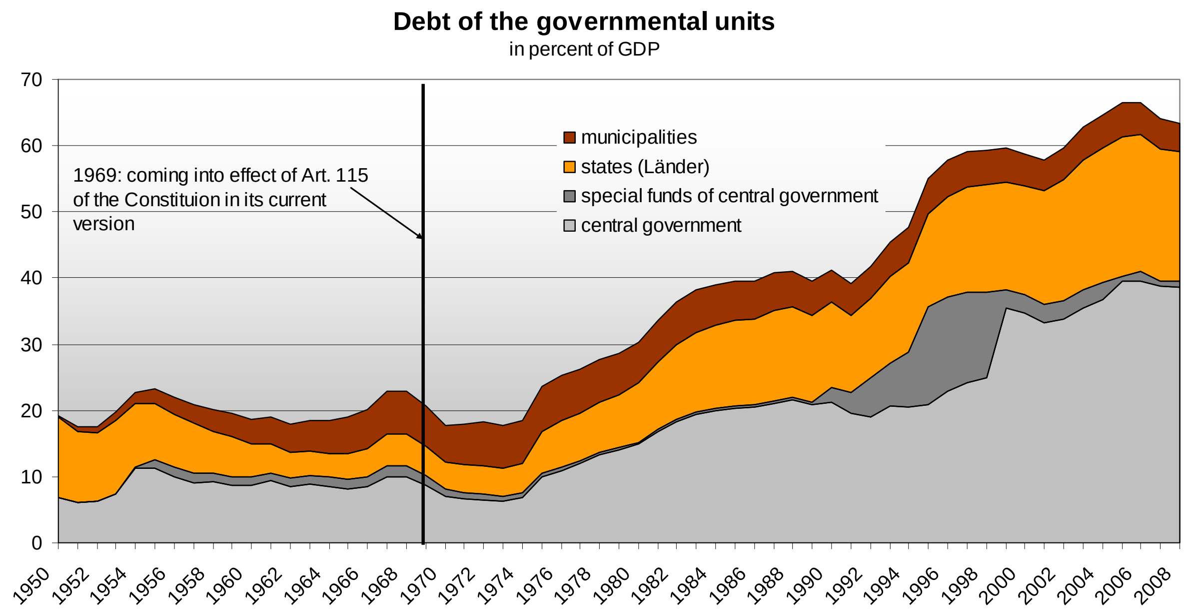
objectives and core elements of the new fiscal rules applying to both the Federation and the *Länder*, which are described in section 3. Section 4 explains the new budget rule for the Federation. The final section concludes.

2 Reform: Point of departure and background

Over the course of the previous decades, Germany's general government debt has risen to reach a level of more than €1.6 trillion today. The debt-to-GDP-ratio stood at around 20 % when the current debt rule for the Federation was anchored in Article 115 of the Basic Law (GG) at the end of 1960s replacing the after war rule which was a very strict analogy of corporate investment schemes, e.g. project oriented cash-returns on investment. By 2008, the debt-to-GDP-ratio in public finance statistics had risen to 63.4 % (cf. Figure 1), while it amounted to 65.9 % in the Maastricht-definition.

Figure 1



Among other factors, this unsustainable development in public finances is essentially due to wrong economic and political incentives created by the 1969 fiscal rules that have been in place to date. The golden rule set out in Article 115 of the Basic Law, which also occurs in a similar form in many *Länder* constitutions, generally permits net borrowing up to the amount of gross investment (roads, buildings etc., drawn on the classical dichotomy between state investment and consumption, which in the area of human capital is misleading already from concept) provided for in the budget estimates – without considering any depreciation. In addition to containing this concept of gross investment that is open to criticism in terms of the value added for the economy as a whole, the rule has even more severe weaknesses. In particular, the definition of the exceptions allowed in the case of cyclical disturbances was too broad; also budget preparation and budget execution were not linked (no ex post-control and correction, no sanctions). Finally and maybe most important, the existing rule reacts asymmetrically over the business cycle: While in situations of a (looming) "disturbance of the overall economic equilibrium" net borrowing is not limited at all, there is no corresponding obligation to reduce net borrowing (or to achieve a budget surplus) in times of cyclical upswing or boom.

Moreover, the economic and institutional framework has altered substantially since the implementation of the current rule in 1969:

- The demographic change and the associated spending on social security imply a high level of additional implicit debt, and thus a need to rebalance the intergenerational distribution of the burden.

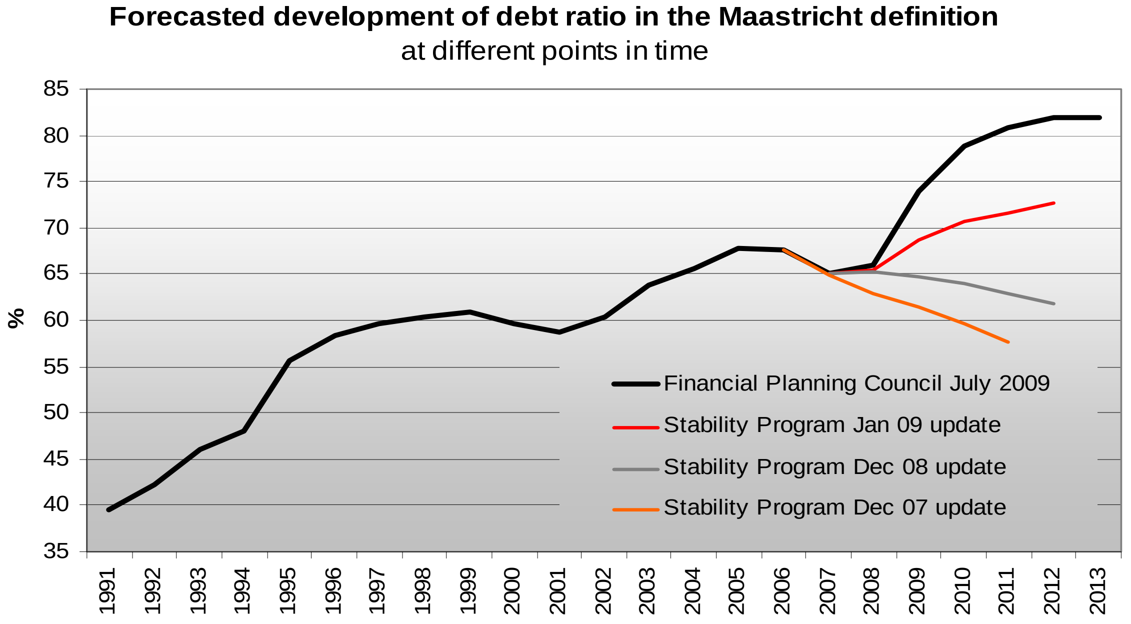
- The high level of debt (and corresponding interest payments) is restricting the state's ability to act/ react on future challenges bringing about losses in potential growth and employment. The big (redistribution) wheel of spending via deficit, debt, interest and ultimately the financing via taxes (expenditure cuts) and social contributions will add to that.

- The quantitative and qualitative provisions of the preventive and corrective arm of the reformed European Stability and Growth Pact must be observed. Additional requirements for a public sector equipped in a sustainable and forward-looking manner also arise from the EU's Lisbon Strategy.

The current crisis in the financial markets further underlines the importance of a state that is fully capable of fiscal policy action at any time. Therefore the new deficit rule is not only a corner stone for the present crisis-related "exit strategy" but will also strengthen the resilience against crises in times to come. This is economics, because it sends a clear signal to market participants and underpins confidence and long term expectations, but it's also policy, because it gives self-restrictions to politicians and administration. All this may add to the expected Keynesian effects of the macro programs some non-Keynesian effects.

The past few months have seen the adoption of numerous economic stimulus measures in many countries that, while essential in terms of preventing a global depression, also place an extraordinary and very serious burden on the public purse – at least in the case of Germany. As a result of the present crisis, the general government debt ratio is predicted to climb to 74 % this year, with a further increase to 82 % by 2013 (cf. Figure 2). Against this background, the reform of the constitutional budget rules can make an important contribution to resolving the crisis by hedging the expansionary effects of stimulating demand against losses in confidence that would arise from permanently higher general government debt.

Figure 2



3 Reform: Objectives and core elements

Certain basic rules and principles limiting net borrowing and applying to both the Federation and the *Länder* will be anchored in Article 109 of the Basic Law. Consistent with the principles and philosophy of the reformed

European Stability and Growth Pact, these rules are to safeguard the long-term sustainability of Federation and *Länder* budgets and facilitate the implementation of a fiscal policy that takes into account both cyclical conditions and future demographic changes. The core elements are as follows:

- The Federation and the *Länder* must generally balance their budgets in terms of revenues and expenditures without net borrowing. As to the Federation, this principle is considered to be met if net borrowing does not, under "normal economic conditions" (i. e. when the output gap is closed), exceed 0.35 % of GDP. No such scope for structural net borrowing is foreseen for the *Länder* budgets.

- In case of divergences from potential output (i. e. when an output gap – positive or negative – does occur) symmetrical adjustments in net borrowing are allowed. This means that cyclical deficits are permissible in a downturn while cyclical surpluses must then be run in an upswing.

- To cover natural disasters and exceptional emergencies, Federation and *Länder* may establish a special arrangement permitting additional borrowing under such circumstances. In case of taking recourse to this exception clause, the amounts borrowed for this purpose must be repaid according to a binding amortisation plan.

The way in which the individual *Länder* implement and give substance to these basic rules is a matter for them to determine within the scope of their own constitutional competences. The Federation's new budget rule is anchored in Article 115 of the Basic Law and regulated in detail in a corresponding law dealing with its implementation.

The new budget rule will apply for the first time in fiscal year 2011. However, the additional borrowing currently incurred in response to the economic and financial crisis has to be taken into account. Pro-cyclical consolidation has to be avoided, also when it comes to implementing the fiscal "exit strategy". Therefore, a bold but economically reasonable consolidation path has to be taken. This means that in the first years after the introduction of the new rule, from 2011 until 2015, a transitional arrangement applies. Under this arrangement, the Federation will commence 2011 with an enhanced leeway for the structural deficit (which increases dramatically due to the stimulus measures in 2009 and 2010) that must then be reduced in equal annual steps until the 0.35 % threshold is reached in 2016. For the *Länder* structural deficits will no longer be permissible from 2020 onwards.

4 New budget rule for the Federation

As set out in the general principles contained in Article 109 of the Basic Law, intergenerational burden-sharing is realigned according to the benchmark of having a budget that is principally balanced. This replaces the current arrangement largely permitting borrowing up to the amount of (gross) investment. With a view to intergenerational equity, the new provision now only has scope for structural net borrowing – borrowing irrespective of the cyclical or other temporary impacts on the budget – within narrow confines; this is the structural component of the rule.

The new budget rule for the Federation also contains a cyclical component. Consistent with the cyclical adjustment applied in the framework of the European Stability and Growth Pact, this component ensures that automatic stabilisers will operate fully and symmetrically in the ups and downs of the economic cycle. Similar in another aspect to the procedure employed under the European Stability and Growth Pact, revenue and expenditure are adjusted for the balance of financial transactions when determining the net-borrowing ceiling.

And finally, the new budget rule for the Federation marks a very important progress in so far as it - for the first time in the German history of deficit rules - contains a control and correction/sanction mechanism as well. This mechanism (a control account) ensures compliance with the new arrangements both in preparing and in implementing the budget. All other rules were just covering the budget process from an ex ante perspective, i. e. governing preparation and legislation of the respective budget bill, but not the enforcement via ex post control and corrective measures. The details of the new rule, summarised in Figure 3, are described in more detail below.

Figure 3: **Core structure of the new budget rule**

	structural component	maximum 0.35 % of GDP
- /+	cyclical component	cyclical adjustment analogous to the SGP
- /+	balance of financial transactions	analogous to the SGP
-	(when appropriate) obligation to reduce debits of the control account	if threshold of 1 % of GDP is exceeded; max. 0.35 % of GDP per year; in upswing
=	maximum permissible net borrowing	

Exception for natural disasters and emergency situations (only possible with a parliamentary majority of 50 % of the members of the Bundestag plus one, and binding amortisation plan)

4.1 Structural component

Accruing new (structural) debt only represents a responsible course of action if it is compatible with the long-term sustainability of public finances. Taking the stock of debt already accumulated, the ageing society, a lower potential growth path and high implicit debt, the debt ratio and the associated burden of interest expenditure must be reduced in a rapid and enduring manner. In order to achieve this objective, debt must grow at a substantially lower pace than GDP. That is why the medium-term budgetary objective (MTO) specified according to the European Stability and Growth Pact permits Germany to have a structural deficit of up to ½ % of GDP.

Within such a narrowly defined framework, having the scope to run a structural deficit is by all means justifiable from an economic perspective. The German Council of Economic Experts (*Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung*), for instance, argues that debt-financing is economically warranted in cases where borrowing is used to fund (net) investments, including investment in human capital. In such cases, an increase in assets is accompanied by new liabilities, which can be financed from the ongoing earnings from the investments. Future generations therefore profit from higher potential growth. But a net investment golden rule would not be consistent with the European Stability and Growth Pact – a very severe weakness – and it would have additional methodological problems which make it difficult to handle in practice, e.g. to come to correct depreciation assumptions, especially in human capital investment.

With respect to the legal fiscal policy framework, this means that the option for limited structural net borrowing may principally be permitted because expenditure is allocated in the budget for policy areas that also, and in particular, benefit future generations by strengthening growth and sustainable development on a lasting basis. Traditional investment expenditure such as spending on transport infrastructure, but for developed countries today even more also expenditure for education, research, ecological/climate change adaptability or development serves this goal. If future generations reap higher growth as a result of the credit-financed measures taken today, then providing the flexibility for borrowing will boost prosperity both now and in the future. The inclusion of coming generations as stakeholders in today’s public investments (in the broadest possible sense, and not just investment in physical capital) for the purpose of increasing potential growth is equitable to the generations as long as enduring sustainability – in other words, the reduction of the debt ratio – is assured.

With this in mind, the new budget rule gives the Federation leeway for structural net borrowing of 0.35 % of GDP per annum; this is about € 8 ½ billion at present (compared to a general allowance within the old rule of some € 25 billion). By decoupling permissible borrowing from the reliance on the budget law’s, in this respect, inadequate concept of investment, the new rule furthermore gives budget legislators greater flexibility to determine the content of policy focussed on enhancing growth and sustainable development on a permanent basis. The new rule thus again seizes upon a major aspect of the reformed European Stability and Growth Pact and the Lisbon Strategy, which are geared towards the concept of the ‘quality of public finances’ in this regard.

4.2 Cyclical component

Public budgets exert an automatic stabilising effect on the economic process because tax revenues decline in a downturn (compared with the trend in normal economic circumstances) and government spending mounts – especially on account of rising transfer payments. An equivalent stabilising impact also occurs in a recovery. The new budget rule ensures that these automatic stabilisers can operate during upswings and slowdowns and allows pursuing a fiscal policy that is constantly responsive to the economic cycle.

The cyclical component explicitly allows for changes in revenue and spending brought about by the business cycle. Cyclical changes in receipts and expenditure trigger corresponding increases or decreases in the maximum permissible scope for net borrowing and/or require budget surpluses to be run. This symmetrical treatment of the cycle through the operation of the automatic stabilisers prevents additional borrowing in difficult economic times from leading to a systematic build-up of national debt over the long term. The need for such ‘symmetry’ was also stressed by the Federal Constitutional Court (*Bundesverfassungsgericht*).

In order to take account of cyclical effects, there must be a definition of the normal situation as a point of reference for the business cycle. Only by calculating the deviations of the actual from the normal economic situation can the cyclical effect be identified, a distinction made between ‘good’ and ‘bad’ times, and thus the amount of the cyclical deficits or surpluses be determined. To ensure that the budget rule is consistent with the European Stability and Growth Pact, the new arrangement employs the cyclical adjustment procedure agreed and applied within the EU. Additional discretionary measures can only be implemented within the 0.35 % limits or on the basis of the exception clause (see below).

4.3 Adjustment for financial transactions

To achieve the closest possible alignment between the budget balance relevant for the new budget rule and the one relevant under the European Stability and Growth Pact, revenue and expenditure will – contrary to previous practice – be adjusted for financial transactions when calculating the threshold for net borrowing. Financial transactions are transactions involving a simultaneous creation or liquidation of a financial asset and the counterpart liability like, for example, proceeds from privatisation (the exchange of equity investment assets for cash receipts) or the granting of loans (disbursing cash to acquire accounts receivable).

By adjusting for financial transactions, it will no longer be possible to use privatisation revenues to achieve compliance with borrowing limits. This removes a major inconsistency between the European Stability and Growth Pact and national budget rules.

4.4 Control account

The European Stability and Growth Pact does not just oblige EU Member States to observe the rules when drawing up their budgets. Compliance is also, and in particular, required as regards actual budget implementation. The applicable rule contained in the current version of Article 115 of the Basic Law, however, only extends to budget preparation. To make sure that budget execution is covered as well, the new rule introduces a control account, which acts as a “memory and buffer” if non-compliance with the rule is established ex post.

The control account documents non-cyclical deviations from the general threshold that are unplanned but necessarily will arise in the individual fiscal years and during implementation of the budget – of course not every single budget item could be projected with the final figure in advance. Such variations can and will occur even if the budget is prepared in compliance with the rules – for example, they can arise in cases where the financial impact of a tax reform is incorrectly forecast *ex ante*. Deviations from the economic activity predicted *ex ante* will, however, subsequently be factored into the cyclical component in the form of adjusted automatic stabilisers. They will not, therefore, appear on the control account.

If the permissible limit on net borrowing is exceeded when executing the budget, this will result in a debit on the account. Conversely, the account will be credited when the maximum permissible net borrowing is kept below that threshold. The debits and credits on the control account will be netted over time. If a negative balance on the control account exceeds a threshold of 1.5 % of GDP, the provisions of the Basic Law require this excess to be reduced in a manner appropriate to the cyclical situation. To ensure the obligation to reduce the debits of the control account has as little detrimental impact on the business cycle as possible, the implementing provisions for the control account state that there is no need for redemption in an economic downturn (i. e. in times when the output gap is getting smaller), and provide that the reduction of the debits of the control account in a recovery remain at a maximum of 0.35 % of GDP per annum (i. e. the maximum reduction is limited to the amount of the structural component in years of economic recovery). Because this spreads repayment over time, however, the obligation to reduce borrowing, set out in ordinary law, applies at a lower threshold value of 1 % of GDP.

4.5 Exception to the rule

To enable the state to borrow additional funds to cover special financing needs justified by exceptional events such as natural disasters or the current economic and financial market crisis, it is essential to allow for an exception in such extreme cases. The new budget rule therefore safeguards the ability of the government and the parliamentary majority upon which it rests to act in unusual circumstances, while at the same time limiting the risk of the exception being ‘abused’. Compared with the exception clause contained in the former version of Article 115 of the Basic Law, which permits increased borrowing to avert a “disturbance of the overall economic equilibrium”, the new exception is more narrowly formulated. In future, the constitutional ceiling on borrowing may be exceeded only in the event of a natural disaster or exceptional emergencies that are outside state control and have severe consequences for the state of public finances. Normal cyclical downturns are not sufficient reason to trigger the exception. Furthermore, the Bundestag may only approve recourse to the special arrangement if at least the majority of its members agree. A “qualified majority” of 50 % of the seats (not the present members) plus one is required. Finally, the Bundestag must approve an amortisation plan if and when the exception is invoked, and the plan must provide for borrowing above the standard limit to be reduced within a reasonable timeframe and thus prevent government debt from growing further.

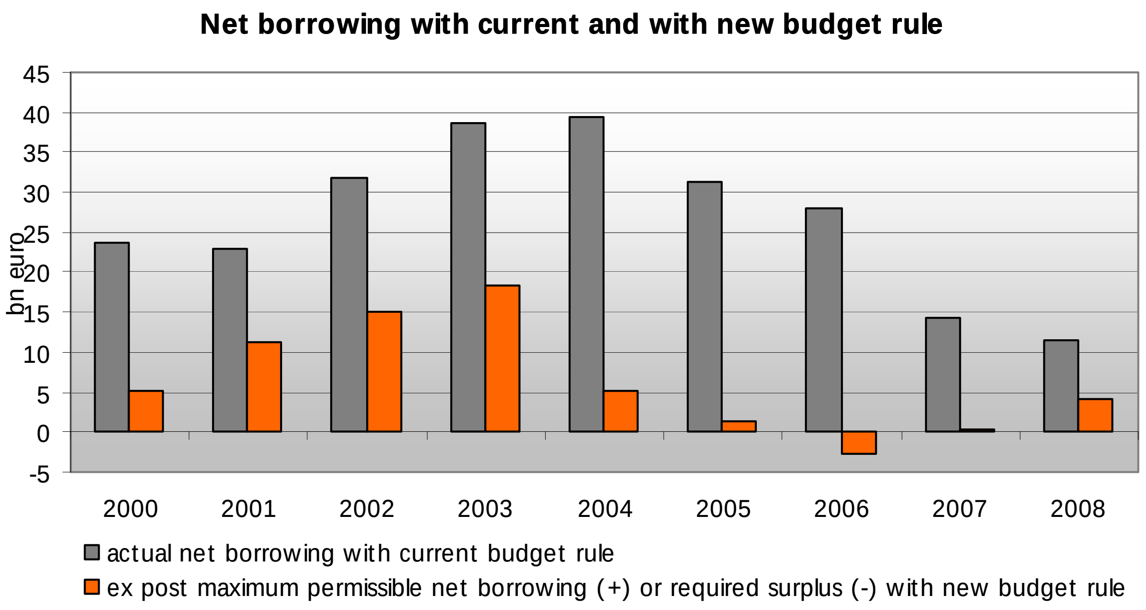
Alongside the strict hurdles for recourse to the exception, the removal of the existing second paragraph of Article 115 of the Basic Law raises the effectiveness of the budget rule over the status quo. Contrary to the situation at present, it will no longer be possible to exceed the maximum permissible net borrowing contained in Article 115 of the Basic Law by establishing a special fund with its own borrowing authorisation.

4.6 Impact of the new rule

Figure 4 compares the leeway for borrowing or the surplus, respectively, that the new rule would have made available or required in the federal budget in the period from 2000 to 2008 with the actual net borrowing incurred in these years. The net borrowing permissible or the required surplus under the new rule is calculated as the structural component adjusted for the cyclical component (as would have arisen at the time of closing the budget) and for the actual balance of financial transactions. In all years, the leeway for borrowing would have been substantially reduced. In 2006, there would have been no leeway for borrowing at all. Instead, a surplus would have had to be run. Looking back, it becomes clear that the new budget rule places a substantial limit on the scope for borrowing[2].

[2] When interpreting the chart it should be noted that the leeway displayed here assuming notional applicability of the new budget rule in the past is not only determined by the structural and the cyclical component, but, to a major extent, by the

Figure 4



5 Conclusion and outlook

The government debts accrued in the past, the undisputed weaknesses of the existing national fiscal rules, and the fiscal risks arising from the evolving age structure of our population are obvious indications that a more effective limit on net borrowing is essential. The constitutional anchoring of the new budget rules for the Federation and the *Länder* creates the foundation for a fiscal policy that is sustainable in the long term, fits cyclical conditions and facilitates those investments that are urgently needed to underpin future growth.

This new budget rule is also a central element of the German exit strategy to anchor expectations and unwind measures taken in the course of tackling the current economic and financial crisis. The medium-term financial plan for the period from 2010 to 2013 that the Federal Government presented in early July 2009 sets out the steps required from 2011 onwards for structural consolidation of the federal budget.

In future, the Federation's and the *Länder*'s compliance with the respective maximum permissible net borrowing thresholds prescribed by the new budget rule will lead to a rapid and substantial retrenchment of the debt ratio. Assuming long-term growth of GDP of 3 % in nominal terms per annum, public debt would fall to below 50 % of GDP at the end of the 2030ies and converge to a value below 20 % in the long term (cf. Figure 5).

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actual balance of financial transactions as well. In 2005, e.g., the difference between the actual and the maximum permissible net borrowing is explained by the fact that the balance achieved for financial transactions in 2005 posted a peak of around €17 billion, which almost tallied with the structural component (around €8 billion) adjusted for the (negative) cyclical component (around €-10 billion). As explained above, it will not in future be possible to use sales of assets in order to keep borrowing within the standard limits. The importance which attaches to the balance of the financial transactions is therefore likely to diminish significantly under the new rule. This does not affect the statement made in the text.

Last but not least such a paradigm change will for sure have an impact in the medium and longer term on fiscal and economics policy and public finances in Germany, including the federal fiscal transfer system where further reforms and improvements are still necessary. Institutional changes may be triggered too, e.g. regarding the role of the finance ministries.

Figure 5