

Schmidt, Christoph M.

**Article**

## The German Debt Brake on Trial: Not Guilty

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## Christoph M. Schmidt The German Debt Brake on Trial: Not Guilty<sup>1</sup>

### THE CURRENT CONTROVERSY IN A NUTSHELL

While periods of a negative interest rate-growth rate differential are nothing unusual in historical perspective, the discussion about its implications for fiscal policy has gained new momentum: in some developed economies nominal short- and long-term interest rates have even reached the negative range, and nominal GDP growth rates have remained relatively high. This holds in particular for Germany. Unsurprisingly, after Blanchard's (2019) elucidation that a sustained negative interest-growth differential might facilitate accumulating additional public debt without endangering fiscal sustainability, this discussion has reached the German discourse on fiscal policy. Most importantly, advocates of higher public debt argue that this could be a panacea for overcoming Germany's large unfulfilled investment needs.

Yet, engaging in such a change of fiscal strategy is hardly risk-free. After all, the risk of a reversal of the interest-growth differential is substantial (Mehrotra 2017). The German Council of Economic Experts (GCEE) estimates the reversal risk based on data for the period 1946 to 2016 to be around 41 percent in five years and over 54 percent in six to ten years (GCEE 2019b). Moreover, systematically incurring more debt would mean altering, circumventing, or even abolishing the debt brake as the principal fiscal rule governing fiscal policy at the federal and the state levels (albeit not the municipal level). Thus, the discussion should clarify whether the potential benefits are worth the risks associated with higher public debt: (i) would softening the debt brake have negative repercussions, especially regarding the German debt brake as an element of the European fiscal framework; and (ii) would more debt indeed be the avenue towards increased public investment?

<sup>1</sup> This article rests heavily on GCEE (2019b), Chapter 5: "The Debt Brake: Sustainable, Stabilizing, Flexible". A preliminary version of this article in German served as a contribution to a public hearing of the Budget Committee of the German Bundestag. I am grateful for numerous constructive discussions to my colleagues in the GCEE and the whole GCEE team, in particular to Wolf Reuter.

It is undisputed that Germany, like many other industrialized economies, needs more public investment. Yet, to make matters even more intricate, the precise magnitude of the current needs for public investment remains unknown. The reasons for this uncertainty are manifold. National income accounting is an imperfect tool for assessing the quality of public expenditure, and projections spanning a period of several years are fraught with difficulties. Furthermore, after a protracted decline in the investment activity of municipalities (*vis-à-vis* overall economic output), the investment share of municipalities is currently approximately one-third (Figure 1). Its recent development is difficult to assess, since it partially reflects the delegation of public tasks to seemingly private companies held by a public majority: their investments are not counted as public. Thus, accurate comparisons of public investment activity across municipalities and over time is difficult (GCEE 2019b).

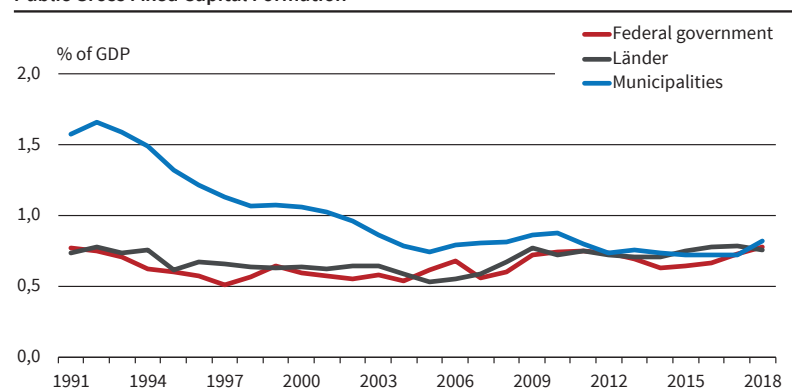
Nevertheless, a sober assessment of overall investment figures reveals that public investment activity has increased markedly over the course of the last couple of years. At the federal level, public investment has even reached the highest value since 1991 (GCEE 2019b), relative to overall economic output (Figure 2). And yet, this is less than what was intended by policymakers, due to a range of important obstacles that are unrelated to the magnitude of funds being earmarked for public investment:

- overstretched capacity of the construction industry, which increasingly complains about skilled-worker shortages (BBSR 2019); it would be difficult to incentivize the industry to increase its capacity substantially by simply publishing more ambitious plans for future public investment (which on average comprises only 13 percent of construction investments anyhow);
- protracted administrative processes due to a heavy dose of regulation, which requires cumbersome planning and complex approval procedures.



Christoph M. Schmidt  
RWI – Leibniz Institute  
for Economic Research,  
German Council of  
Economic Experts  
and Ruhr-University  
Bochum

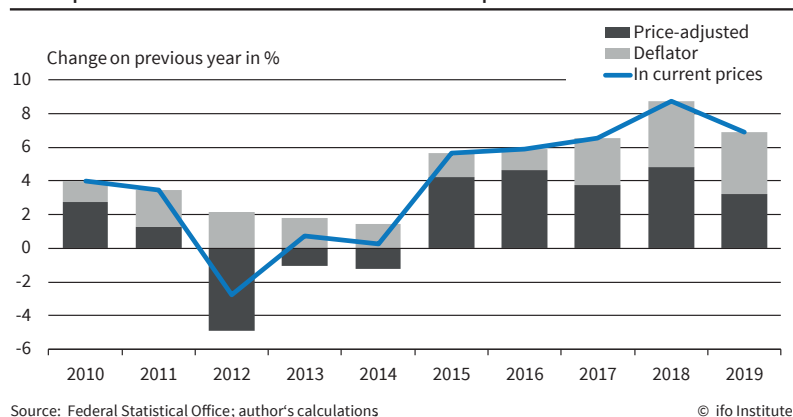
Figure 1  
Public Gross Fixed Capital Formation



Source: Federal and Länder Statistics Offices; author's calculations.

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Figure 2  
Development of General Government Gross Fixed Capital Formation



- over-indebtedness of some individual municipalities concentrated in four western German states, which might prevent them, inter alia, from quickly increasing their planning capacity for the administration of large infrastructure projects.

In consequence, the available financial means are not put to effective use to their full extent; a large share of them is still awaiting their disbursement. This impasse also implies that additional earmarked funds would have failed to deliver the realization of more public investment. Moreover, as the German economy, and in particular its construction industry, have been running at full capacity for some years, more than half of the observed increase in public investment figures merely reflects increasing prices. Lower prices would require capacity in the construction industry to be enhanced or construction to be made less cumbersome and costly, or both.

For the near future, substantial public revenues are expected to be collected at the federal, state, and municipal levels. Moreover, the additional public debt that would be acceptable under the rules of the debt brake also amounts to a substantial figure. Together, these financial resources would provide ample means for a steady increase of public investment, at least as long as this is not prevented by non-financial obstacles. Admittedly, their precise amount is difficult to forecast, since calculations depend, inter alia, on the assumed medium-term growth rate. With this caveat in mind, the forecast of approximately EUR 300 billion over the next ten years derived by Feld et al. (2020) unquestionably provides substantial fiscal leeway for increasing public investment.

And the medium-term plans published by, for instance, the federal government in its projections for investments in traffic infrastructure correspondingly document the intentions to realize such a steady increase. It would be the prerogative of governments

at the various federal levels to obtain even more leeway for public investment by challenging the case for other public expenditures. And this would certainly be advisable: during the last decade, the ample fiscal space provided by low interest rate payments on outstanding public debt was mainly used for expenditures that on closer scrutiny might have been considered less worthwhile than investment expenditures.

In politically less contentious times, this brief assessment of the state of public investment would suffice to suggest concentrating on the alleviation of the practical obstacles retarding more public investment from being realized, not on a discussion of the financial means available for financing these investments. Obviously, the following options would be desirable for public policymakers:

- arranging for increased capacity in the construction sector, by enhancing productivity and especially by more immigration of skilled (blue-collar) workers;
- reducing regulatory red tape and streamlining both planning procedures and the mechanisms for obtaining sufficient civil society participation; and
- bailing out highly-indebted municipalities – which would predominantly be the responsibility of the states, not the federal level.

That is, underneath the ceiling set by the debt brake, policymakers would need to set priorities and decide between expenditures for public investment and public consumption given their limited, albeit quite respectable budget. This, after all, is exactly what voters could expect, as they handed over their sovereignty to their elected officials. And yet, the current discussion is taking a dramatically different route. This might be unsurprising from an economic policy perspective, since the suggested options appeal to the individual responsibility of policymakers at all levels of government. Setting priorities with a limited budget is certainly more difficult than finding an avenue to smother the problem by simply amassing even more financial means.

Unfortunately, the political debate in Germany has homed in on another narrative, supported by advocates in international institutions and by some other participants in the international macroeconomic debate. In essence, this narrative states that the current generation could confidently push more of the burden of financing current public investment onto future generations. Eliminate the debt brake

and all problems will vanish, we are told. Given the low interest rate environment, the narrative's proponents argue, it would even be a cost-free alteration of the fiscal strategy. Most importantly, as future generations will enjoy a substantial share of the fruits of this investment, so the narrative goes, they should also participate in its financing.

On the surface this is an attractive thought, but its merit has of course to be assessed both in the context of already pre-determined intergenerational burden sharing and with respect to its macroeconomic implications. Implicating the debt brake as an obstacle to public investment requires strong assumptions that reach far beyond ignoring the practical issues of implementation identified as the real obstacles above. It is telling that these typically remain implicit in the eliminate-the-debt-brake narrative: the narrative's accusation relies on assessing all previously arranged expenditure items in the public budgets as fundamentally unalterable, and on earmarking all leeway arising from future revenue increases for expenditures other than public investments. These implicit assumptions are highly questionable, though.

Consequently, blindly following the popular eliminate-the-debt-brake narrative would be a deplorable fiscal strategy: identifying the wrong culprit for the unsatisfactory development of public investment will not provide the basis for finding a reliable path towards increased investment. After all, getting the diagnosis wrong never serves to pave the avenue to good therapy. It rather seems advisable to address the real obstacles, even if that means engaging in an unpopular debate about the failure of public officials to set the right priorities in their budgets, and comprehensive – and therefore challenging – reforms of administration and civil participation procedures.

The eliminate-the-debt-brake narrative apparently receives support from numerous political voices outside Germany, which, by and large, advocate a less stringent German approach to public debt. Apart from the fact that the economic discourse is far more diverse on these matters than the proponents of the narrative frequently suggest, two key aspects have to be kept in mind in the assessment of the weight that should be given to these voices. First, the available evidence suggests that the possible spillover effects of German fiscal policy measures on adjacent economies

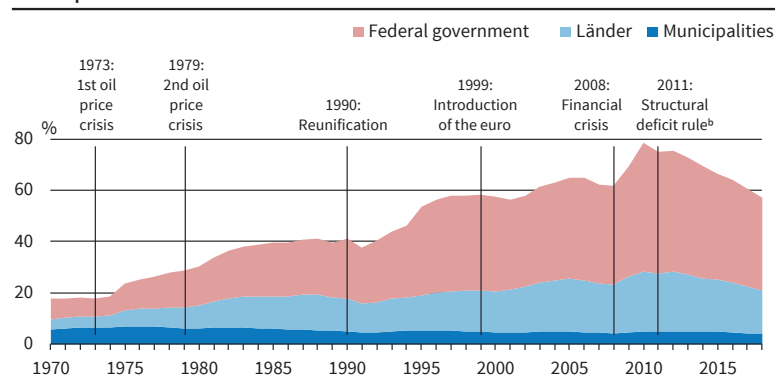
will be quite meager, relative to their cost for German taxpayers. Second, and even more important, as the German debt brake is part of the European fiscal framework, which intends to prevent debt crises and to ascertain the independence of the European Central Bank, setting a precedent for disregarding fiscal discipline by tampering with it could be a detrimental signal for the euro area.

### THE GERMAN DEBT BRAKE AS AN INTELLIGENT FISCAL RULE

Within limits, public debt is perfectly acceptable; the extent to which it is palatable has to be determined carefully in the context of macroeconomic circumstances, though. In theory, one particularly convincing guideline is the so-called 'golden rule' stipulating that a deficit corresponding to the amount of net investment would be sensible. Such a balance between net investment and the structural deficit will, however, typically not emerge as the automatic outcome of economic policymaking. Instead, empirical evidence suggests that fiscal policy tends to display a deficit bias (Alesina and Passalacqua 2016). Several motives generate such a bias, such as problems of governance involving a common pool of resources, self-serving signals being sent to potential voters during electoral campaigns, or the attempt to provide a particularly bad start for the successors in public office. Instead of hoping that this deficit bias remains small, the general consensus is that fiscal rules are needed (Eyraud et al. 2018).

One such rule would indeed be the 'golden rule', and exactly this rule was the guideline for German fiscal policy until the time of the Great Recession. But the experience with this rule was disappointing. As Figure 3 documents for the years since 1970,

Figure 3  
Development of the General Government Debt-to-GDP Ratio<sup>a</sup>



<sup>a</sup> General government gross debt-to-GDP ratio according to the definition of finance statistics excluding social security. Deviation from figures according to the definition of national accounts due to methodological differences (Heil and Leidel 2018). Comparability over time prior to 2010 is limited due to methodological changes. From 1955 including Berlin (West) and from 1960 including Saarland. Since 1991 all-German results. Only until 1992 were hospitals with commercial accounting included in the federal debts. Special federal funds taken into account: from 1999, Federal Railway Property Fund, the Redemption Fund for Inherited Liabilities and the Coal Compensation Fund; from 2007, ERP Special Fund. From 2006 including selected public fund, institutions and enterprises in the public sector.

<sup>b</sup> Converted into a structural deficit rule in 2009 with effect from 2011.

Source: Federal Statistical Office; author's calculations

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the German debt ratio increased relentlessly until 2009, with – from the perspective of 2009 – no alleviation in sight. German states frequently used the low threshold for claiming the existence of a ‘serious disturbance of economic equilibrium’ to motivate a higher deficit, and some states even declared a fiscal emergency. These developments partially reflected the poor incentives characterizing the system for distributing tax revenues between the federal and the state level, which will hardly be reformed fundamentally any time soon, but also the opportunity for circumventing the fiscal rule via the implementation of special funds.

This disenchantment with the ‘golden rule’ formed the basis for reforming the fiscal rules stipulated in the German constitution. It seemed all the more sensible, as a severe demographic change is well underway in consequence of the German baby boom of the 1950s and 1960s. This will challenge the sustainability of public finances in earnest in the next decades. Moreover, fiscal solidity in Germany had become increasingly important as a signal for the euro area and for financial markets. In the wake of the crisis in the euro area, its member states pledged in the Fiscal Compact to implement effective fiscal rules in their national laws, thereby strengthening the existing set of fiscal rules. These fiscal rules are viewed as an important instrument for supporting individual member states in their quest to fulfill their national responsibilities for conducting a solid fiscal policy and, thus, for obtaining the independence of the European Central Bank.

The German debt brake introduced in 2009 is an intelligent compromise between the objective of embedding fiscal decisions into a rule-based framework and the provision of sufficient discretionary leeway. It is a fiscal rule of the ‘2nd generation’ comprising three central elements (GCEE 2019b):

- Cyclical adjustment: the debt brake restricts the cyclically adjusted structural budget balance, by contrast to a balanced-budget rule.
- Exceptions: in case of factual emergencies such as natural disasters, the debt brake offers extraordinary fiscal leeway.
- Banking: to account for surprises arising in the practical implementation of the debt brake in real time, banking via a separate account will be allowed.

Most importantly, the debt brake is part of the fiscal framework in the euro area. As a signatory, Germany had to choose, one way or another, to implement the fiscal compact; if it did not stipulate the debt brake as it stands, Germany would have to devise a similarly strict rule instead. Arguably, European agreements under the fiscal compact would allow for adjustment of the deficit threshold upward, once a low debt ratio has been achieved; this is not

yet the time for discussing this adjustment, though. Moreover, one should not forget that the Maastricht threshold for the debt ratio of 60 percent of GDP has always been meant to be a ceiling, not a target rate.

The German debt brake works intelligently against the potential weaknesses of any fiscal rule. Perhaps most importantly, cyclical adjustment serves to preserve – by contrast to a balanced-budget rule – the necessary fiscal leeway for automatic stabilizers to work without restraint. Due to the mechanics of banking via the separate account, estimation problems that simply cannot be avoided in real time will not lead to a systematic underestimation of acceptable fiscal leeway (GCEE 2019b). The alternative, choosing a fiscal rule that would not attempt to adjust the estimated output gap cyclically, would hardly be preferable. And there is hope that economic research might even produce more reliable forecasts.

Furthermore, the systematic cyclical adjustment under the debt brake ascertains a provision of funds for public investment that is unrelated to the state of the economic cycle. Indeed, there is no evidence that in Germany public investments are reduced more strongly than consumptive expenditures in a downswing (Feld et al. 2020). Since lacking financial means are obviously not the decisive obstacle for more public investment, the debt brake can hardly be made responsible for an unsatisfactory state of affairs regarding public investment. There is only one possible conclusion: there is no evidence for the concern that the debt brake fails to deliver. To be fair, as the economic cycle since 2009 has not been completed yet, it would be advisable to go through a downturn as well, before finally calling the jury in. Meanwhile, we might rely in our assessment on previous experiences with fiscal rules, especially those being scrutinized by internationally comparative studies (Feld and Reuter 2017; Eyraud et al. 2018; Heinemann et al. 2018).

#### **WEAKNESSES OF CURRENT SUGGESTIONS FOR REFORM**

Despite the high surplus currently being accumulated in public coffers and despite the fact that a large share of the budget being earmarked for public investment has not been retrieved to finance actual investments, especially by local governments, Germany is currently discussing intensely the circumvention or softening of the debt brake. Frequently, proponents of such reforms refer to the claim that during the next ten years there will be an additional need for public investment at the order of some 450 billion euros (Bardt et al. 2019). This figure apparently exceeds the current budgetary plans for investment by a veritable amount.

It seems to be advisable, though, to assess this figure critically. At its core is a survey of a very small sample of municipalities, which are asked to state estimates of their own investment requirements. By contrast to a normal budgeting procedure, respondents in this survey are in their answers free of any consideration regarding alternative uses of their financial resources. In addition, one might be somewhat wary regarding the representativeness of the survey and, even more importantly, regarding the obvious incentives for responding strategically. To be fair, the precise amount of investment requirements at the municipal level is quite uncertain, with a degree of uncertainty that rivals the imponderability regarding the future fiscal leeway under the rules of the debt brake.

A prudent strategy for fiscal policymakers should therefore be to utilize the quite sizeable fiscal leeway offered under the rules of the debt brake for increasing public investment step by step. It seems more than heroic to instead devise a plan for public investment, let alone for concrete investment projects, over a ten-year time frame. Rather than engaging in such a futile exercise, it would make sense to address the factual obstacles to more public investment, as indicated above. That is to say, faster administrative procedures, less regulation, and a leaner public administration should be on the political agenda, not more public debt.

Moreover, there are good reasons to shy away from revitalizing the ‘golden rule’ as a fiscal rule or from circumventing the debt brake via the implementation of an investment fund. While revitalizing the ‘golden rule’ might, at first glance, appear to be an innocuous suggestion, it has not passed the test before and probably will not pass it now: after all, German fiscal history provides ample evidence against its effectiveness in disciplining fiscal policy – only with a systematic deficit bias could German public debt increase so relentlessly in comparison to GDP over several decades up to 2009.

At the heart of the problem lies the definition of public investment as contrasted to consumptive expenditures. At the level of individual expenditure items, it proves difficult to delineate more and less sensible investment and consumption expenditures. While not every public investment project might be factually sensible, expenditures for maintenance or for paying the salaries of judges and teachers are counted as public consumption. This definitional problem plagues proponents of a reform of the debt brake as well: should, for instance, expenditures for preventing social imbalances or incentivizing sustainable behavior be counted as investments or not? Instead of hunting for the unachievable ideal definition, policymakers are called upon to set the right priorities and to take ‘ownership’ of their decisions.

By the same token, it would not be advisable to implement an ‘investment fund’ that could spend its

resources outside of the otherwise required parliamentary budgeting procedures and thereby allow circumvention of the debt brake. First and foremost, if Germany were to introduce such a device, this would send a clear and detrimental signal to the rest of Europe, mocking all pledges to henceforth be adamantly committed to preserving solid public finances. Moreover, from an economic policy perspective, it is hardly certain that the additional fiscal leeway offered by such a fund will not simply enhance consumptive expenditures, marking them as politically important projects of a more or less comprehensible investment character.

Finally, climate policy is a tremendously important topic, but it also does not provide a good motivation for implementing such a special fund. The quality of a concrete policy strategy addressing the urgent transition from an energy system based on fossil fuels to an energy system based on renewables can ultimately not be assessed with a view to the amount of funds disbursed for public investment. Most of the – arguably tremendous – investment needed to accomplish the energy transition will arise for private investors. This clearly implies that any expenditures for public investment in this area need to be chosen intelligently, with the aim of crowding private investment in and not out.

But the key question is a different one (GCEE 2019a): is carbon pricing the key instrument of climate policy or not? If the answer is ‘yes’, then climate policy not only provides the right incentives for the transition, but carbon pricing will also generate additional revenues. These additional financial resources could be used for public investments into the decarbonization of our economy – and for generating a better social balance in sharing the burden of this transition. The debt brake has nothing to do with this; it will best be left as it is, because it supports the stability of fiscal affairs during particularly challenging times.

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