A NEW BUDGET RULE FOR GERMANY

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1 Introduction

Though Germany has finally come out of its long economic stagnation in 2006, its public finances – although having become much better – are still in a "state of sorrow". Germany's public debt, meanwhile, amounts to around € 1,500 bn. The deficit was in excess of the 3 per cent deficit ceiling of the European Stability and Growth Pact from 2002 for four years in a row and was reduced only below it again in 2006. The Federation and a large number of Länder also could not comply with the respective – and quite generous – limits of net borrowing laid down in the constitutions. Looking only at the level of the Federation, debt equals to around € 900 bn. This leads to annual interest payments of almost € 40 bn or about 15 per cent of the expenditures of the federal budget. Having such a high public indebtedness narrows room for manoeuvre of fiscal policy and poses a heavy burden to future generations especially under the conditions of an ageing society and implicit debt.

As the current budget rule laid down in the Federal Constitution could not prevent the accumulation of debt which rather confines more and more the government's capacity to act, the political discussion has focused on a new budget rule since a while. First "practical" work in the Ministry started already in late spring 2006. This work has led to a central goal of Stage 2 of the Federalism Reform in Germany, carried out by the Committee on the Modernisation of the Financial Relations between the Federation and the Länder which was established in March 2007. This central goal therefore is to enact a more effective budget rule than the current one. The Federal Ministry of Finance now is still involved in the conceptual work about a new budget rule. We present here some latest principal thoughts of an internal project team of the Economics and Public Finance Department of the Federal Ministry of Finance with no means of claiming to reflect the views of the Federal Ministry of Finance as such. Now, end of 2007, the proposal presented to the Perugia Conference has passed and won several economic and political "checks" against competing models – e.g. the net-investment model of the Council of Economic Experts (CEE) – and has come close to be chosen as government proposal. Decision will be early 2008. After that the full-fledged technical preparations within the federal government and the negotiations with the Länder will go in the final phase.

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The views expressed are those of the authors and do not necessarily reflect those of the Federal Ministry of Finance.

Section 2 will deal with the status quo of the existing budget rule and the problems resulting of it. In Section 3, the two main concepts of how a budget rule can be designed are discussed. Our own proposal for a reform is formulated then in Section 4. The question, if a reform of the budget rule should be expanded also to the level of the Länder and what problems on this level might emerge, is dealt with in Section 5 before Section 6 concludes.

2 Status quo and problems of the existing budget rule

According to Article 115 of the German Constitution net borrowing is limited to the amount of (gross) public investment. Exceptions to this rule are only allowed in the case of a "disturbance of the macroeconomic equilibrium". Art. 109 II of the German Constitution has another, but similarly imprecise obligation, stating that the Federation and the Länder have to meet the concerns of the macroeconomic equilibrium in their budget management. This means that even within a macroeconomic equilibrium, public net borrowing is only allowed within the limit of expenditure for investment as long as this equilibrium is not endangered.

This budget rule was implemented at the end of the 1960s, the heyday of Germany's "Keynesian inspired" fine-tuning of fiscal policy. But the economic as well as the institutional general framework has changed since then which makes the rule in some aspects obsolete. Globalisation reduced the power of the instrument that once was seen as a global controlling mechanism. Secular decline of potential growth rates plus demographic changes lead – and most probably will do so much more in future – to challenges in the social security system concerning questions of intergenerational distribution. Last but not least, besides the Federal Constitution (and the respective constitutions of the Länder), now also the guidelines introduced by the European Stability and Growth Pact (SGP) have to be adhered to.

The changed general framework might be one of the reasons that contributed to the increase in public debt at the federal level. As the constitutions of the Länder have similar, in some cases even the same rules as the Federation, this might also have contributed to the rise in public debt at the level of the Länder and communities since the 1970s, exacerbated after German reunification when public debt increased much stronger than GDP.

One of the biggest, if not the biggest problem of this rule is that it reacts asymmetrically over the business cycle. While in situations of a "disturbance of the macroeconomic equilibrium", net borrowing is not limited any more, there is no corresponding rule for the opposite case, *i.e.* there is no obligation to reduce net borrowing or to create surpluses if the economy is in a situation with a positive output gap, defined as the difference between GDP and potential output relative to potential output. In the past, public expenditures rose and revenues decreased in economic bad times while there was no analogous behaviour in economic good times as there was no rule enforcing this.

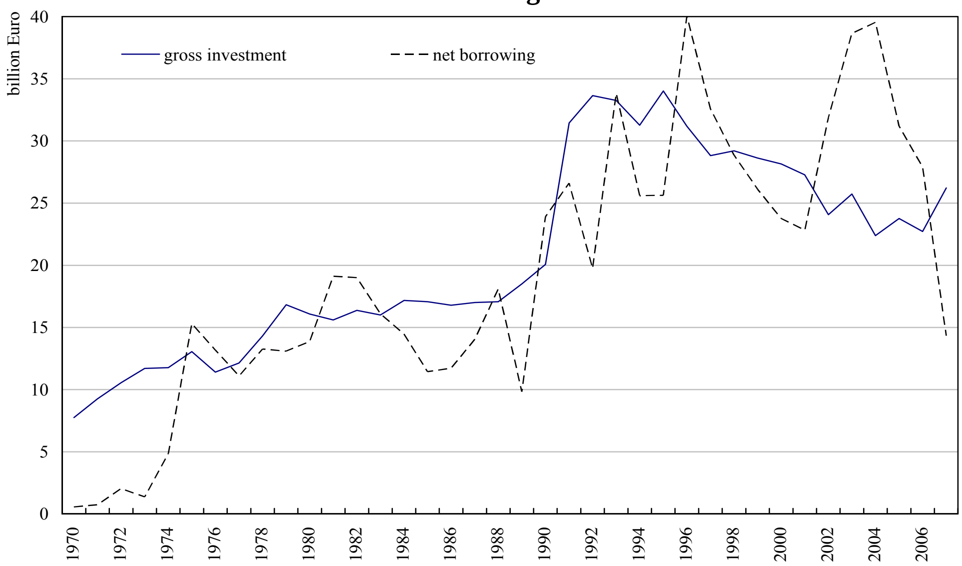
Second, the exception, *i.e.* the "disturbance of the macroeconomic equilibrium", never was clearly defined and therefore it is always difficult to decide whether – in case of referring to the exception – the macroeconomic equilibrium really is disturbed. There have been two judgements by the Federal Constitutional Court: one in 1989 about the budget in April 1981 and one in July 2007 relating to the budget in 2004. In 1989, the Federal Constitutional Court did not make a precise definition of the exception but stated that the legislator had a scope for judgemental evaluation in this question. The only obligation was that the assessment of the situation had to be based on economic data and backed by statements of the legitimated institutions of opinion making in financial and economic policy (Financial Planning Council, Business Cycle Council, Council of Economic Experts, Deutsche Bundesbank). Besides the assessment had to be traceable and justified by the perceptions of economic theory and public economics. Ultimately, in case of a dispute, it is the Federal Constitutional Court itself that has to examine and evaluate the question if the assessment of the legislator was traceable und justifiable.

All in all these "incentives" made it also relatively easy for the political class to solve political or economic pressure from all sides simply by increasing structural debt behind the veil of "macroeconomic equilibrium" and "intergenerational burden sharing". Political short term rationality here led the wrong way, a way which for some decades seemed to be without major negative impact on economy and therefore again was used to "finance" German unification. But also almost two decades later, this track was not abandoned.

Net borrowings of the Federation from 2002 until 2005 – and even in the proposed budget for 2006 – exceeded the limit defined by the investment expenditures sometimes by far; this was also true for some of the Länder in recent years. While in 2002 and 2003, net borrowings of the Federation exceeded investment expenditure only in the supplementary budget, in 2004 the excess of the limit was already in the original budget. In all cases this was officially justified by a disturbed macroeconomic equilibrium. Because the opposition parties at that time, the CDU/CSU and the FDP, reasoned that there was no disturbance of the macroeconomic equilibrium they filed an action against the 2004 budget. In 2005 the government did not have to prepare a supplementary budget, and saved to rely again on the argument of a disturbed macroeconomic equilibrium because it still had credit authorizations from former years that had not been used. Finally, in 2006 again the government justified higher net borrowing exceeding investment with the disturbance of the macroeconomic equilibrium though there had already been some signs that the economy was recovering. But also in the years before 2002, the exception to the existing budget rule was used without having a clear-cut knowledge about whether the macroeconomic equilibrium really was disturbed. In almost half of the years since 1970, net borrowing was higher than gross investment, *i.e.* the rule given by the Constitution was broken (Figure 1).

Figure 1

Gross Investment and Net Borrowing of the Central Government



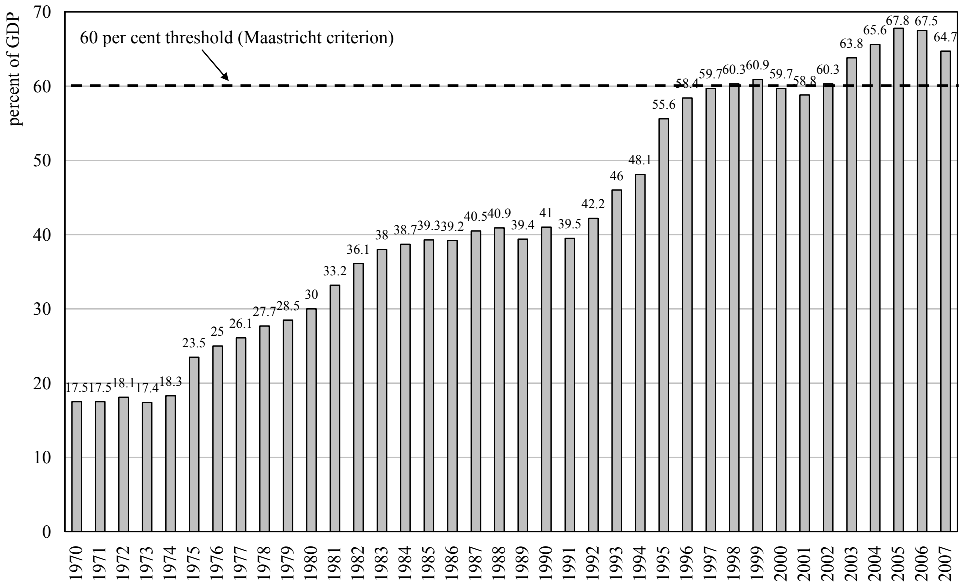
Source: Federal Ministry of Finance.

The marked increase in the central government's indebtedness from 17,5 per cent relative to GDP in 1970 to 67.9 per cent in 2006 could not be prevented (Figure 2). With rising interest payments room for manoeuvre was reduced dramatically. Moreover, a clear causality between this budget rule as a form of golden rule and investment could not be observed.

Besides, Article 115 of the German Constitution more and more turned out to be incompatible with the SGP though in some years like 2006, the deficit was below the 3 per cent criterion and therefore in line with the rules laid down in the SGP while net borrowing was still exceeding gross investment. Beyond this, the existing budget rule with rising public debt going along with it is not in line with the objective of long-term sustainability. But the current budget rule can be criticized also methodologically from different points of view. The investment concept for example relates to gross investment as the limiting factor. By neglecting depreciation of the public capital stock, the limit for net borrowing is set too high and does not make sense economically. Moreover, there is no enforcement during execution of the budget which can make the establishment of the budget to be a farce. But even in case of a definite violation of the rule, there are no direct sanctions, maybe only indirectly by the decisions in the next elections. However, as a decision by the Federal Constitutional Court is being made only with a time lag of several years, even the voters' decision is not really an indirect enforcing mechanism.

Figure 2

General Government Debt
(percent of GDP)



Source: Federal Statistical Office; own calculations.

On 9 July 2007, the Federal Constitutional Court again dismissed the action of an unconstitutional budget, this time for the year 2004. The Court acknowledged that the reasons and actions of the former government had been traceable and justifiable. But the Court also assessed that the existing budget rule was in need of a reform though not going into any detail about how a reformed rule should look like. In contrast to the decision in 1989, the Court did not give any further guidelines and it neither gave a delay until when the government must have reformed the existing rule.

As a consequence of the increasing public debt and the non-conformity with the SGP – together with the increased consciousness about the necessary consolidation that should and could not be postponed any more –, but also because of the judgment of the Federal Constitutional Court, a vivid discussion started in the public about a reform of the existing budget rule. One of the prior goals of the Committee on the Modernisation of the Financial Relations between the Federation and the Länder that was established by the Presidents of the Bundestag (Lower House) and the Bundesrat (Upper House) in March 2007 therefore is the formulation of a new budget rule. Given the economic and fiscal situation of Germany and the current majority situation of parliament, chances for a binding decision for a reform

– that needs a change of the Constitution – together with a fixed date of coming into effect are as good as never. For the short term, the cyclical improvement of the fiscal stance led to compliance with the existing budget rules (German Constitution and SGP). This allows for a structural improvement of revenues in the medium term by substituting one-off measures by tax revenues. This also guarantees broad acceptance by the public.

3 Concepts of a new budget rule: golden rule versus balanced budget in the medium term

Basically, there exist two different concepts of a budget rule. The idea of the golden rule of fiscal policy is to limit public net borrowing to the amount of public net investment. Contrary to that stands the transformation of the SGP approach on the EU level, a rule aiming for a balanced budget that enforces net borrowing to be (close to) zero in the medium term, except for automatic stabilizers in the short term.

The idea behind the golden rule is the classical and theoretically correct economic assumption that public investment is accompanied by an asset accumulation which is also of use for future generations such that it is justified that these bear a share in the costs arising in the financing. The underlying rationale is that productive public investment raises potential output per capita in future. Besides Germany that follows a modified golden rule in that gross public investment is the restraining factor, the UK, Australia and New Zealand apply the golden rule. Other countries that introduced this rule in the 1950s and 1960s, like Belgium, the Netherlands and Sweden, have given up the golden rule in the course of time. Another difference between Germany and, for example, the UK is, that while the limit of the budget has to be observed in Germany every year, the rule in the UK has to be followed over the medium term financial planning only. In order to ensure sustainable public finances, there exists a so-called sustainable investment rule in addition which states that the public debt ratio must be kept below 40 per cent of GDP.

Theoretically, a golden rule can be optimal if otherwise, *i.e.* if public debt was prohibited, public investment was below the socially optimal level; if there were – in the presence of political or institutional restrictions – incentives to cut productive public investment, or if – seen from a point of view of fairness – intergenerational redistribution in favour of today's generations and at expense of the future's generations was felt adequate. Without really knowing what the socially optimal level of public investment is, Figure 1 shows a clear downward trend of public (gross) investment since German reunification in spite of having a kind of a golden rule. One of the reasons certainly was that these expenditures are the easiest to cut. Even worse, the reduction of public investment came along with an increase of public debt, punishing future generations from two perspectives.

Not only because of this experience is the golden rule criticized. One of the major problems associated with the golden rule is the problem of how to define investment. In practice, it turns out to be technically difficult to determine the precise depreciation rate. Besides the determination might be prone to manipulation as there is an incentive to underestimate these rates. In Germany, an additional problem is that also governmental investment grants for the private sector or for other countries are counted as investment. In neither case, however, a (direct) net wealth increase at the government level is involved. Another problem with a correct classification of the investment term is that there is some expenditure that is classified as consumptive public expenditure but it has an investment characteristic, e.g. expenditure for R&D or education. A golden rule that does not include this kind of expenditure as investment could lead to incentives to diminish these expenditures to a level below the socially optimal one.

As in Germany education is a matter of the Länder, this question is not so much of relevance for a budget rule on the level of the Federation. But counting all education expenditures as investment would widen the debt limit for the Länder considerably. On the level of the Federation this would amount largely to the non-investitve allocations of funds to the Länder for research institutions of the so-called Blue List (Scientific Community Gottfried Wilhelm Leibniz, an association of German research institutes of different specialisations) – with only about € 320 m in the budget – as well as the allocations for the support of R&D of private enterprises within the governmental programs of research and innovation.

The difficulty arising with the inclusion of education expenditure is that in order to include net investment correctly, one has to determine the depreciation of human capital. This is very difficult, and there are only a few studies trying to do so. They point to a very high depreciation rate (see examples given in Sachverständigenrat, 2007, p. 130). Together with the very low correlation with the outcome – empirical studies find no or if at best a very weak relationship between the amounts invested in the educational sector and the outcome (see the zero or even negative correlations between the PISA results and education expenditure e.g. in Sachverständigenrat, 2004, p. 578, or Hanushek, 2002) – this suggests allowing for education expenditure as investment expenditure and thereby increasing the tolerable level of net borrowing only in a very restrictive manner. These and other difficulties led the Advisory Council to the Federal Ministry of Finance (1980) as well as the Federal Constitutional Court in its judgement about Article 115 of the German Constitution (1989) to decide against including education expenditure in the investment concept.

An imminent – and again creating a political incentive to spend with "good reason" – danger involved with the question of the correct definition of the investment term is that it might open the floodgates to a discussion of including other non-investment public expenditures as, for example, in the health sector, for childcare or for security reasons as they could be interpreted as investment in the future and preconditions for economic growth. Even a narrowing of the investment term could involve a discussion and wet the appetite.

Another problem with the golden rule is that – though it follows the principle of intertemporal equivalence – it is accompanied by a growing sustainability gap in the face of demographic changes witnessed in many industrial countries, especially in Germany. Adding to the fact is that investment is depreciated with a shrinking population. In so far, a golden rule does not obey sustainability principles in an ageing society.

These facts speaking against a golden rule have to be seen together with the robust result of economic theory which holds that debt financing of public expenditure – no matter if this is used for consumption or investment – burdens future generations and leads to lower growth. This is true at least for the plausible case in the long run that the interest rate is greater than the – secular shrinking – potential growth rate. Desired redistribution effects to the detriment of future generations are then the only justification for long-term debt financed public expenditures. These effects, however, are counteracted in an ageing society by the burden that future generations have to bear in the face of the demographic change especially in the systems of social security which is merely on a pay-as-you-go-basis.

Aside from the intergenerational problem, a golden rule neglects the productivity of the private investment being a substitute to public investment. Though public investment might encourage private investment and increase their productivity, the opposite effect is possible as well depending on the kind of investment and the existing capital stock. In this case the waiving of public investment, together with less debt and less future tax burden, might lead to more productive private investment.

Finally, the analogy to the private sector concerning return on investment is limited. While the economic profitability of an investment project of a private enterprise has to show up at least in the long run in financial returns, public investment does not have to.

In the face of all these problems with the golden rule, there are a lot of arguments in favour of a structurally balanced budget in order to guarantee sustainable public finances and to limit net borrowing. While a golden rule allows net borrowing at the amount of public investment, net borrowing with a rule following a structurally balanced budget is allowed only for cyclical reasons (automatic stabilizers), and there must be additional saving efforts in the case of a cyclical upswing. The consequence is a reduction in public debt relative to GDP. Even a budget rule that is less restrictive, but still in accordance with the SGP – e.g. the "close to balance"-rule which allows for Germany for example a minimal structural deficit of 0.5 per cent of GDP – would be much more advantageous than the current rule. Finally, the quality of public finances is also guaranteed in a structurally balanced budget rule. It might be even superior to the golden rule as it does not have a bias towards "physical" capital formation. This rule would oblige the legislator to shift the expenditures to those of "high quality" that are viable for the future, independent of them being classified as investment or consumption expenditures. Here the new deficit regime meets or is even part of the "Quality of Public Finance" Agenda, now developed in Germany, in many other countries and on the level of the EU.

4 Criteria and proposal for a new budget rule

Independent of how a new budget rule looks like, a budget rule has to fulfil certain indispensable criteria. First, there should be an effective limit for (structural) net borrowing. Second, the rule should be such that on the one hand it provides for stabilization over the business cycle and that, on the other hand, it provides for sustainability of public finances in the long run. Moreover, the budget rule has to be compatible with the SGP. Additionally, it must have an enforcement mechanism to allow for control not only *ex ante*, *i.e.* with the establishment of the budget, but also after execution of the budget. Finally, the viability of the rule has to be guaranteed by having an exception clause in case of an emergency case. These essential criteria must be embedded in a budget rule that is technically and legally feasible. Further aspects that have to be taken care of are the appointment of a starting point and the answer to the question if a transition path to the new budget rule should be defined. As a special problem of Germany's federalism, federal aspects also have to be taken account of.

As the previous Section has pointed out, there are a lot of arguments against a budget rule relying on the golden rule concept. This holds especially for the case of Germany where a necessary new definition of the investment concept might involve serious problems. This is one of the main differences to the proposal of the German Council of Economic Experts (CEE) that was published in its expertise by order of the Federal Minister of Economics and Technology on *Limiting Government Debt Effectively* (Sachverständigenrat, 2007) in Spring 2007 where it defends the (net) investment concept. A prominent supporter of a renunciation from the golden rule is the Advisory Council to the Federal Ministry of Finance which advocated its position in a letter to the Federal Minister of Finance in July 2007 (Wissenschaftlicher Beirat beim Bundesministerium der Finanzen, 2007). But besides relying on the investment concept, the CEE also introduced in its proposal a component for cyclical adjustment close to the so-called debt brake in Switzerland that was proposed in 2000 (Schweizerischer Bundesrat, 2000) and realized in 2002.

In our view, a new budget rule should be specified that is compatible with the "close to balance or in surplus" approach of the SGP – while it also shows some similarities with the Swiss debt brake – according to the following principles. First and as the main principle, the budget must be balanced in general in revenues and expenditures without net borrowing.

Second, the new rule should provide for a stabilizing role of budget policy over the business cycle. Allowing automatic stabilizers to work assures that the budget rule reacts symmetrically over the business cycle. In case of divergences from potential output, cyclical adjustments in net borrowing therefore should be allowed. A cyclically caused increase in net borrowing or a lower surplus, respectively, should be possible with a negative output gap while net borrowing is to be reduced/diminished by cyclically caused excess revenues or reduced expenditures or a fiscal surplus has to be realized in a situation with a positive output gap, respectively. This symmetry over the business cycle prevents additional room for net borrowing in bad times to lead to a systematic increase of public debt in the long run. The symmetrical consideration of the business cycle was also demanded by the Federal Constitutional Court: “It is necessary to develop mechanisms that guarantee the necessary balance of the budget over several fiscal years... The choice and institutionalization of rules that … counteract conveniently the incentive to postpone balancing burdens on future legislations … is the task of the legislator who is able to change the Constitution”.

Cyclical adjustment is already used in the application of the SGP in order to control for and evaluate the medium term objectives (MTO) of the budget, the adjustment steps leading to the MTO, and recommendations of the European Council to the member states in the dissuasive arm of the SPG concerned to correct an excessive deficit and the time frame for doing so.

While in the concept of the CEE as in the Swiss model the cyclical component is calculated with the Hodrick-Prescott filter, we propose to go hand in hand with the SGP and apply the production function approach in order to estimate potential output. This is the reference method agreed by the European Council on 12 July 2002.[1] However, as potential output is an unobservable variable, there is no single correct estimation approach and therefore neither a unique result. The Hodrick-Prescott-filter method is a purely statistical one; the production function approach is based more on economic theory. These as well as other methods in general lead to similar results though the output gaps might differ even in sign in certain periods. All methods also have the problem that values for former periods are revised where a change in the sign of the output gap might also appear here.

Cyclical adjustment then is applied as follows. The cyclical component of the fiscal balance is calculated as the product of the budgetary sensitivity and the output gap. Budgetary sensitivities, *i.e.* the elasticities of the budget deficit on a change in the output gap, have been derived for the European Commission by the OECD in a sophisticated approach (André and Girouard, 2005). Cyclical components of the budget according to the SGP are tax revenues, social security contributions, and labour market expenditures. The result for Germany has been evaluated also in a separate work by the Ifo Institute (Büttner *et al.*, 2005). The general government budgetary sensitivity obtained by the OECD for Germany of 0.5 was confirmed by the Ifo Institute. The analysis also showed that about 50 per cent of the cyclical component can be attributed to the federal budget and 50 per cent to the budgets of the social security system, the Länder and the communities. Subtracting the cyclical component from the fiscal balance leads to the cyclically adjusted fiscal balance. This means for example that an output gap of –1 per cent results in general in a cyclical component of the budget deficit of 0.5 per cent of GDP. In addition, in order to be compatible with the Maastricht definition, this amount must be corrected for net financial transactions (mainly privatization gains).

[1] Cyclical adjustment is stipulated by law in Council Regulation (EC) No 1467/97 (OJ 1467/97, OJ 1056/2005) on speeding up and clarifying the implementation of the excessive deficit procedure.

Third, the medium-term objective of the SGP has to be observed. Therefore, net borrowing must be limited to the medium term objective of the SGP ("close to balance or in surplus") which tolerates a maximum structural deficit of 0.5 per cent of GDP for the general government. This is in order to guarantee durably sustainable public budgets and therefore to comply fully with the Code of Conduct of the revised SGP which states: "Member States should achieve a more symmetrical approach to fiscal policy over the cycle through enhanced budgetary discipline in periods of economic recovery, with the objective to avoid pro-cyclical policies and to gradually reach their medium term objective, thus creating the necessary room to accommodate economic downturns and reduce government debt at a satisfactory pace, thereby contributing to the long-term sustainability of public finances. The presumption is to use unexpected extra revenues for deficit and debt reduction".[2]

As the Federation and the social security system take about 70 per cent of the cyclical fiscal balance – as measured by tax revenues – we propose a breakdown of 70:30 between the Federation and the Länder. This would mean 0.35 per cent of GDP for the Federation, *i.e.* a tolerated Maastricht-deficit of about € 8½ bn at the moment. The allowed net borrowing ceiling or the required minimum fiscal surplus, respectively, then is the cyclical component of the budget minus the sum of 0.35 per cent of GDP and net financial transactions.

Because in the long run, public debt in percent of GDP will be reduced to far below 60 per cent, our approach – as well as that of the CEE – allows for intergenerational justice and future viability. Debt reduction can be used to cover implicit liabilities and as such makes an important contribution to long-term sustainability of public finances. Decreasing public indebtedness relative to GDP also opens room for manoeuvre such that expenditures can be shifted towards tasks relevant to the future. This improves the quality of public finances.

An exception clause to the general rule should be formulated for specific emergency cases only. In order to overcome an extreme crisis, e.g. a natural disaster, coupled with a severe economic downturn, a two-thirds majority or an even higher quorum of the Lower House might allow extra room for net borrowing.

In terms of enforcement, there is a need for monitoring and setting incentives not only for the establishment but also for the execution of the budget. Deviations from the allowed expenditure ceiling or the minimum fiscal surplus, respectively, defined by this budget rule will be put on a special account, the so-called balancing fund, which acts as memory and as buffer if non-compliance with the rule is established *ex post*. The balancing fund therefore links the establishment with the execution of the budget, a link that so far is missing in the current budget rule. But only such a link creates a real commitment and makes the budget rule credible and enforceable.

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2 *Specifications on the implementation of the Stability and Growth Pact and Guidelines on the format and content of Stability and Convergence Programmes*, 2006, ec.europa.eu/economy_finance/about/activities/sgp/codeofconduct_en.pdf

Deviations of the actual from the minimum fiscal balance are accumulated over the years in the balancing fund. However, the minimum fiscal balance might change over the course of the fiscal year compared to the one that was forecasted at the time of the establishment of the budget due to another economic, *i.e.* cyclical development than forecasted. This must be taken into account. The logic behind the concept presented so far would be to estimate again potential output and compute the output gap by using realized GDP data. The disadvantage of this approach, however, would be that due to the uncertainty underlying this unobserved variable, there were permanently revisions that could be very huge, deviate in both directions over time and sometimes would not be plausible, at least against the background of the available information at the point of time when the budget was established. A more pragmatic approach would be to correct the cyclical component by the deviation of the actual growth rate of GDP from the forecasted one. As Figure 3 shows, deviations from targeted to actual figures go – except for 2001 and 2002 – into the same direction for both variables. A similar approach was chosen in the assessment of the excessive deficit procedure for Germany. This would mean, for example, that with a forecasted real GDP growth of 2.0 per cent, but a realization of only 1.0 per cent, the one percentage difference between these two rates would be multiplied by the budgetary sensitivity and the share of the Federation. The same is true for the opposite case if the forecasted GDP growth was more pessimistic than the realization. This so-called *ex post* additional cyclical component will then be added to the *ex ante* cyclical component and either reduces or increases the minimum fiscal balance that is not relevant for the balancing fund.

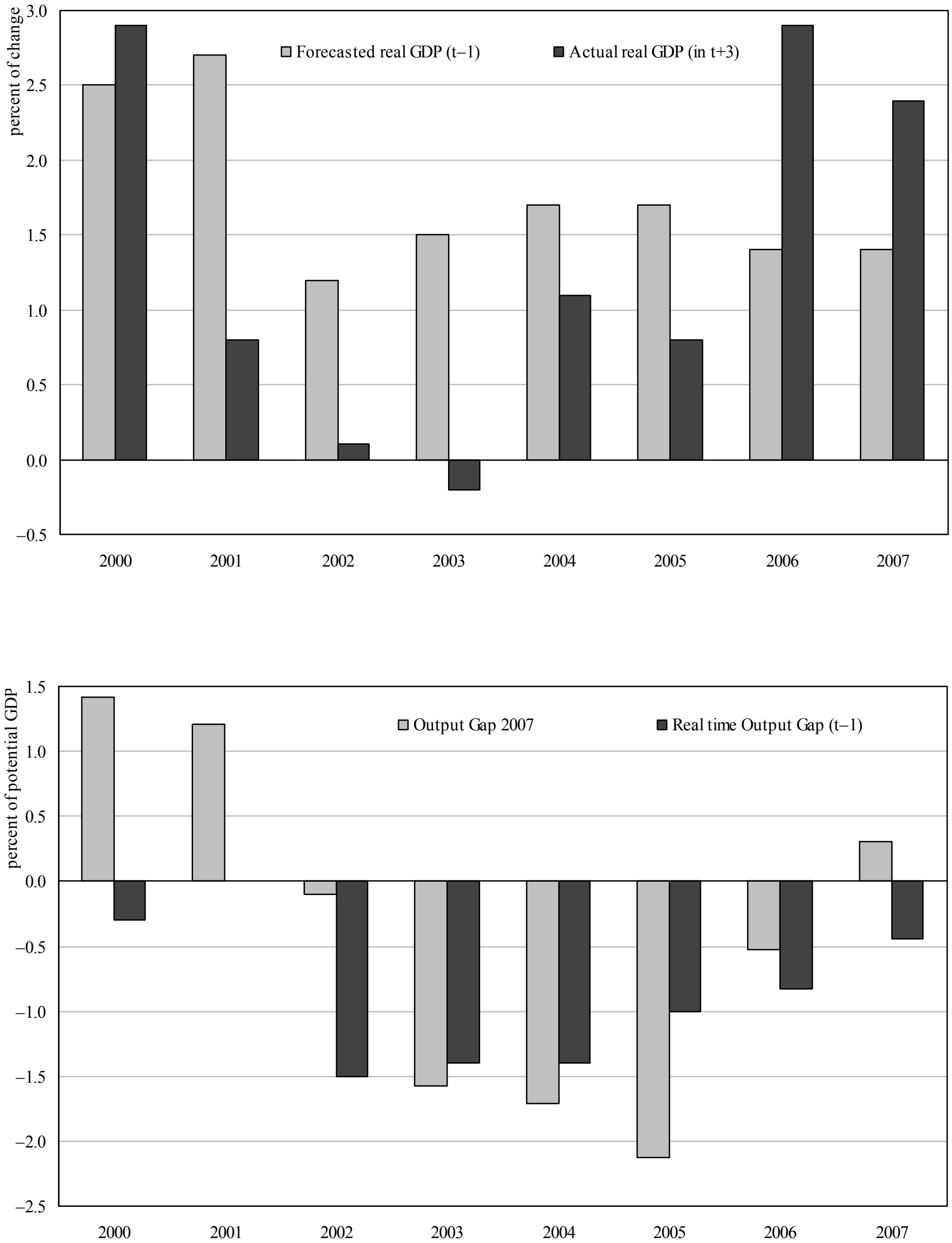
A first target-performance comparison will be made as soon as there are preliminary results for the budget and GDP growth of the fiscal year. The balancing fund, however, will be updated with the revision of GDP figures until these are final which is only three years later. Further revisions in the context of so-called big SNA revisions will not be accounted for as long as they come after the cut-off year $t + 3$. This means that the balancing fund is final for a certain fiscal year only three years later.

Nonetheless, possible policy measures in case if the debit side is in excess of a defined threshold level have to be tackled as soon as an excess is observed. Consolidation measures have to be introduced such that the debit side falls below the threshold level again in a specified time. In case of a credit in excess of the positive threshold level public debt can be reduced by this amount. The threshold amount could be set at 1 per cent of GDP, for example. A backward simulation of this rule to the years 2000 until 2007 shows, that this level would never have been exceeded on the debit side. This simulation was done under the assumptions that the allowed net borrowing was bailed out *ex ante*, *i.e.* at the time of budget establishment. Deviations between targeted and actual net borrowing equal the actual deviations in the past (taking account of net financial transactions).

However, there remains at least one problem with the cyclical adjustment: the application of constant budgetary sensitivities resulted in huge estimation errors in the past. Especially taxes on profit fluctuate at cyclical turning points much stronger

Figure 3

Deviations from Targeted to Actual Figures



Sources: Federal Statistical Office, Autumn Forecasts of the Federal Government, EU Commission for output gap.

than predicted by standardized methods of cyclical adjustment. This might lead to a higher share of non-cyclical additional tax revenues or a non-cyclical short-fall of tax revenues than justified in fact. Therefore, the balancing fund might contain also cyclical parts that in principle should not be accounted there. One solution might be to increase the threshold level of the balancing fund by an “uncertainty margin”. But there still needs to be done some research in this field before deciding how to take care of this problem.

In general, however, this is no problem that should be seen as an impediment to the rule becoming effective. As pointed out above, the window of opportunity to introduce a new budget rule should be used now. And as the general government budget will be structurally balanced in 2011 according to the budget plan, there seems to be no need to think about an adjustment path until the new budget rule can work. As such, the new rule would become effective when the budget is structurally balanced.

5 New budget rules also for the Länder?

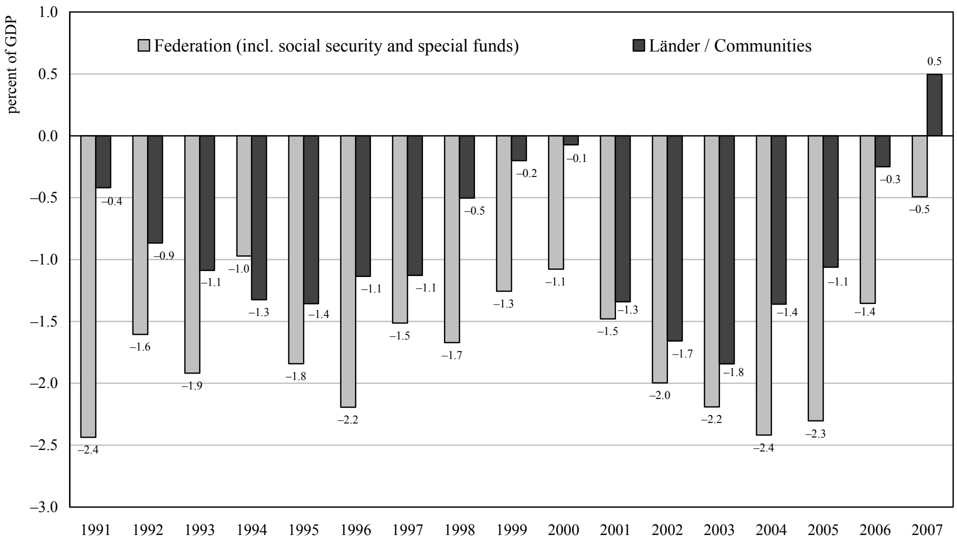
Federalism in Germany poses a special challenge on how to fulfil the requirements of the SGP. Twelve of the 16 Länder – including all of the new Länder – have copied the rule of Article 115 of the German Constitution to their own constitutions. Additionally to the problems on the level of the Federation, the isolated use of the exception in case of a “disturbance of the macroeconomic equilibrium” by the Länder is inefficient.

As the SGP demands budget discipline for the general government and the Federation takes the responsibility against the EU, it might be politically desirable to have a budget rule that covers not only the central governmental level, but also the level of the Länder (communities structurally should have no deficit). In general, there is no technical problem to translate the budget rule into all levels of government though there is no necessity for fiscal policy reasons to do so. As tax revenues among the Länder are equalized by the financial equalization scheme between the Federal Government and the Länder, there is no relation between regional GDP and regional tax revenue. The cyclical component therefore could be distributed according to the distribution of the tax revenues after financial equalization which corresponds to distribute the cyclical component by the share of the population.

Indeed, on the one hand, as shown in Figure 4, the main problem, *i.e.* the higher contribution to the deficit, is due to the central government. But on the other hand, a translation of this budget rule to the Länder could lead to problems as starting conditions and therefore also the time path to a structurally balanced budget differ throughout the Länder: While some of them have a balanced budget or even are in surplus, others have a distressed budget; the eastern Länder additionally receive special equalization payments by the Federal Government.

Figure 4

Fiscal Balances (Maastricht Definition) by Governmental Levels
(percent of GDP)*



* differences due to rounding.
Source: Federal Statistical Office; own calculations.

The Länder themselves started the discussion about a reform, voicing different proposals. The ideas for a reform of the budget rule, especially concerning its strength, differ among the Länder, some of them even advocating for a prohibition of any amount of debt while others might agree to this kind of budget rule only if they receive additional payments by the Federation or the equalization scheme between the Länder in order to achieve a balanced budget. So it seems to be difficult to find a unanimous solution. Especially it is a problem that the financial weakest Länder link this theme with a general or partly relief of accumulated "old debt" or at least to debt service assistance from the Federation or from "rich" Länder, which the Federation cannot and will not accept. In the light of the high debt of the Federation itself it is not realistic that the Federation would settle payments in order to eliminate public debt obligations of the Länder.

But in general, there is no need for fiscal policy reasons to copy the budget rule of the Federation 1:1 to the Länder. Modifications are at the Länder's discretion as long as the results are compatible with the SGP. Even now the debt limits differ over the Länder with heterogeneous formulations in the respective constitutions. As the Länder and communities in aggregate are in surplus already, it is however essentially a problem of the Federation to limit new debt. A new stricter rule for the

Federation will anyway put political pressure on the Länder not to be much looser in their debt regime.

The main task of the Länder merely is to introduce a preventive arm in order to prevent financial distress of single Länder. This could be for example an early warning system that formulates a concept of financial restructuring for a Land in distress.

If the Länder should copy the new budget rule, the CEE suggested modifications for sanctions: instead of automatic tax increases as proposed for the Federation, at the level of the Länder, revenues should to be used for repayment. Because of the fiscal equalization scheme, there should neither be an exception to the rule in case of severe economic downturns.

6 Conclusions

As the analysis has shown, a reform of the existing budget rule is inevitable. Economic and fiscal conditions as well as the political environment of a grand coalition are right now very favourable for a reform and should be used as soon as possible. As the reform of a budget rule is both one of the main topics of the Committee on the Modernisation of the Financial Relations between the Federation and the Länder and a task being given by the Federal Constitutional Court, chances of realization are good, too.

Though it seems to be clear that a new budget rule will be introduced, the question however remains about its format. The dialogue on the political level has started and ideas have already been transmitted there. The link of the budgetary process to the business cycle is not new. What is new is the link to econometric methods that would mean to tread uncharted trails in budget policy. Another innovation would be the introduction of a link between the establishment and the execution of the budget in the form of the balancing fund. The case of Switzerland shows that this is technically as well as politically feasible. But this demands great political commitment and to renounce discretionary measures.

Beyond the necessary political commitment, there remain, of course, still some unsolved questions about the technical realization if the budget rule will be reformed in the sense lined out above. These concern especially the design of the balancing fund and how it works. In case of an excessive debit side of the balancing fund, accumulated net borrowing could be reduced according to the accepted obligation of annual reduction within the SGP, for example. This would mean a reduction of the deficit by 0.25 per cent of GDP per year. An automatic tax increase as suggested by the CEE might be neither politically desirable nor making sense from an economic viewpoint nor probably marking a credible threat to politicians not being reelected. The formulation for the Constitution also poses a challenge. But we think that these all are manageable challenges. The gain of a credible commitment to sustainable public finances should by far outweigh its costs.

Last but not least all this has to be fed in the daily work of preparing, executing and controlling the budget. Parliamentarians of all colours now seem to accept Germany needs a new stricter debt rule which will also diminish or self-restrict Ministers and/or MP's power to spend. Nevertheless, it is a paradigm change, more complex and less transparent, more "economistic" than the old rule everybody is used to. So it will take time to overcome still existing scepticism, to implement the new system and of course this presented blue print will have changes and further developments. Nevertheless we are convinced that this new model will win political and public acceptance via the results it will bring for public finances and therefore also for growth and sustainability.

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