

IMPLEMENTING GERMANY'S NEW CONSTITUTIONAL FISCAL RULES

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1 Historical background

In June 2009, a new constitutional debt rule was passed by the Bundesrat following approval by the Bundestag. 2/3 majorities of the members – as required by article 79 II of the German Basic Law – voted in favour of a debt brake for Federal and state government budgets to become fully binding as of 2016 and 2020, respectively. To understand the reasons for this step, it seems necessary to take into account prior developments concerning government deficit and debt in Germany.

Government borrowing has been subject to constitutional limits since the foundation of the Federal Republic of Germany in 1949. By the end of the 1960s, a constitutional reform had been made to commit fiscal policy to safeguarding macroeconomic equilibrium. According to Section 1 of the Act to Promote Economic Stability and Growth, fiscal policy measures must contribute to the stability of the price level, high employment levels, external equilibrium and continuous as well as adequate GDP growth. In order to avert a disruption of the macroeconomic equilibrium, the former article 115 of the Basic Law allowed central government borrowing to be extended above the ordinary limit defined by the total of estimated investment expenditure in the budget. The extent of such exceptional borrowing was not limited effectively and there was no obligation to repay these debts. General exceptions from borrowing limits could also be claimed for special funds outside of the core budget.

Given that strong political incentives to spend now and to shift financing burdens into the future exist in Germany, too, it was no surprise that debt levels grew significantly in the decades after the aforementioned constitutional reform for Federal and state government budgets.¹ During the first few years, attempts were made to stabilise GDP growth and employment levels. While providing additional stimuli was easy and also successful at first, cutting deficits in relatively good times was not nearly as successful. As trend GDP growth declined significantly throughout the last decades, the misinterpretation that the cyclical environment was unfavourable prevailed and eliminating deficits was not considered to be the main task of fiscal policy. Instead of implementing consolidation measures, the exception clause for averting a disruption of the macroeconomic equilibrium was used quite often, especially during the first decade of the 21st century. Consequently, debt levels climbed considerably.

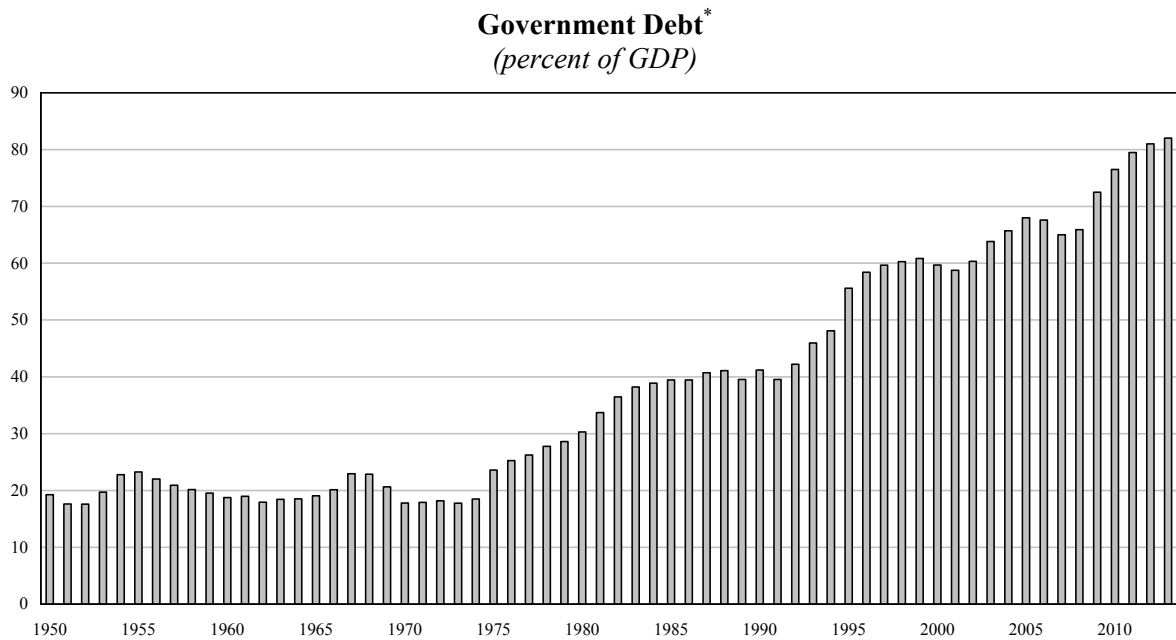
In addition, during the process of German reunification, off-budget funds and entities were used to finance political tasks, such as compensating east German banks for converting customer deposits at more favourable exchange rates than those applicable to their own assets, providing state governments with money for creating infrastructure and preparing state enterprises for a competitive environment while providing their staff with earnings above productivity levels. By 1995, a respective debt total of about 10 per cent of GDP had been accumulated. The largest part was attributed to a new special fund for the redemption of inherited liabilities. While it was possible to repay a minor part, e.g., by means of part of the Bundesbank profit distributions, the

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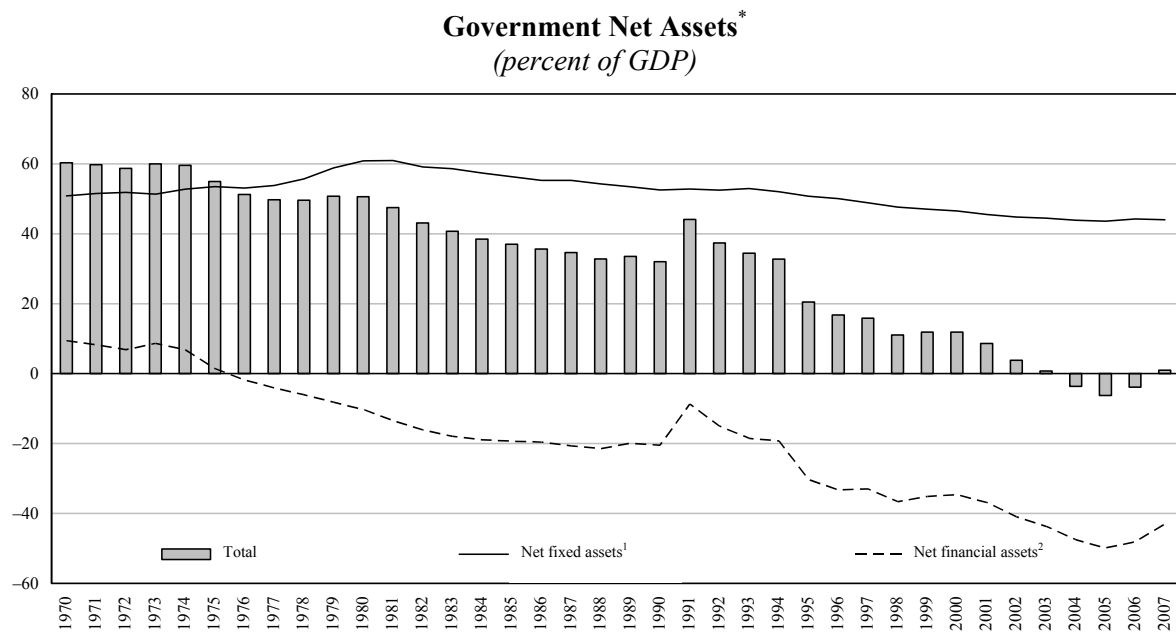
¹ For the development of debt levels and the underlying reasons, see Deutsche Bundesbank (2010), "Government Debt and Interest Payment Burden in Germany", monthly report, April, pp. 15-33.

Figure 1



* Up to and including 1990, data from debt statistics, Western Germany. From 1991, pursuant to the Maastricht criteria. From 2009, data from the updated stability programme of January 2010.
Deutsche Bundesbank.

Figure 2



Source: Federal Statistical Office and Bundesbank calculations.

* As defined in the national accounts; central, state and local government and social security funds. Up to and including 1990, western Germany.

¹ At replacement cost: tangible and intangible fixed assets less depreciation, as at the beginning of the year.

² Financial assets less liabilities, as at the end of the year. Results of the Deutsche Bundesbank's financial accounts.

Deutsche Bundesbank.

majority was refinanced via Federal debt instruments and is no longer separated from other debt instruments.

Even before the financial crisis and its effects on economic activity began to have an impact on government finances, the German Maastricht general government debt-to-GDP ratio had climbed to above 65 per cent. Bringing this ratio back below the reference value of 60 per cent sufficiently quickly seemed barely feasible after the outbreak of the crisis. If the development of the general government debt rate had been accompanied by a comparable increase in the asset position, it probably would have given less cause for concern. But, in reality, the net asset position had decreased significantly during the previous decades. Furthermore, in 2007, the German constitutional court judged that the central government's 2004 budget – for which the exemption clause for averting a disturbance of the macroeconomic equilibrium was used for the third time in a row, despite rising GDP growth rates – could not be declared unconstitutional. It noted that the constitutional borrowing limits were not sufficient to safeguard sound public finances. As the judges are not entitled to change the constitution, they called for politicians to create an effective framework to safeguard sustainable public finances.²

While in many European countries deficits and debt occur almost exclusively at the level of central government, state governments in Germany are usually responsible for about 1/3 of general government deficit and debt levels. Despite a revenue sharing system that largely aligns per capita-tax revenue, significant differences prevail between the budgetary positions of the sixteen German states. In 1992, the German constitutional court decided that the two (least populated) states of Bremen and Saarland were suffering from extreme budgetary hardship and were consequently entitled to claim assistance from the other members of the German federation. From 1994 to the end of 2004, the two states received aid totalling €15 billion and were obliged to limit their annual expenditure increases (e.g., to just 1 per cent on average for 2003 and 2004).³ Nonetheless, they did not manage to return to sound budgetary positions and filed lawsuits for further financial assistance. In addition, the state government of Berlin also called for help to overcome a situation it considered to be a case of extreme budgetary hardship (following a judgment by the Berlin state constitutional court offering additional borrowing possibilities in such a case).⁴ However, in 2006, the German constitutional court decided that help for Berlin was not necessary because such assistance can only be claimed if all possibilities to improve revenue have been used and expenditure levels have been restricted to the level considered strictly obligatory under Federal law and other binding commitments.⁵ As most other state governments also faced severe budgetary pressure in the first years of the 21st century,⁶ they acknowledged that a comprehensive change of their fiscal policies was necessary to avoid unsustainable debt growth and further cases of states claiming help due to extreme budgetary hardship. All in all, strict borrowing rules were considered to bring about the exterior pressure needed to enable politicians to eliminate deficits from the budgets.

2 The main elements of the German debt brake

The main elements of the new fiscal rules were agreed by a commission of 16 Bundestag members and one member of each state government – in most cases the prime minister. Discussions were held for about two years starting in 2007. The time was considered suitable for

² See German Constitutional Court, 2BvF 1/04 from 9 July 2007, Sections 133-135, available in German only.

³ See Bericht des Saarlands zur Sanierung des Landeshaushalts – Sanierungsbericht 2004, p. 9-10.

⁴ See Berlin state constitutional court, VerfGH 125/02, Section D.III, available in German only.

⁵ See German constitutional court, 2BvF 3/03 from 19 October 2006, available in German only.

⁶ See Deutsche Bundesbank (2006), "State Government Finances in Germany", monthly report, July, pp. 29-50.

changing budgetary rules as a coalition of the two largest German parties formed the central government in the legislative period from autumn 2005 to autumn 2009. They had a 2/3 majority of Bundestag members and were also in a position to organise the majorities in the Bundesrat that were needed to change the Basic Law. Furthermore, following the impressive deficit reduction from 2006 onwards, many politicians believed that avoiding borrowing in the future should not be too challenging.

While the Council of Economic Experts had favoured a net investment-based borrowing limit,⁷ politicians decided to follow an “at least close-to-balance approach” as already prescribed over the medium term by the European Stability and Growth Pact. Keeping in mind that a structural general government deficit ratio of about 0.5 per cent was considered to be in line with European rules, central government – in line with its share in general government debt and its financial responsibility share in the event of European sanctions due to persisting excessive deficits – claimed a structural borrowing limit of about 2/3 of this amount. However, dividing up the remaining amount among the sixteen states would have created significant problems. A zero borrowing limit was ultimately agreed. Some relatively strictly defined exceptions are foreseen under the condition of a redemption plan for incurred additional debt. As it was obvious that the deficits expected in early 2009, partly due to measures aimed at overcoming the effects of the financial crisis, would not be eliminated in the near future, transitional periods were agreed. While the years up to 2016 were considered sufficient for central government, prior to the final outbreak of the crisis state governments had already claimed the period up to 2020 to give those states with high structural deficits enough time to balance their budgets. Transitional auxiliary payments for five states with high deficits or debt levels were agreed under the condition of a gradual reduction of structural deficits in the transitional period. In order to closely monitor the agreed deficit reduction and also to prevent new cases of extreme budgetary hardship, a stability council was founded.

For central government, the commission also developed the main rules for the use of the debt brake, which were passed as the new article 115 of the Basic Law and the Law to Execute Article 115 of the Basic Law. For state governments, a balanced budget rule is prescribed in article 109 of the Basic Law. It will become effective in 2020 without further state parliament action. However, the relevant details (and the limited set of exceptions) have to be defined by state (constitutional) legislation.

3 The details of the debt brake for the Federal government budget

3.1 Constitutional and legal framework

The new borrowing limit for central government budgets clearly refers to the European Stability and Growth Pact.⁸ The draft law to introduce the constitutional debt brake stresses the intentions of the reform. By setting an at least close-to-balance budget in structural terms as an upper limit, the reform aims to stop the upward trend of the Maastricht debt ratio in particular. As a consequence, several changes to the traditional concept were introduced.

To begin with, the borrowing limit had to be defined precisely. In order to come close to the deficit relevant for the preventive part of the Stability and Growth Pact, a cyclical adjustment procedure was introduced. The Basic Law stresses the importance of symmetry of the procedure during upturns and downturns to prevent an increase in the debt level. An accumulation of

⁷ See Council of Economic Experts (2007), “Effectively Limiting Government Indebtedness”, March, available in German only.

⁸ See Bundestag Document No. 16/12410, e.g., pp. 1 and 5.

“cyclical” debt would have to be expected if the procedure were to detect more severe or longer recession periods than years with output levels above potential. Section 5 (4) of the Law to Execute Article 115 of the Basic Law also contains an indication that the methods used by the European Commission should be followed. Furthermore, the cyclical adjustment procedure is also to be adjusted to reflect scientific progress. The legal definition of the cyclical effect is the output gap multiplied by the budget sensitivity of the central government budget. More detailed prescriptions on how to calculate this effect were laid down in a regulation by the German Ministry of Finance in consultation with the Ministry of Economics and was published in summer 2010. According to the regulation, output gaps have to be calculated in line with the EU Commission procedure when the budget is drafted and finalised. In later steps, a simplified approach is envisaged. Differences between expected and actual GDP growth are considered to be entirely cyclical. According to Section 7 of the Law to Execute Article 115 of the Basic Law, revisions of the cyclical component will be stopped by 1 September of the year after the budget is implemented.

In addition, financial transactions are not included in the borrowing limits. While central government budgets have, in the past, often contained significant amounts of sales of financial assets⁹ – in order to limit borrowing and not to exceed the former borrowing limit – such transactions can no longer be used for this purpose. On the other hand, the acquisition of such assets is not limited by the debt brake. As granting loans and acquiring shares are also excluded from the Maastricht deficit, this procedure could be considered to be straightforward.

Furthermore, the borrowing rules no longer apply only for the drafting period but also for the implementation stage, too. This was deemed necessary, since problems might occur if cyclical conditions prove to be better than expected or net borrowing requirements for financial transactions are lower than budgeted. If a government nevertheless uses the full amount of borrowing entitlements given in the budget and possibly also inherited borrowing entitlements from the previous year, constitutional structural limits could be exceeded. Consequently, a control account was identified as being needed. On this account, the difference between the constitutional borrowing limit – adjusted for actual net financial transactions as well as the actual cyclical effect – and the actual net borrowing in a budget has to be booked every year. If a debt threshold of 1 per cent of GDP is surpassed on this account and the government expects cyclical burdens to decrease, borrowing has to be restricted below the constitutional limit by an amount of up to 0.35 per cent of GDP (Section 7 (4) of the Law to Execute Article 115 of the Basic Law) to prevent a permanent increase of burdens on that account. Under this restrictive framework concerning results, borrowing limits for supplementary budgets were made less challenging to avoid urgent needs for sizeable short-term consolidation measures. Section 8 of the Law to Execute Article 115 of the Basic Law consequently allows additional borrowing for such budgets of up to 3 per cent of estimated tax revenue above the constitutional limit provided that no additional deficit-increasing measures are implemented.

Moreover, reflecting that the Maastricht deficit also includes government entities beyond the core budgets, the general exception from borrowing limits granted for special funds was abandoned. According to article 143d of the Basic Law, which stipulates rules for the introduction of the debt brake, from 2011 onwards – also defined as the first year of application of the debt brake for the central government budget – no additional special funds may be founded or given entitlements to borrow. Only those special funds that had been given borrowing entitlements before the end of 2010 may still use them up to the expiration date.

Furthermore, article 143d of the Basic Law contains the clause that the reduction of structural deficits – expected to rise up to 2010 – should begin in 2011. A postponement of consolidation measures was not definitively ruled out due to concerns about a possible need for

⁹ From 1995 to 2010 receipts of €140 billion were recorded – in addition to total borrowing of about €470 billion.

further government stimuli in order to return to macroeconomic growth after the crisis.¹⁰ However, the Law to Execute Article 115 of the Basic Law (which could be amended by a Bundestag majority if needed in the event of a longer severe crisis phase) goes further and stipulates that the structural borrowing limits of the central government budget are to be reduced in equal steps, starting in 2011, from the level reached in the budgetary year 2010 (Section 9 (2)).

Finally, according to article 109 of the Basic Law, exceptions from the debt brake are only envisaged in the event of natural disasters or outstanding emergencies beyond government control (meaning that the government and the legislation are not in charge of the situation) and if budgetary effects are sizeable. According to the draft law to change the constitutional borrowing rules, the traditional justification for exceptional borrowing to avert a disruption of the macroeconomic equilibrium does not qualify for the new clause. Even more importantly, exceeding the constitutional borrowing limit will only be allowed if a concept is approved on how to repay the additional debt incurred. The incentive to use the exception clause should consequently be much lower than under the preceding borrowing rules.

In summary, the clearly announced intention to limit the growth of central government debt levels was underpinned by a series of relatively detailed constitutional and legal rules which intended to close the main loopholes of the old constitutional borrowing limits. Only time will tell whether these efforts are really sufficient. The first months of the implementation stage, however, show that continuous vigilance is necessary to avoid recourse to – almost unavoidable – loopholes.

3.2 *Implementation of the framework: possible loopholes and actual problems*

As the first application of the debt brake was for the 2011 budget, the actual implementation for central government budgets was due after the general elections in autumn 2009. Voters changed the majorities by adding much weight to the Free Democratic Party (FDP), which had stressed its firm intention to cut levies, especially income taxes. Hence a coalition agreement between the Christian Democrats and this party was signed promising further tax cuts of €24 billion (about 1 per cent of GDP). After additional smaller steps in 2010, major tax relief was envisaged – if possible – for 2011 or later in the legislative period (up to 2013). However, all additional measures were only promised on the condition that they could be refinanced within the budget already burdened by a high structural deficit. It was also declared that the rules of the new debt brake would be respected.¹¹ It therefore seemed at least useful for the new government to find loopholes in order to finance the promised tax relief measures.

The first attempt was already mentioned in the coalition agreement. The parties proposed the creation of a *special fund* to finance transfers to compensate crisis-related deficits of the Federal Employment Agency and possibly also revenue shortfalls of the statutory health insurance scheme (page 24 of the agreement). By creating the fund before the old exception for borrowing by such bodies had expired, sizeable transfers could have been financed for a number of years without being subject to the new borrowing rules. However, the public response was strictly negative. Such very obvious recourse to loopholes in the highly appreciated debt brake could not be explained credibly. Hence, the idea of creating a big special fund to provide – interim – relief for the core budget was dropped at an early stage.

However, one year later, a new special fund responsible for stability within the financial sector has been created. In October 2008, at the peak of the banking crisis, SoFFin was established

¹⁰ See Bundestag Document No. 16/12410, pp. 13-14.

¹¹ See “Growth. Education. Unity. The coalition agreement between the CDU, CSU and FDP for the 17th legislative period”, available at: <http://www.cdu.de>

as a special fund to stabilise monetary financial institutions for a limited period. New measures could only be taken up to the end of 2010. While borrowing entitlements, mainly for recapitalisations, amounted to up to €80 billion, actual borrowing requirements only reached about 1/3 of this amount by the end of 2010. The successor fund is primarily to be financed via a bank levy. As regular annual revenue was expected to reach about €1.3 billion only, the idea of “inheriting” borrowing entitlements from SoFFin was proposed. In order to fulfil the requirements of the debt brake, the new special fund had to be created before the start of 2011 and the inheritance of borrowing entitlements had to take place just before the actual end of the SoFFin assistance measures. Unlike the above mentioned intentions to create additional borrowing facilities in late 2009, the actual transfer of borrowing entitlements of €20 billion did not cause any political problems. While this transfer was obviously designed to circumvent the veto on borrowing by new special funds, the transaction ultimately does not give any additional room for budgetary manoeuvre. A possible extension of the SoFFin assistance period could have led to even higher borrowing. Furthermore, as the borrowing entitlements of the new fund are to be used for capital injections to stabilise the financial sector, acquiring equity through the central government budget instead would not be limited under the debt brake if the measures can be considered to be financial transactions.

A further issue for concern is the *borrowing limit during the transitional period* from 2011 to the end of 2015. The Law to Execute Article 115 of the Basic Law states that the limit is formed by the structural deficit of the 2010 budgetary year being reduced in six even steps in each of the following years, leading to the permanent limit of 0.35 per cent of GDP in 2016. Two main questions arose concerning the starting level for the structural borrowing ceiling in 2011.

The first issue not explicitly addressed in the legal rules was *how to proceed with one-offs* in the reference year 2010. The new coalition partners agreed that no adjustment was to be made. Consequently, by budgeting high one-off burdens in 2010, structural borrowing limits in the following years up to 2015 could be increased. Consequently, instead of providing a loan to finance the expected very high deficit of the unemployment insurance scheme (Federal Employment Agency) – as legally prescribed since 2007 and considered to be exempt from the structural deficit under the debt brake rule as a financial transaction – the government decided to make a transfer for this purpose just for 2010. Furthermore, a one-off transfer to the statutory health insurance scheme to provide compensation for crisis-related revenue shortfalls was budgeted. As labour market developments turned out to be not as bad as expected, the estimated transfer to the Federal Employment Agency was revised downwards from €16 billion in December 2009 to €12½ billion when finalising the 2010 budget in the Bundestag in March 2010. Together with the additional transfer to the health insurance scheme, estimates of about €16½ billion were budgeted for one-off burdens. Adjusted for the cyclical component in the transfer to the Federal Employment Agency, the one-off structural deficit increase in the reference year would have been about €10 billion (0.4 per cent of GDP), leaving short-term scope for parts of the tax cuts promised in the coalition agreement or the postponement of ultimately necessary, but unpleasant consolidation measures.

The second issue was *when to define the reference value* prescribed by law as the “structural deficit in the 2010 budget year”. The necessity to draft budgets and medium-term financial plans on the basis of reliable assumptions was stressed by the Federal Ministry of Finance. Hence, it was announced that the budget estimates for 2010 would be used to calculate the reference value.¹² However, there seemed to be an even more important factor. As budgetary developments were much better than to be expected under the improved macroeconomic conditions – mainly owing to positive tax revenue surprises, labour market-related expenditure shortfalls, €4.3 billion in one-off relief from an auction of mobile phone licences and declining interest expenditure – using the

¹² See the statement by parliamentary state secretary Steffen Kampeter, Bundestag Document No. 17/494, pp. 14-15.

budget estimates instead of the final result or a best interim guess leads to a much higher reference value for the structural deficit and higher borrowing limits in the transitional period.

All in all, the 2010 budget law granted borrowing entitlements of €80.2 billion. After deducting cyclical components and net effects of financial transactions, an amount of €66.7 billion was classified as the structural component. Taking into account the structural part of the upward revision of the official tax forecast from May 2010 and the revenue from the mobile phone licence auction also concluded in that month combined with the positive surprises from German labour market developments and from the interest conditions for German bonds, it could be expected in June that the actual deficit would probably be about €60 billion and the structural component still about €10 billion lower. Neglecting the positive developments would have enabled the Federal government to draft a budget for 2011 showing an increase in the structural deficit and total borrowing entitlements compared with the results for 2010 that were expected in June.

In order to avoid a scenario with a deficit increase, which was too obviously not in line with the intentions of the debt brake, the Federal Ministry of Finance decided to adjust the starting point for the structural deficit limits notably by assuming a 2010 result for the total borrowing requirement of €65 billion and a structural component of €53 billion.¹³ Based on these figures, central government agreed a consolidation package on 7 June 2010. On 7 July, the draft budget for 2011 was approved by the cabinet. The borrowing entitlement amounted to €57.5 billion, the structural component – excluding, in particular, a loan of €6.6 billion to balance the deficit of the Federal Employment Agency – was calculated to be about €46 billion and hence just fulfilled the limit for 2011 derived from the Ministry's own (cautious) 2010 estimate.

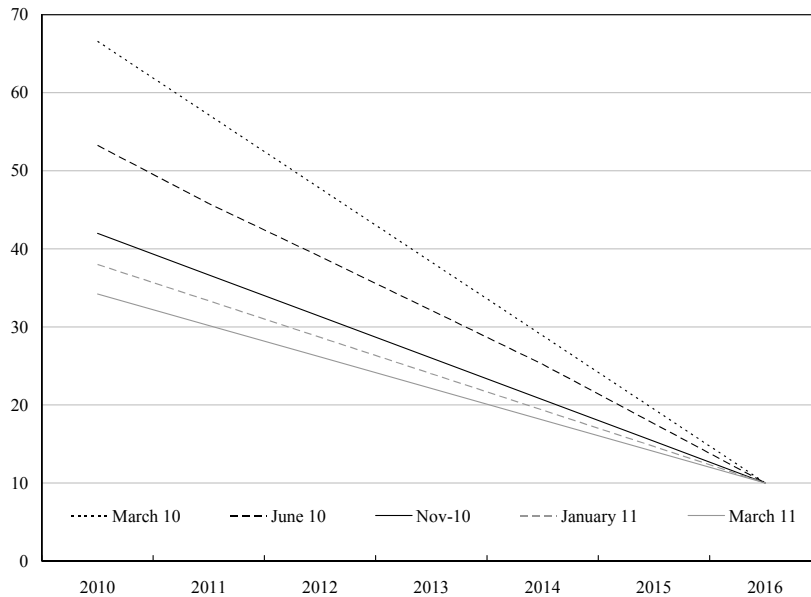
However, positive surprises continued to occur up to the end of 2010. When making final parliamentary adjustments to the 2011 draft budget after the new official November tax revenue forecast, the government conceded that the actual borrowing requirement in 2010 would be only about €50 billion. However, no figures for the structural component were mentioned. According to rough estimates, a size of about €40 billion seemed plausible. To avoid an increase in the 2011 borrowing entitlements compared with the expectations for 2010, the figures for 2011 were adjusted mainly for the increase in tax revenue estimates. However, further adjustments, mainly regarding lower interest or labour market-related expenditure, remained strictly limited. Hence sizeable buffers remained in the budget estimates. Total borrowing entitlements were reduced to slightly above €48 billion, while the structural component was declared to be €41 billion. The borrowing limit, however, had not been adjusted to the new 2010 forecasts. Hence, a safety margin of almost €5 billion between the borrowing entitlement and its constitutional limit was claimed to exist – created mainly by the base effect of a more favourable outcome for 2010.

By mid-January, official figures for the 2010 budget had been published. Total net borrowing amounted to just €44 billion. However, figures for the cyclical impact as well as for the net effects of financial transactions were not published by that time. According to preliminary approximate calculations by the Bundesbank, the structural component should be about €38 billion instead of the amount of €53.2 billion estimated in June 2010. Not adjusting the starting point for the constitutional borrowing limits for the transitional period is hence a clear and quantitatively highly significant contravention of the intentions of the debt brake. Assuming that most factors contributing to this improvement cannot be considered to be “one-offs”, there would be no need to reduce the structural deficit until 2013 by additional measures in order to keep borrowing in line with the adjusted limit for the transition period. While analyses from the most important economic research institutes and from the German Council of Economic Experts reached the conclusion that 2011 offers very good conditions for consolidation measures,¹⁴ central government's interpretation

¹³ See Federal Ministry of Finance press release: “Debt Rule Compels Us to Consolidate”, 6 July 2010.

¹⁴ See *Gemeinschaftsdiagnose Autumn 2010*, p. 47, and *Council of Economic Experts (2010)*, p. 11.

Figure 3
Minimum Adjustment Path
for the Structural Federal Government Budget Deficit
(billion euros)



March and June 2010 data from Budget Law resp. Federal Ministry of Finance, later data partly based on own estimates for cyclical effects and financial transactions.

the current opportunity of good cyclical conditions to bring down structural deficits by more than the prescribed minimum amounts – not least in order to be in a better position in case macroeconomic growth perspectives take an unexpected turn for the worse in the future. If the minimum target is not set at a sufficiently ambitious level now, there is a danger of repeating a major mistake from past years when necessary consolidation measures were postponed during good times.¹⁶

The fact that the government has used a misinterpretation of the wording of the debt brake rules becomes even more evident under the assumption that the 2010 budgetary development would have brought about sizeable negative surprises from June onwards. If the starting point for the structural deficit had been fixed in June and the expected outcome after the official tax forecast in November had been, e.g., €10 billion higher owing to lower tax revenue, there would have been an urgent need to fully compensate this amount in 2011 on top of the graduated consolidation measures agreed upon in June 2010, as the budget for 2011 would have had to respect the borrowing limit derived from the June estimates. Such pressure would have been against the spirit of the transitional rule for the debt brake and could have led to its failure during the first year.

The importance of the 2010 reference value can be seen in the chart below. Sticking to the structural deficit figure estimated in June 2010 leads to a difference of €15 billion for the structural

of the debt brake signals no necessity to do so. Adjusting the starting point for the borrowing limits in the transitional period is essential to preserve the credibility of the debt brake. Otherwise, the deficit in the 2011 budget – the first year under the debt brake – would be allowed to rise again substantially, even in structural terms.¹⁵ If the consolidation of the 2011 budget is nevertheless continued as announced, the room for possible deficit increases in the next few years will remain significant and pressures, e.g., to lower tax rates despite still high structural deficits may become hard to resist. In general, it is very important to make use of

¹⁵ The biggest opposition party in the Bundestag proposed passing a law prescribing corrections for the structural borrowing limits in the transitional period by using the 2010 results as the starting point. See Bundestag Document No. 17/4666 dated 8 February 2011. However, a majority of Bundestag votes rejected the proposal. See Bundestag Protocol No. 17/117 (30 June 2011), p. 13486.

¹⁶ See also Deutsche Bundesbank (2010), “Overview”, monthly report, November, p. 10.

borrowing limit in 2011, if March 2011 figures (derived by using the new cyclical adjustment procedure agreed upon for the European Union budgetary surveillance procedure currently used for the German debt brake) are taken as a benchmark. Up to 2016, the difference would accumulate to almost €50 billion for the stock of Federal government debt.¹⁷

Besides the issues surrounding special funds and the starting point, the treatment of *financial transactions* might prove to endanger the success of the debt brake. While excluding sales of financial assets from the deficit rule closes an important gap in the old constitutional borrowing limit, the general exemption for the acquisition of such assets could open another loophole. After paying a transfer to finance the deficit of the Federal Employment Agency in 2010, central government budgeted a €5.4 billion loan for 2011. However, the good performance of the German labour market in 2010 may mean that only a much smaller amount will be needed. The medium-term financial plan from 2010 to 2014 had already envisaged repayments from 2013 onwards. Given the better-than-expected performance, continuously accumulating loans no longer seemed to pose a threat. As a consequence, politicians soon came up with the idea of diverting funds. The German constitutional court had judged that a reform of the benefits for the long-term unemployed was necessary. As approval from the Bundesrat was required (and the central government parties had lost the majority of votes in the second chamber), a package was bundled to obtain approval. As local governments had run up high deficits during the crisis and improvements were hard to achieve, the central government offered to take on their burdens of about €4 billion for social benefits for the basic needs of the elderly and persons with disabilities affecting their capability to work. State governments co-responsible for the finances of their local authorities hence were under pressure to approve the reform package. Ultimately, with only small adjustments to the benefits for the long-term unemployed, the reform passed the two legislative chambers. As the central government budget still suffers from high structural deficits and the borrowing limits of the debt brake have to be respected, recourse was made to the regular transfers to the Federal Employment Agency. Since 2007, revenue from 1 percentage point of the increase in the general VAT rate has been forwarded to the Federal Employment Agency, which, in turn, has lowered contribution rates by 1 additional percentage point. From 2012 onwards, this transfer will be lowered in three steps. From 2015 onwards, an annual amount of €4 billion will be diverted to the aforementioned local authority relief measure. Hence, a trend towards growing stocks of central government loans to finance deficits of the Federal Employment Agency can no longer be ruled out.¹⁸ By practically shifting burdens to the agency (while still offering central government loans to balance deficits), a possible loophole of the debt brake was already used in the first months of the new rule being applied.

A crucial question will then be how to proceed if the loans given to finance deficits reach a level that makes repayment obviously implausible. If a *debt release* takes place for the benefit of the Federal Employment Agency, Federal government debt will remain without the corresponding financial assets. From a budgetary perspective, this might be no cause for concern, because no entitlements for payments are needed. But under the debt brake framework, this is obviously inappropriate. Article 109 (2) of the Basic Law postulates that the main goal is to balance the general government budget according to the European budgetary accounting rules laid down in the European System of National Accounts 1995. Under this framework, debt releases have to be booked as capital transfers. As these potentially very sizeable transactions increase the deficit, the use of such instruments has to be restricted under the debt brake rules. Hence, a debt release would

¹⁷ See the Statement given by the Bundesbank at an expert hearing by the budget committee of the Bundestag on 21 March 2011 at www.bundestag.de, available in German only.

¹⁸ See Deutsche Bundesbank (2011), Public Finances, monthly report, May.

need to be recorded as a transaction that increases borrowing analogously for the debt brake.¹⁹ Otherwise it would be possible to pay, e.g., individual social benefits as principally repayable loans and borrow as much as needed for such purposes. After a defined period without (sufficient) repayments, unlimited debt releases could take place, leaving high government debt without corresponding financial assets. This would be a clear breach of the intentions of the debt brake. If this is not stopped, there will be only very limited hope for the lasting success of the new rules.

Generally, strict rules to *clarify which payments may be classified as financial transactions* seem necessary. Given the principal goal pursuant to article 109 II of the Basic Law, the rules for the European budget supervision should be applicable. The above-mentioned loans to the Federal Employment Agency are given without interest claims and redemption dates. Hence, they would usually hardly qualify as a financial transaction. The same conclusion would have to be reached in the case of capital injections to enterprises that do not seem to be sufficiently profitable to pay an adequate return via profit distributions. For central government, capital injections have so far only played a minor role of less than €1 billion per year. The largest part is obviously paid as capital injections into multilateral development banks that mainly give concessional loans and hence can hardly be profitable. The government classified these payments as financial transactions until 2011, but obviously treats them as transfers in the 2012 draft budget. This new treatment seems appropriate and should be used in all similar cases in the future. Otherwise even regular transfers to prevent or compensate losses might qualify as financial transactions under the debt brake framework. The incentive for misclassification would then strongly endanger the effectiveness of the new borrowing limits. A more difficult question is how to treat calls on guarantees. Backed by the experience that calls on guarantees given for claims from exports typically lead to notable repayments in later years, central government considers such calls to be financial transactions as well as received corresponding repayments. When expecting a continuation of high repayments, this treatment seems adequate. By contrast, calls on guarantees given for transactions within Germany increase structural deficits.²⁰ However, within the regular reporting framework for 2010,²¹ no budgetary figures were published showing a breakdown of calls on guarantees within Germany and those abroad. Hence, there was at least a lack of transparency regarding the actual structural deficit 2010.

In principle, the *cyclical adjustment* of deficits within the framework of fiscal rules is an accepted procedure. However, it is necessary to respect some basic principles. The debt brake for the central government budget encompassed the concept of symmetry as a constitutionally fixed condition. Following the wording of article 109 of the Basic Law, symmetry could be understood as using the same procedures in upturns and downturns. The explanations in the draft law to establish the constitutional reform, however, make it clear that the intention is to prevent a structural increase in nominal debt levels due to effects labelled as cyclical. The Law to Execute Article 115 of the Basic Law also rules that the details of the adjustment procedure have to be fixed by a regulation from the Ministry of Finance (with the agreement of the Ministry of Economics) in accordance with the rules used for the European budgetary surveillance procedure. This reference to an institution considered competent and neutral seemed at that time helpful to prevent politicians from fine-tuning procedural details in order to achieve cyclical components that are compatible with the intended fiscal policy. Furthermore, the principles of transparency and simplicity should be taken into account. Although there was no legal prescription to publish the code of the cyclical

¹⁹ See the Statement given by the Bundesbank at an expert hearing by the budget committee of the Bundestag on 21 March 2011 at www.bundestag.de, available in German only.

²⁰ See Kompendium zur Verschuldungsregel des Bundes gemäß Artikel 115 Grundgesetz, pp. 11-12.

²¹ Adjusted figures for financial transactions were only given after an inquiry by a member of the Bundestag. See Bundestag Document 17/4987, p. 12, available in German only.

adjustment programme or the data used, central government provided experts with detailed explanations.

Meanwhile, the *cyclical adjustment procedure* used for European budgetary surveillance was *changed considerably*.²² While the new concept is said to produce less sizeable data revisions for individual years, the pattern of calculated cyclical effects has changed markedly. Compared with the preceding adjustment procedure, cyclical effects in the past tended to be more positive or less negative, while the results for the most recent years show less positive or more negative cyclical impacts. While long-term symmetry still seems to be given, higher cyclical burdens during the crisis and the following recovery period justify higher borrowing even in coming years. When deciding headline figures for the 2012 draft budget in March 2011, central government assumed a cyclical component of –2.9 billion, whereas a comparable estimate with a standard filter (HP-filter, lambda 100) delivered a slightly positive cyclical component.²³ If the change in the adjustment procedure is fully based on scientific progress, this may be no reason for concern.

However, given the special rules for the central government borrowing limit in the transitional period before 2016, the cyclical component for deriving the structural deficit for 2010 as the starting point would have to be recalculated with the new cyclical adjustment procedure. The consequence would be a notably lower structural borrowing limit, especially in the first years of the transitional period. By changing to the revised cyclical adjustment procedure and not redefining the borrowing limits, central government is using another loophole, securing some margins that might be used to fill up the control account (with the option of strategically distorting budget estimates in the future if needed to circumvent consolidation measures) or in order to limit short-term consolidation efforts or to fulfil tax relief promises made for the current legislative period. Each of these options would be in clear contrast to the intentions of the debt brake. However, it seems questionable whether this can still be stopped.

Another possible problem concerning cyclical adjustment is the question of *when and how to calculate the cyclical effects ex post*. While safeguarding symmetry would, in principle, also require an adjustment of the effects recognised for former years, probably numerous sizeable revisions of the total stock recorded on the control account could lead to some general distrust concerning any results. Hence, stopping adjustments for every single year after a limited time span would seem to be useful if systematic breaches of the symmetry principle can be avoided. Section 7 of the Law to Execute Article 115 of the Basic Law stipulates that the final entry for a budgetary year has to be made on 1 September of the following year. Furthermore, the regulation on execution details of article 115 of the Basic Law rules that after passing the main budget law no adjustments are to be made with regard to estimates of trend growth: differences between predicted and actual GDP growth have to be considered entirely cyclical. While the rules did not define whether real or nominal growth has to be considered, the Ministry of Finance obviously decided to base its calculations on nominal rates,²⁴ which are in fact more important for tax revenue developments. Having a final deadline for entry adjustments on the control account and simplifying *ex post* calculations of cyclical impacts on the budget really simplify the application of the new borrowing rules. However, problems regarding the constitutional symmetry condition for cyclical effects will occur if trend GDP growth continues to decline as it did over the past few decades or is just overestimated when drafting the budgets. If this occurs, misestimates of trend growth will be labelled as cyclical once a budget has passed the legislative process. To limit corresponding debt

²² For information on the interconnection with the German debt brake, see Deutsche Bundesbank (2011), “Requirements Regarding the Cyclical Adjustment Procedure Under the New Debt Rule”, monthly report, January, pp. 55-60.

²³ The Bundesbank Spring 2011 forecast also envisages a positive output gap for 2012. See Deutsche Bundesbank (2011), “Outlook for the German Economy – Macroeconomic Projections for 2011 and 2012”, monthly report, June, pp. 13-26.

²⁴ See Baumann, E. and J. Schneider (2010): “Die neue Regel des Bundes”, in C. Kastrop, G. Meister-Scheufelen and M. Sudhof (eds.), *Die neuen Schuldenregeln im Grundgesetz*, Berlin, pp. 109-110.

increases, it would also be useful to introduce a control account for cyclical effects. While no limit on its stock is needed, it seems useful to prescribe that after a full cycle the stock may not increase on its level at the start of the cycle. If this condition is not fulfilled, the respective debt growth should have to be compensated by lowering the structural borrowing limit over the next few years.

A further loophole might be found in the use of *public private partnerships* (PPPs). By giving orders to build and operate infrastructure projects, budgetary burdens can be postponed under the framework of cash-based accounting systems run by central government and also by most state governments. Instead of budgeting investment expenditure and borrowing to finance it right from the start of a project, when choosing a PPP only smaller payments in later years have to be budgeted. Hence, borrowing limits could be formally respected without reducing long-term budgetary burdens in a comparable way. Paying for a PPP might be considered to be indirectly paying interest and redemption for incurred debt. From a purely legal point of view, this does not seem to be a problem, as constitutional borrowing limits are usually understood as rules governing immediate borrowing only.²⁵ However, the objective of article 109 II of the Basic Law to achieve an at least close-to-balance general government budget seems to necessitate a different approach. According to the European accounting rules, PPPs have to be recorded as government investment if certain main risks are not transferred to the private partner. In Germany, the necessary degree of risk transfer to avoid investment expenditure entries in the government accounts does not seem to be achieved in most cases. Hence, PPPs will have an immediate impact on the Maastricht deficit. Not including PPPs in the borrowing rule would then make it impossible to ensure that the above-mentioned overriding objective of the debt brake laid down in article 109 II of the Basic Law is achieved. However, it cannot be ruled out that the legalist view may be followed. As a consequence, it would seem useful to explicitly include transactions similar to taking up a loan in the structural borrowing limit.

Although the above-mentioned possible loopholes could already endanger the debt limitation intended by the reform of the borrowing rule, there is a further problem that might prove to be very severe. While additional borrowing entitlements are available for supplementary budgets, and higher-than-expected deficits during the execution of the budget may be financed via recourse to borrowing entitlements inherited from the previous budget, the budget for the next year has to fulfil the structural borrowing limit set by the debt brake. As deficit problems in the German central government budget were often caused by tax shortfalls which went beyond the amounts that could be classified cyclical, they could not be reverted easily. During the protracted phase of low GDP growth from 2001 to 2004, even additional substantial structural tax shortfalls were noticed in every year. If the debt brake had been implemented before that time and no *safety margin* had been established between the structural borrowing limit and the actual structural deficit, a series of very sizeable consolidation measures would have become necessary despite real and nominal GDP growth rates that were (almost) close to zero (instead of the former common recourse to sales of financial assets or the exemption clause “averting a disturbance of the macroeconomic equilibrium”). Sizeable consolidation measures might have even aggravated the poor performance of the German economy during that phase. This could have strongly endangered the acceptance of the strict borrowing rule. As a consequence, sufficient safety margins between constitutional limits and budgetary plans or smooth adjustment path rules should be implemented.²⁶ However, no such elements are explicitly included in the central government debt brake. A useful instrument would be an obligation in the budget regulations law for central government to strive for a slight structural

²⁵ See Tappe (2010), “Haushaltsrechtliche Umsetzung der Artikel 109 und Artikel 115 GG n.F. in Bund und Ländern”, in C. Kastrop, G. Meister-Scheufelen and M. Sudhof (eds.), *Die neuen Schuldenregeln im Grundgesetz*, Berlin, p. 435.

²⁶ For information on the necessity of safety margins, see also Deutsche Bundesbank (2009), “The Reform of the Borrowing Limits for Central and State Government”, monthly report, May, pp. 78-79, and Kremer, J. and D. Stegarescu (2009), “Neue Schuldenregeln: Sicherheitsabstand für eine stetige Finanzpolitik”, *Wirtschaftsdienst*, Vol. 89/9, pp. 630 and the followings.

surplus. If this target is missed, gradual adjustments during the medium-term financial planning period could be a useful setting to prevent fiscal policy from being obliged to almost immediately take sizeable consolidation measures. The safety margin might also be used for active countercyclical policy in very bad times. Given that no redemptions are necessary in that case, stabilisation success might be easier to achieve than by using the exception clause. In order to prevent abuse of the growing bonus amounts booked on the control account due to the safety margins, it might be helpful to also introduce an upper limit of 1½ per cent of GDP. Higher amounts would not be recorded then. Notwithstanding, reaching this level should not be considered a signal to change fiscal policy to, e.g., tax relief measures, at least as long as debt levels are still above the European reference value.

4 Implementation of the debt brake at state level

Whereas the legal details of the central government debt brake had been laid down together with the reform of article 109 of the Basic Law in summer 2009, overall progress at state government level is far more moderate. Without amendments in the state constitutions, a balanced budget rule without any exceptions at all will be applicable for state government budgets from 2020 onwards. As also mentioned above, the long transitional period was agreed to give sufficient adjustment time for the states that had high structural deficits even before the outbreak of the major crisis in the course of 2008 (mainly Bremen, Saarland and, to a far lesser extent, Schleswig-Holstein). From 2011 to 2019, these states plus two heavily indebted ones (Berlin and Saxony-Anhalt) will be granted annual transitional aid of €0.8 billion in total, financed by the Federal and each of the state budgets. As a gradual reduction of structural deficits was prescribed as a precondition for actual aid payments, these states should feel compelled to make early adjustments, whereas the other ones are just vaguely obliged by article 143d of the Basic Law to avoid a fiscal situation that might make a balanced budget in 2020 impossible. However, there seems to be a lot of scope for different interpretations about what was actually agreed in 2009.

A first and very important question refers to the definition of the ban on (structural) borrowing for state budgets. Legal experts tend to follow the traditional definition of borrowing. According to this approach, only the issuance of all types of bonds or financing by taking up loans is prohibited. Consequently, transactions as sale-and-lease-backs or PPPs would not be limited directly.²⁷ As at central government level, this does not seem to reflect the wording of 09 2) of the Basic Law or the intentions of the debt brake. Besides limiting the increase in future budgetary burdens, caused in particular by growing outstanding debt, a clear commitment to the rules of the European Stability and Growth Pact was given. This means that at least close-to-balance budgets have to be ensured. As European rules treat typical German PPPs in a different way than national budgetary practice, the overriding goal of avoiding breaches of European obligations should be given priority over the traditional view of legal experts. Hence, the budgetary data should be corrected if European rules lead to a different classification. As a by-product, future budgetary burdens as a result of present decisions would be limited much more effectively.

In addition, the traditional view might lead to the conclusion that the ban on structural borrowing would only apply for the core budgets. From this point of view, borrowing limits would only bind the legal person immediately addressed. *Entities beyond the core budgets* would then have constitutionally unlimited recourse to financing by loans. However, article 143d (1) of the Basic Law governing the introduction of the debt brake already casts doubts on such reasoning. It is stipulated that from 2011 onwards, special funds may only use those credit entitlements granted

²⁷ See Tappe (2010), "Haushaltsrechtliche Umsetzung der Artikel 109 und Artikel 115 GG n.F. in Bund und Ländern", in C. Kastrop, G. Meister-Scheufelen and M. Sudhof (eds.), *Die neuen Schuldenregeln im Grundgesetz*, Berlin, p. 435.

up to the end of 2010.²⁸ While no explicit reference is made in this section, the background documentation as well as the difference concerning the date of entry into force seem to indicate that the focus was only on central government special funds.²⁹ Once again, a look at the rules for European budgetary surveillance proves helpful. As their focus is on general government, all entities to be classified within the government sector would have to be included. Consequently, not only the core budgets of the states would have to be (structurally) balanced, but also their special funds and those among their institutions that do not have sufficient autonomy in their main business or cannot be considered market producers. Furthermore, the Basic Law only distinguishes two levels of government (see article 106 of the Basic Law). Hence, deficits at local government level would have to be interpreted as state government deficits,³⁰ although background parts of the draft law to introduce the constitutional debt brake state that such an inclusion of local government would be impossible due to insufficient timely information. However, local governments usually already have to adhere to very strict budget rules forcing them, ultimately, to avoid structural deficits over a longer period. Hence, the question of including local government deficits in state borrowing does not need as much attention as the issue of outsourcing deficits to special funds and state enterprises.

There seems to be uncertainty over whether state governments also have to establish *control accounts* recording differences between the constitutional borrowing limit and the actual level *ex post* and whether to make adjustments for financial transactions. Article 109 (3) of the Basic Law does not give any indications on this matter. For central government, these elements were introduced on the basis of article 115 of the Basic Law, which is announced as just specifying details regarding the principle rules in article 109 of the Basic Law. As the prescription of an at least balanced budget in structural terms must include the results, *ex post* control via control accounts seems to be necessary for state government budgets, too. Given the reference to European budgetary obligations, adjustments for purely financial transactions also seem to be intended for state government budgets. At least for those states receiving transitional aid, reporting obligations were introduced that explicitly prescribe adjustment of budgetary figures for financial transactions and also encompass *ex post* controls (Section 2 of the law on granting consolidation assistance).

While state parliaments are explicitly allowed to include *cyclical adjustment* mechanisms in their debt brakes provided the symmetry condition is fulfilled (see article 109 (3) of the Basic Law), there seemed to be widespread objections to using the central government method. Concerns especially referred to the significant revisions of structural deficits that tend to occur when using established cyclical adjustment procedures. In addition, it is still questionable whether the state governments will agree on a single procedure for all of them. While comparability of data is desirable for analysts as well as taxpayers, state politicians might fear augmented control of their fiscal policy. Moreover, being able to fine tune the adjustment procedure may help to obtain politically desirable results. Meanwhile, agreements have been reached between the Federal Ministry of Finance and the five states nominated for transitional aid to use a procedure very similar to the one chosen by central government.³¹ However, the procedure may be revised later and it cannot be concluded that the other states will follow suit.

²⁸ This might be considered as also referring to state governments' special funds. See, for example, the statement by Reimer (p. 91) at an expert hearing concerning the introduction of a debt brake in the state constitution of Hesse (draft law: 18/2732) on 3 November 2010, in *Stenografischer Bericht – öffentliche Anhörung* –, available at: www.hessischer-landtag.de

²⁹ For arguments referring to the timing issue, see Tappe (2010), "Haushaltsrechtliche Umsetzung der Artikel 109 und Artikel 115 GG n.F. in Bund und Ländern", in C. Kastrop, G. Meister-Scheufelen and M. Sudhof (eds.), *Die neuen Schuldenregeln im Grundgesetz*, Berlin, p. 456.

³⁰ See Reimer (p. 90) at the expert hearing mentioned in footnote 29.

³¹ See the respective administrative agreements, available at: www.stabilitaetsrat.de

Nonetheless, some states have already *introduced constitutional debt brakes* according to the new concept of the Basic Law. In May 2010, *Schleswig-Holstein* (just under 3 million inhabitants)³² was the first state to pass a new constitutional borrowing limit after attempts in North Rhine-Westphalia and Thuringia failed due to the lack of the necessary high degree of parliamentary approval. Being forced to gradually reduce its structural deficit by 2020 in order to receive its annual transitional aid of €80 million (almost 1 per cent of the state budget), the minimum deficit adjustment path was also defined: each year the constitutional borrowing limit declines by 1/10 of the structural deficit level achieved in 2010. Compared with the old regular constitutional borrowing limit, this provides significant additional scope for deficits over the coming years. While the borrowing limit derived from estimated investment expenditure would be about €0.5 billion, the budget for 2011 and 2012 includes entitlements of €1.3 billion and €0.9 billion, respectively. Despite the constitutional reform, the state budget regulations law has so far not been adjusted. However, the administrative agreement with the Federal Ministry of Finance closes the gap by including the details of the consolidation process up to 2020 regarding cyclical adjustment, financial transactions, inclusion of entities beyond the core budget and borrowing limits to qualify for transitional aid payments. While the state constitution does not explicitly address the treatment of off-budget entities such as the unit founded in 2009 to supply the HSH Nordbank with necessary additional own funds (contribution of Schleswig-Holstein: €1.5 billion), the agreement excludes it. Other entities belonging to the government sector and being allowed to borrow are included in the borrowing limit under the agreement and hence cannot be used as a loophole. Furthermore, the constitutional reform prescribes a 2/3 majority approval by state parliament for using the exemption clause according to article 109 of the Basic Law to prevent abuse by the government parties.

The second state to change its constitutional borrowing limit was *Rhineland-Palatinate* (4 million inhabitants). As this state does not receive transitional aid, politicians felt no need to define a constitutional path for minimum consolidation up to 2020. Instead, the old borrowing limit will be applicable until the end of 2019.³³ Furthermore, in comparison with article 109 of the Basic Law, an additional exemption was introduced. Stressing the need for stable revenue development but being afraid of having a minority position in the Bundesrat, the state considers consequences of Federal laws on structural revenue (and expenditure) to have a similar status to natural disasters or major emergencies as they may have severe budgetary consequences and cannot be influenced by the government of Rhineland-Palatinate. During the transitional period up to the end of 2019, the state is free to define its constitutional borrowing limits. From 2020 onwards, the rules of the Basic Law will have to be complied with. It has to be considered at least questionable whether Bundesrat decisions will obtain the same classification as natural disasters in the case of complaints being submitted to the Federal constitutional court. However, with regard to the delineation of the debt brake, it is stressed that no structural deficits shall be outsourced to circumvent the constitutional borrowing limit. Rhineland-Palatinate had founded public enterprises to take over responsibilities from the core budget in the fields of road construction and real estate management in the first years of the 21st century. For European budget surveillance, these enterprises are to be included in the government sector. Hence, the inclusion of their borrowing³⁴ would follow the intentions of the national debt brake laid down in article 109 (2) of the Basic Law.

³² The number of inhabitants compared with the German total population of about 82 million is a good indicator for the specific state's share of total state government expenditure.

³³ The draft budget for 2011 referred to the need to avert a disturbance of the macroeconomic equilibrium and it cannot be ruled out that this clause might have to be used again for the next budget despite strong GDP growth and broadly normal capacity utilisation in 2011. Using a moderate negative output gap as a main indicator for such a disturbance appears to be problematic as such figures do not show severe imbalances.

³⁴ Article 117 III of the state constitution contains some conditions for borrowing by enterprises to be included in the debt brake framework. The respective enterprises have to perform governmental tasks and the debt service has to be financed from the core (continues)

In *Hesse* (6 million inhabitants), the state parliament passed a law to adjust the constitutional borrowing limit which was approved by a very large majority of votes afterwards. The rule strictly follows article 109 (3) of the Basic Law. To give voters a better foundation for their decision, the main features of the future law to execute the state debt brake were also agreed by a very broad parliamentary majority and published. As the Federal government debt brake is used as a guideline, adjustments for financial transactions, a control account (limited to 15 per cent of average tax receipts) and additional borrowing options for supplementary budgets are envisaged. With regard to special funds and enterprises, however, the debt brake tends to remain rather vague. Borrowing will not be allowed for them unless a specific law entitles them to do so.³⁵ Upon request, it will be up to the Federal constitutional court to decide whether such laws can be considered to be in line with article 109 (2) of the Basic Law (primarily referring to European obligations concerning deficits). However, attempts to make laws that are not in line with European budgetary surveillance principles cannot be excluded.

In *Mecklenburg-Western Pomerania* (less than 2 million inhabitants) the state parliament also passed a debt brake for the state government budget with the necessary 2/3-majority of votes. The rule strictly follows the wording of Article 109 (3) of the Basic Law. While the draft law also included an explicit redemption duty for borrowing related to cyclical burdens, the final version sets this restriction only for exceptional borrowing in case of severe catastrophes and similar cases.

Some other states introduced *balanced budget rules in their state budget regulations law*. The first state to do so was *Bavaria* (12 million inhabitants) in 2000 starting with the budget for 2006. While principally prohibiting borrowing, exemptions can be made to respect the needs of macroeconomic equilibrium. If they are used, redemption duties do not exist. As Bavaria's politicians were very proud of the low level of their state government indebtedness, strong efforts were taken to meet the balanced budget provision. During the recent crisis, substantial reserves could be used. However, when the Bavarian Landesbank got into trouble in late 2008, a supplementary budget was passed with a borrowing entitlement of €10 billion (to be compared with regular total expenditure of about €40 billion). Possible conflicts with the Bavarian debt brake were resolved by a paragraph ruling that the legal borrowing rules need not be respected for this specific transaction. The protective power limit of state budget regulations law became apparent as even a budget law might adjust the rules of the budget regulations as an equivalent *lex posterior*.

Similar problems could be observed in *Baden-Württemberg* (almost 11 million inhabitants). This state introduced a debt brake in its state budget regulations law in 2008. Balanced budgets are prescribed in principle. Exemptions can be made to compensate cyclical effects or to avert a disruption of the macroeconomic equilibrium. Only in severe emergencies, natural disasters or decreases of tax revenue by at least 1 per cent is borrowing allowed and the level of state government indebtedness reached at the end of 2007 may be exceeded. However, a full redemption has to be accomplished within seven years. The exemption clause had to be used for the budgets of 2010 and 2011 that were passed together by the end of 2009. Meanwhile, tax revenue perspectives for 2011 look much better and the conditions for the exception clause seem to be met no longer. But without a supplementary budget updating these estimates, the use of the exception clause will still be in line with the debt brake rule as a tax revenue decline was budgeted and a redemption plan had been agreed upon. Furthermore, in 2009 and 2010, additional recourse to a loophole was taken by creating state enterprises that borrow to finance capital injections into the Landesbank (€2 billion) and the acquisition of the regional energy supplier (up to €6 billion). While these

budget. According to parliamentary documentation (see Rhineland-Palatinate parliamentary documents 15/4966 and 15/4967 as well as the protocol of the 97th session in the 15th legislative period, p. 5768 ff), it was intended to include those enterprises that are not in the position to finance interest and redemptions by performing profitable activities. Consequently, special funds are covered by the debt brake, too.

³⁵ See Hesse Parliamentary Document No. 18/3492.

enterprises are not included in the state debt brake and hence no borrowing limits apply, for European budgetary surveillance purposes their indebtedness has to be treated as part of the Maastricht debt. However, as borrowing by these enterprises is just for financial transactions, the exclusion from the debt brake might be considered acceptable. The election of a new state parliament in 2011 changed political majorities, and the limited protective power of state budget regulations law seems to have become an issue as the new majority parties appear to have postponed the aim of a structural balanced budget to 2020.³⁶

While in the east German state *Thuringia* (more than 2 million inhabitants) an early attempt to introduce a constitutional debt brake failed, especially Section 18 of the state budget regulations law was adjusted in 2009 to become effective in 2011. Borrowing is allowed only in the case of major emergency or natural disasters. A further exception applies to the extent that expected tax-related revenue (excluding gradually diminishing special central government transfers to east German states) is lower than the average value in the three years preceding the year of the drafting process (2007-09 for the 2011 budget). This exception clause was used for 2011 and net borrowing estimates of almost €0.5 billion could be budgeted. According to the state budget regulations law, the redemption has to be accomplished within five years after the first year without additional borrowing requirements. In the medium-term fiscal plan, the start of repayments was announced for 2013. However, given the better-than-expected macroeconomic and fiscal development, far less borrowing than budgeted might be needed in 2011 and more timely redemptions seem to turn out to be only a moderate challenge. Adjustments for cyclical effects (and also for financial transactions) are not made within the state debt brake. While special funds, in principle, have to respect the balanced budget rule, exceptions may be granted by special laws (Section 113 of the state budget regulations law).³⁷

All in all, much progress still has to be achieved during the coming years. While the 2020 deadline is still relatively far away, a significant acceleration of the implementation process might be brought about by *rulings by state constitutional courts* that partly even try to make the old borrowing limits effective. The most prominent example is the constitutional court of *North Rhine-Westphalia* (state population: 18 million inhabitants). After the state elections in May 2010, the new government soon drafted a supplementary budget raising borrowing entitlements by another €2 billion (almost 4 per cent of total expenditure) to almost €9 billion. Immediately after the law became effective, the biggest opposition parties started a lawsuit similar to a previous case where the ruling went against the government and the parliament majority in 2003 and – for the first time in German history – asked for an immediate intervention to stop the execution of the budget. In the latest case, the judges actually ordered the execution to be stopped and announced a final decision by mid-March 2011. The court was in doubt as to whether the exception clause to avert a disruption of the macroeconomic equilibrium could still be used by the end of 2010, given the relatively favourable economic conditions in Germany by that time. Ultimately, the judges decided that there was insufficient explanation as to how the measures chosen would solve the macroeconomic problems claimed by the state government.³⁸ As the macroeconomic situation has since improved, justifying further recourse to the exemption clause might turn out to be almost impossible.³⁹ As individual state governments have only very limited tax-setting powers, expenditure cuts seem to be inevitable. However, short-term adjustments are possible only to a very limited degree as compensation of employees (mainly civil servants), grants for local government

³⁶ See *Der Wechsel beginnt* (coalition agreement for Baden-Wuerttemberg up to 2016), available at: www.gruene-bw.de

³⁷ Further legal debt brakes were introduced in Saxony, Saxony-Anhalt and Hamburg, partly still to become effective by 2013.

³⁸ See press release by the state constitutional court of North Rhine-Westphalia: Supplementary budget law 2010 unconstitutional, 15 March 2011.

³⁹ See Deutsche Bundesbank, Implications of the ruling on the supplementary budget of North Rhine-Westphalia for 2010, Monthly Report, April 2011, pp. 10-11.

and interest expenditure are responsible for about 2/3 of total expenditure. There is a risk, that a *changeover to the debt brake* is used as a less painful exit for politicians if a gradual adjustment path is defined, starting with the deficit level achieved in 2010. An extension of borrowing compared with the old constitutional limits was obviously not intended by the introduction of the debt brake. However, taking the opportunity to define a moderate adjustment path in the state constitution might prove to be a politically attractive loophole.

5 Summary and conclusions

The 2009 constitutional reform to introduce a national debt brake in the German Basic Law was a huge success. The preceding “golden rule” had failed to stop the increase in the government debt ratio. In addition, the net government asset ratio had also decreased rapidly. The reform directly addressed the main weaknesses of the old borrowing limits:

- the definition of investment expenditure did not contain sufficient restrictions. To avoid definition problems, the balanced budget concept was chosen;
- the exception clause regarding macroeconomic imbalances contained vague definitions and no redemption duties while inheriting respective unused borrowing entitlements was allowed. To avoid further abuse, definitions of exceptions are much stricter and redemptions are mandatory;
- a general exception clause was included for special funds. To stop outsourcing deficits, the old article 115 (2) of the Basic Law was abrogated. Furthermore, there is a reference to the Stability and Growth Pact (setting limits for the whole government sector);
- borrowing limits were applicable only for the drafting process. To safeguard adherence *ex post*, a control account was introduced explicitly for the Federal government.

However, whether the debt brake for central and state government budgets will be able to safeguard sustainable public finances in Germany ultimately depends on the implementation of the new rules. Some recent developments give cause for concern:

- The exception for financial transactions might induce abuse (e.g., classification of transactions as loans despite very favourable conditions for the debtor). However, from the author's point of view, the clear reference to the objectives of the European Stability and Growth Pact should make it necessary to follow its classification rules. As a consequence, (strict) ESA definitions and Eurostat decisions should be applicable. In the case of significant transfer elements (e.g., sizeable interest concessions or debt release agreements), classification as a financial transaction would be impossible.
- State government implementation plans so far do not fully exclude outsourcing government borrowing to special funds or – which also seems to be under debate for central government – public enterprises. As this would not be in line with the structurally almost balanced budget objective of the Stability and Growth Pact and the clearly stated intentions of the reform of the Basic Law, limits might ultimately have to be drawn by constitutional courts.
- As German budgetary rules traditionally defined borrowing as limited to transactions acquiring cash funds, PPPs might be used as a loophole. However, taking the Stability and Growth Pact as a benchmark again, exclusion of investment via PPPs from the borrowing limit is only acceptable if there is sufficient transfer of risks to the private sector. As this does not seem to be a typical element of most German PPP treaties, respective attempts to circumvent the debt brake might also be stopped.
- The cyclical adjustment procedure seems to offer room for creating fiscal scope mainly by redefining methods as needed in a given circumstance. Such adjustments can be stopped by strictly referring to the clearly announced necessary condition for cyclical adjustment – the symmetry condition intending to avoid systematic growth of the debt level due to effects

(mis)labelled as being cyclical. Hence, a change in the method should make it necessary to also adjust data for past years and to correct the amounts booked on the control account accordingly. In general, cyclical deficits should also be monitored closely. Misclassifications can be detected by subtracting allowed amounts of structural borrowing and by means of financial transactions from the total debt level increase after a full cycle. Corresponding amounts should be corrected by lowering the limit for the structural deficit over the next few years.

- Politicians are obviously trying to manipulate the borrowing limits during the transitional period. From the author's point of view, constitutional reference to the 2010 structural deficit or an even later one as a starting point does not give much room for interpretation. As it was clearly stated that the adjustment path could not be defined by mid-2009 due to crisis-related high uncertainty concerning macroeconomic and budgetary developments, only actual results can be an acceptable benchmark. Refusing to adjust the starting level would bring about additional borrowing options of about €15 billion for central government in 2011. However, the fiscal leeway added would decline every year and come to an end in 2016. If this leeway were not (fully) used, it would lead to a significant buffer stock on the control account which might induce central government to make strategic favourable budget estimates in future years. While deficit-increasing effects could only be of a temporary nature, it is important to stop the abuse of the debt brake in order to avoid additional interest burdens and – much more importantly – to strengthen the trust in and the effectiveness of the new borrowing rules.
- A very big fundamental problem of binding constitutional borrowing limits seems to be the need for sufficient safety margins to prevent the need for sizeable almost immediate consolidation measures mainly occurring in bad times. In Germany, budget execution during the past years often suffered from major surprises due to lower-than-expected “structural” tax revenue. Major parts of deviations could not be classified by common methods as cyclical effects or just one-offs. Such surprises cannot be ruled out for the future. Consequently, a need to compensate such effects almost without delay will come up under the new debt brake, if there is no sufficient safety margin between the constitutional borrowing limit and the budgetary entitlement. It seems impossible that politicians will agree to strive for such reserves – possibly up to €20 billion – without binding rules. Hence, a respective supplement to the German debt brake seems useful. However, the use of this safety margin will have to be governed by rules strictly limiting flexibility concerning timing and the size of consolidation measures needed to regain the buffer between the budget estimate and the constitutional limit for borrowing. A delayed gradual correction of a structural balance not in line with the safety margin may be an adequate approach. Generally using significantly more cautious (nominal) GDP growth assumptions when preparing a budget and especially the medium-term financial plan would also help to prevent negative surprises such as those often experienced in the past.

A restrictive implementation of the debt brake taking into account the problems listed will be a challenging task. Effectively limiting circumvention activities requires transparent and – as far as possible – simple rules. This is a precondition for the necessary public support. Furthermore, only clear rules can be given effective judicial protection against abuse. Hence, definitions of details should be made with care. If this seems hard to achieve, explicit reference to well-defined and carefully supervised statistical figures – as the Maastricht deficit – may enable a clear interpretation and avoid the creation of dangerous loopholes.