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**Working Paper**

## Austerity and the political economy of the german debt brake

ZÖSS Discussion Paper, No. 106

**Provided in Cooperation with:**

University of Hamburg, Centre for Economic and Sociological Studies (CESS/ZÖSS)

*Suggested Citation:* Heise, Arne (2024) : Austerity and the political economy of the german debt brake, ZÖSS Discussion Paper, No. 106, Universität Hamburg, Zentrum für Ökonomische und Soziologische Studien (ZÖSS), Hamburg

This Version is available at:

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Arne Heise

## Austerity and the Political Economy of the German Debt Brake

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ZENTRUM FÜR ÖKONOMISCHE  
UND SOZIOLOGISCHE STUDIEN

ZÖSS-Discussion Papers  
ISSN 1868-4947/106  
Discussion Papers  
Hamburg 2024

# **Austerity and the Political Economy of the German Debt Brake**

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Discussion Paper

ISSN 1868-4947/106

Zentrum für Ökonomische und Soziologische Studien

Universität Hamburg

Juni 2024

**Impressum:**

Die Discussion Papers werden vom Zentrum für Ökonomische und Soziologische Studien veröffentlicht. Sie umfassen Beiträge von am Fachbereich Sozialökonomie Lehrenden, NachwuchswissenschaftlerInnen sowie Gast-ReferentInnen zu transdisziplinären Fragestellungen.

**Herausgeber/Redaktion:**

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## **Abstract**

The recent judgment of the German Federal Constitutional Court has clarified that the debt brake enshrined in the German Basic Law (*Grundgesetz*) is intended to do exactly what the legislature intended when it was adopted in 2009: to tie the hands of political actors and block the 'easy way out through debt.' This not only intensifies calls for the abolition or reform of the debt brake, but also raises the question being examined here of how such a restrictive fiscal policy rule could become a constitutional norm in the face of its scientific and political controversy, especially when its 'natural opponents'—left-leaning political actors—consistently held constitutional veto positions. Based on the Agenda Theory of Political Economy, it is demonstrated that the 'Third Wayism' of the German Social Democratic Party (SPD) as an adaptation strategy to a neoliberal discourse environment was the necessary precondition for a fiscal decision of 'historical significance.'

**JEL codes:** H 30, H 60, H 62, P 10

**Key words:** Fiscal rules, Debt brake, Sound Finance, Functional Finance, Political Economy

"In order for the state to remain capable of action, the SPD must pursue the goal of balanced budgets very confidently."

*Carsten Schneider, SPD budgetary policy spokesperson*

## 1. Introduction

The ruling of the German Federal Constitutional Court on November 15, 2023, declared the constitutionality of the federal budget for 2023 and the federal budget draft for 2024 invalid. This decision compelled a reduction in the net deficit of the federal budget for 2024 by approximately €17 billion, or 3.8 percentage points of the original budget estimate. This call for consolidation intensified the already looming discussion surrounding the so-called debt brake of the Basic Law (*Grundgesetz*), whose endangerment the constitutional judges decisively used as the basis for their decision.

The immediate political manoeuvring that followed the ruling—where the liberal coalition partner and the conservative opposition immediately called for savings in social spending, while the social democratic and green coalition partners deemed social policy interventions sacrosanct and proposed revenue increases or a suspension of the debt brake—did not only push the government coalition to the brink but also raised the question of *how a fiscal constraint like the debt brake could become a constitutional norm* in the first place. This is especially pertinent when its 'natural' opponents—ideologically left-leaning parties that generally acknowledge the need for fundamental fiscal corrections and stabilizations in capitalist market economies<sup>1</sup>—consistently hold constitutional veto positions. Or, to put it differently: the question under examination here is how, in the year 2009, the constitutional majorities necessary for the inclusion of the debt brake in the German Basic Law were achieved, when not even 15 years later—a short span for a constitutional norm—its dysfunctionality becomes apparent.

Although the literature on fiscal rules in general and the German debt brake in particular is abundant, the question of its historical origins—meaning not only the historical sequence of events but an explanation against the backdrop of diverse societal interests in a specific historical context—appears to have received little attention so far. This could be justified by the fact that at the time of the introduction of the debt brake in 2009, there was no serious disagreement about its necessity, and therefore its introduction did not need contextualization. However, assuming scientific and political consensus on fiscal questions would negate the significant paradigmatic differences in the scientific approach to fiscal issues, as well as their direct and indirect distributional effects. Additionally, the fact that the constitutional majority in the German *Bundestag* was only narrowly achieved was due not

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<sup>1</sup> There is a long series of publications that outline the connection between left-wing, especially social democratic parties, and Keynesian ideas in general, and deficit-based stabilization policies in particular: cf. eg.g. Hibbs (1977), Przeworski (1985). Even publications from the institutional environment of Social Democracy emphasize this connection: Vaut et al. (2011: 127ff.).

only to the opposition voting against it<sup>2</sup> but also to a portion of the members of the social democratic coalition partner in the Merkel government.

The following is intended to provide a political-economic contextualization of this development based on the Agenda Theory of Political Economy (Section 5), which the then-social democratic Federal Finance Minister Peer Steinbrück assessed as a "legal and political decision of historical significance" (Steinbrück 2009: 24866; own translation). Before that, a brief historical overview of the development of public indebtedness in Germany and its causes must first be given (Section 2). Against this empirical background, the scientific positions on the orientation of fiscal policy in times of high indebtedness will be worked out on a competing theoretical basis to better assess the question of the (consensus on the) theoretical foundation of the debt brake (Section 3). Since national fiscal policy decisions, at least in the European Union, are embedded in a superordinate governance structure, its development must be presented, and the effects on the national debate reflected (Section 4). The contribution concludes with a brief summary (Section 6).

## **2. Government Debt in Germany – a history of policy failure?**

In the initial recording of government debt in the young Federal Republic of Germany in 1950, a debt-to-GDP ratio of 19.2% was observed—a level that could be roughly maintained throughout the entire 1950s and 1960s, the era known as the 'economic miracle.' The economic downturn in 1966/67, which prompted the enactment of the Stability and Growth Act in 1967 and thus the implementation of Keynesian-inspired deficit spending, led to a temporary increase in the debt-to-GDP ratio to over 20%. However, it did not bring about a fundamental reorientation of fiscal policy.

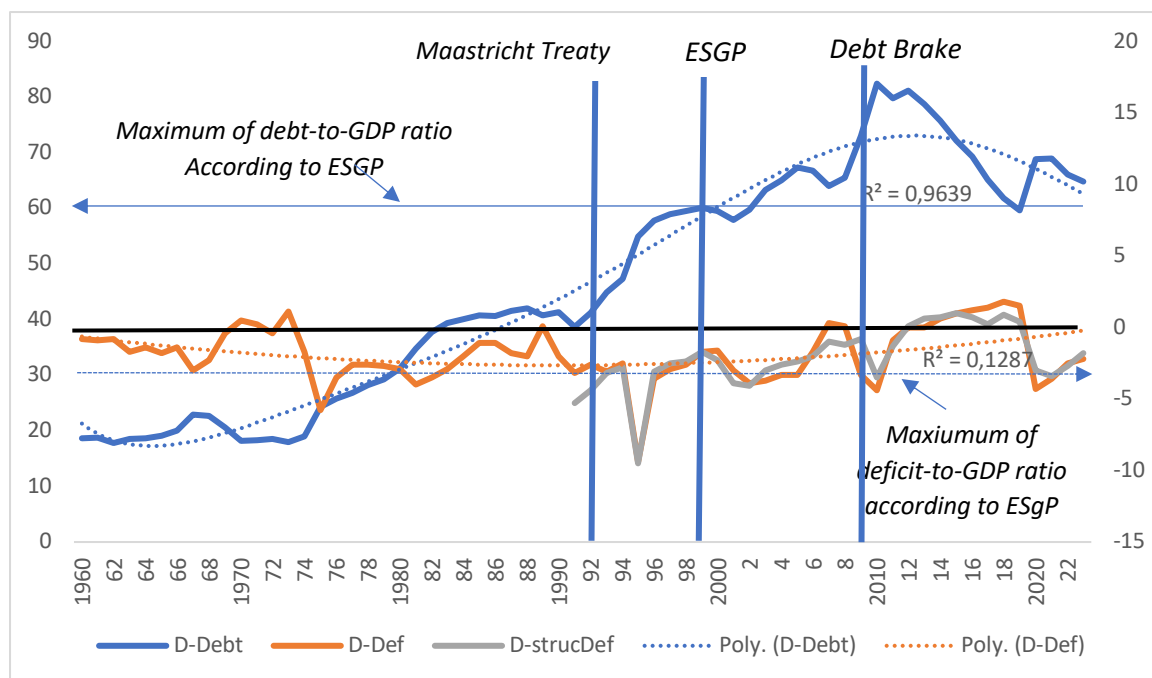
### *2.1 Deficit and debt since the 1960s*

It was only with the end of the reconstruction phase in Germany and the 'golden age of capitalism' worldwide that the rise in government debt began: during the two oil price crises in the early 1970s and 1980s and the reunification crisis in the early 1990s, the debt-to-GDP ratio increased to about 60% by the end of the 1990s (cf. Fig. 1). This development is remarkable on one hand because the Keynesian-inspired 'policy of deficit spending' had already been replaced by a supply-side policy, prioritizing budget consolidation, with the change of government in 1982 (cf. Semmler 1981, Flassbeck 1982). On the other hand, the substantial increase in government debt in the 1990s can be attributed to the confluence of a secular economic slowdown with the high costs of German reunification (cf. e.g. Bofinger 2007: 159f.).

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<sup>2</sup> The Free Democrats (FDP) abstained from supporting the debt brake in the *Bundestag* not due to ideological reasons but solely for opportunistic reasons. In the *Bundesrat*, the state governments supported by the FDP also agreed to the debt brake.

**Figure 1: State indebtedness in Germany 1960 - 2022**



Quelle: Ameco database and European Economy, stat. Annex, various volumes

Also noteworthy is the significant reduction in net new borrowing in the second half of the 1990s and the sharp flattening of the debt trajectory in the late 1990s—indicating the need to comply with the convergence criteria established in the Maastricht Treaty for the introduction of the European Economic and Monetary Union (EMU): a maximum net new borrowing of 3% of GDP during the last 3 years before entering the EMU and an upper limit for government debt at 60% of GDP.

In the 'post-9/11 crisis' of the early 2000s, and particularly in the global financial crisis after 2007, the debt-to-GDP ratio continued to rise drastically, exceeding 80% of GDP. This was well beyond the debt limit of 60% of GDP established since the agreement on the European Stability and Growth Pact (ESGP) and the introduction of the common currency in 1999. Despite the fact that net new borrowing only briefly surpassed the maximum level set in the ESGP (for 'normal times') of 3%, the debt-to-GDP ratio rose significantly. Looking at Fig. 1, it can now be understood why, especially in the first decade of the new century and particularly after the effects of the global financial crisis became noticeable from 2007 onwards, government debt increasingly came into focus in the (economic) political discourse, and the call to tie the hands of finance ministers grew louder<sup>3</sup>. It is in this sense that liberal Finance and Justice Ministers Christian Lindner and Marco Buschmann retrospectively praise in their assessment the achievements of that fiscal rule, which the Free Democrats (FDP) had initially denied approval in the parliamentary voting process:

*"The debt brake of the Basic Law is a constitutional achievement. It ensures sound public finances, fiscal crisis resilience, and strengthens intergenerational justice. It particularly draws consequences from a historical learning process."*

<sup>3</sup> Cf. e.g. CEE (2007), Janeba (2008), Meister-Scheufelen (2011).



*In the late 1960s of the last century, the constitution-amending legislature had opened the doors wide for state indebtedness. This was based on the theory of 'deficit spending,' which asserted that the state should borrow and spend more money in bad times to stabilize the economy. It also stated that these debts should be repaid in better economic times. However, this concept did not succeed. From 1967 to 2009, the year of the introduction of the debt brake, state debt had more than tripled as a percentage of the gross domestic product.*

*Apparently, it was too tempting in the democratic process to finance day-to-day politics through debt and too unattractive to repay accumulated debts. The result was a kind of fiscal ratchet effect: debts always went up but never down.*

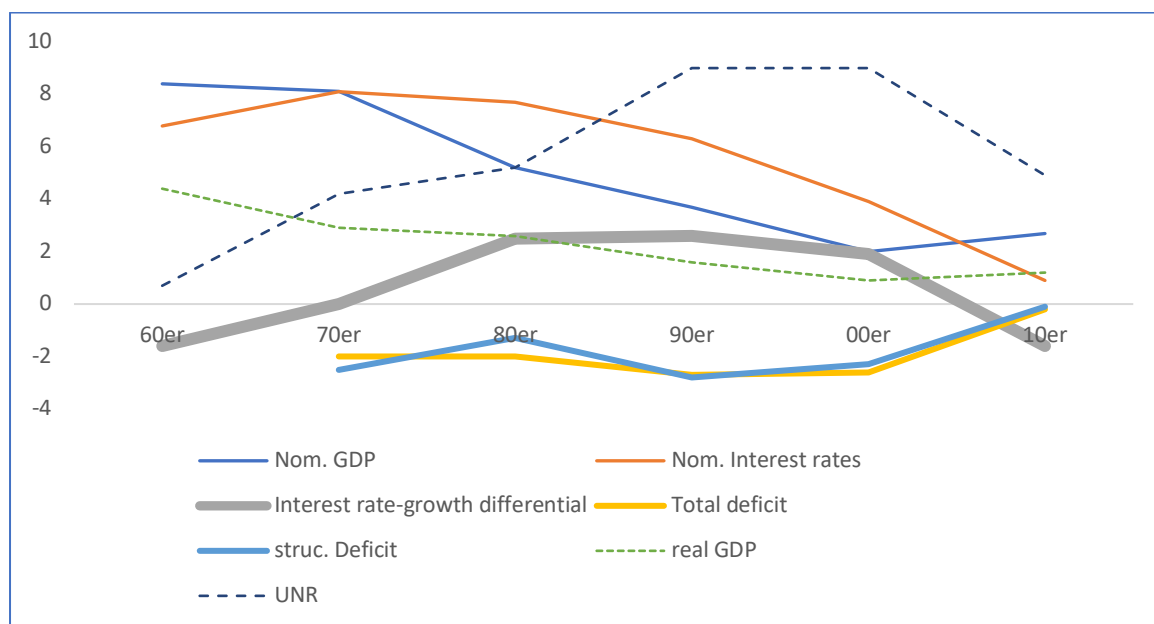
*During this time, it was also tested whether the concept of investment could lead to an effective limitation of state debt. The so-called 'Golden Rule' of the old financial constitutional law before the implementation of the debt brake stated that the state could take on loans to the extent that it engages in investments.*

*..... Differences between the economic-balancial and the budgetary-legal concept of investment led to the fact that the "Golden Rule" did not result in an effective limitation of state indebtedness. " (Buschmann/Lindner 2023; own translation).*

## 2.2 Fiscal policy in times of low growth and adverse financial conditions

Upon on closer inspection the narrative of the indispensability of a debt brake to curb public indebtedness cannot be readily agreed upon for several reasons: On the one hand, the demand-oriented 'policy of deficit spending,' which was held responsible for the increase in indebtedness, was replaced by a supply-oriented policy focusing on budget consolidation and market liberalization, especially with the change of government in 1982.

**Figure 2: Development of selected economic variables**



Quelle: Ameco database

On the other hand, there are several real and financial-economic developments underlying the trend of increasing state indebtedness: a secularly declining growth trend (Nom.GDP and real GDP in Fig. 2) and, as its labour market correlate, an increase in unemployment (UNR in Fig. 2), along with a negative interest rate-growth differential (see Figure 2). Finally, the mentioned 'golden rule' of fiscal policy had already been restricted by the overarching European legal norm of the ESGP. Therefore, the polynomial trend estimation<sup>4</sup> suggests that the trend increase in state indebtedness did not come to an end only with the effect of the debt brake in the 2010s but had already ceased with the introduction of the ESGP in the 2000s: The dense sequence of crisis developments – post-9/11 crisis, global financial crisis, COVID-19 pandemic – within the last two decades has forced discretionary debt policies repeatedly. However, the often only a few intervening years have been used for massive consolidations through the reduction of structural new borrowing. Just as the polynomial trend of the debt-to-GDP curve approaches the 60% mark, the polynomial trend of the net new borrowing curve moves toward the 0% mark of a balanced budget, as demanded by the ESGP (since 1999) and the German debt brake (effectively since 2011)<sup>5</sup>.

With the end of the 'golden age of capitalism' in the late 1960s, not only did the cyclical crisis return to the economic reality of the Federal Republic (and all Western economies after World War II), but there was also a distinct slowdown in economic growth. This slowdown was accompanied by the phenomenon of persistent mass unemployment – structural rather than merely cyclical unemployment (cf. Heise 1994). In parallel, there was a significant change in fiscal policy leeway: In the 1980s, the previously negative interest rate-growth differential turned positive. That is, the nominal interest on long-term government securities henceforth exceeded the nominal growth rate of GDP. The interest rate-growth differential indicates the primary budget balance<sup>6</sup> that must be achieved to keep a certain debt-to-GDP ratio constant, thus allowing for sustainable fiscal policy. With a negative interest rate-growth differential<sup>7</sup>, fiscal sustainability can be achieved with a primary deficit. However, when the interest rate-growth differential becomes positive – as in the 1980s, 1990s, and 2000s – a primary surplus must be generated. This means that not only the entire new borrowing but even parts of the

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<sup>4</sup> The polynomial trend curve demonstrates greater forecasting accuracy than a linear trend approximation.

<sup>5</sup> The ESGP (European Stability and Growth Pact) sets as its target a 'budget close to balance or in surplus.' The numerical value of 0.5%, accepted in the framework of the ESGP, should be understood as the maximum, not the average level of the structural deficit. Similar considerations apply to the slightly more restrictive magnitude of 0.35% of GDP for the structural deficit according to the provisions of the debt brake; cf. Kastrop et al. (2012: 2).

<sup>6</sup> The primary balance indicates the surplus or deficit of the public budget after deducting interest payments. It is thus an indicator of the fiscal policy leeway of a government. That this issue can be construed quite differently is demonstrated by the statements of the *Sachverständigenrat* (Council of Economic Experts): "A positive primary balance (revenues > primary expenditures) means that the revenues are sufficient to finance these core tasks, and even a portion of the interest expenses can be covered. Conversely, a negative primary balance indicates that the revenues are insufficient to finance the core tasks. For this remaining portion and to finance the interest service, borrowing is necessary" (*Sachverständigenrat* -SVR 2007: 20; own translation)

<sup>7</sup> Its exact magnitude depends on the size of the differential and the debt-to-GDP ratio to be stabilized: For example, if the interest rate-growth differential is -2%, and a debt-to-GDP ratio of 60% is to be stabilized, a sustainable primary deficit ratio of -1.2% would be required.

tax revenue must be paid to creditors in the form of interest payments, resulting in a loss of fiscal policy room to manoeuvre. Maintaining policy flexibility requires a primary deficit, leading to an increasing government debt ratio ('debt trap')<sup>8</sup>. Only in the 2010s did the interest rate-growth differential turn negative again, thanks to a slightly rising (real and nominal) economic growth path and negative nominal interest rates on German government bonds after the global financial crisis, significantly relieving public fiscal policy.

**Table 1: Development conditions in a comparison across decades**

Decade	Growth rates	Labour market burden	Financial conditions	Budget balance	Debt level	Fiscal rule
1960s	High	Low	Positive	Negative	Low	Debt prohibition
1970s	High	Medium	Neutral	Negative	Low-rising	„golden rule“
1980s	Medium	Medium	Negative	Negative	Medium-rising	„golden rule“
1990s	Medium	High	Negative	Negative	Medium-rising	„golden rule“
2000s	Low	High	Negative	Negative	High-rising	ESGP
2010s	Low	Medium	Positive	Neutral	High-falling	ESGP/ debt brake

In summary, it can be stated that the development of government debt in Germany depends on both the real and financial economic conditions, as well as fiscal policy orientations (cf. Table 1). The latter can be rule-based (fixed) or discretionary (flexible), expansive, or restrictive. Neither fixed, restrictive fiscal rules (as the ESGP or debt brake in the 2000s and 2010s) nor high growth rates (as in the 1960s and 1970s) are *sufficient* conditions for sustainable fiscal policy (as in the 1960s and 2010s), but they increase the chances of its realization, as do favourable financial conditions (negative interest rate-growth differential as in the 1960s and 2010s).

The significance of the debt brake in shaping sustainable fiscal policy now crucially depends on the extent to which a government can purposefully influence its other cornerstones – growth and financial conditions.

<sup>8</sup> This is formulated by the *Sachverständigenrat* (Council of Economic Experts) as follows: "In the long run, additional leeway through borrowing would only exist if net borrowing consistently exceeded interest expenses. However, this would lead to an unchecked increase in the debt-to-GDP ratio, which could ultimately lead to insolvency for a government entity" (SVR 2007: 21; own translation).

### 3. 'Sound Finance' versus 'Functional Finance' – Fiscal policy in academic controversy

When it comes to the theoretical justification of government debt, a distinction must be made between *temporary, cyclical deficit*, and *permanent, structural deficit*. Only the most extreme variants of the standard economic equilibrium model would argue against accepting cyclical deficits in case the economic cycles express not just temporary under- and overutilization of production capacities but endogenous productivity fluctuation – so-called real business cycles. In principle, however, even the fixation of mainstream economics on the general equilibrium state as a long-term, self-regulating gravitational centre allows for countercyclical and symmetric deviations from a structurally deemed appropriate budget balance. And if these deviations are not the result of discretionary fiscal interventions but rather the effect of the economic responsiveness of government revenues and expenditures ('automatic stabilizers'), not only should *countercyclicality* be accounted for but also *symmetry*, and a potential 'debt bias'<sup>9</sup> should be prevented.

Paradigmatic differences in justifying structural deficits are of greater significance. The '*sound finance*' and '*functional finance*' positions stand in contrast here<sup>10</sup>: The 'sound finance' position is based on the standard economic theory of general equilibrium and denies the (long-term) possibility of increasing economic growth in an economy through deficit-financed fiscal interventions—the so-called *policy ineffectiveness hypothesis* of the Barro-Ricardo Equivalence Theorem (BRET)<sup>11</sup>.

Due to the stability assumptions of general equilibrium theory, structural deficits cannot be justified by stability policy considerations—this can be left to cyclical deficits, and a 'balanced budget' orientation would be adequate for the structural part of the budget. However, intertemporal considerations arising from the durability of certain public goods, which are utilized not only by current taxpayers but also by future generations, could lead to a revision of this budgetary guideline. If such government expenditures are restricted to public investments, a budgetary orientation of the '*golden rule*' could be better justified than a '*balanced budget*' orientation (cf. e.g., Heijdra/Meijdam 2002).

The 'functional finance' position, attributed to Abba Lerner (1943), is based on the assumption of permanent underutilization of production factors without inherent self-stabilizing mechanisms, as theoretically justified by Post-Keynesianism (cf. e.g., Heise 2019). In this perspective, the task of stabilization is not viewed as *cyclical but rather structural*. It links the

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<sup>9</sup> The 'debt bias' refers to the tendency of governments (as agents) and voters (as principals) to lean towards deficit-oriented budgeting because government spending brings them positive benefits (electoral approval for governments, public goods for voters), while government revenues (in the form of taxation) causes disutility (cf. e.g., Alesina/Tabellini 1990).

<sup>10</sup> Olivier Blanchard (2023: 10ff.) speaks of 'functional finance' versus 'pure public finance'.

<sup>11</sup> Occasionally, a distinction is made between Ricardian equivalence and the neoclassical perspective (cf. SVR 2007: 35ff.). In Ricardian equivalence, long-term real economic neutrality is based on expectation effects, while in the neoclassical perspective, it relies on displacement effects of increasing interest rates under a growing burden on the financial market. Whether these perspectives indeed lead to intergenerational burden differences depends on the 'definition' of a generation. This distinction is not further explored here.

state's willingness to accumulate debt quantitatively to the size of the gap that arises in a mature, highly developed economy between potential and actual output. In other words, the state must be willing to close the gap between potential full employment savings and the private investments (made by businesses) through public investments. If it fails to do so, national income falls below its potential level (achieving the accounting identity of 'Savings = Investments'), leading to underutilized capacities. This approach would also allow for a fiscal orientation of the 'golden rule.' However, the level of the structural deficit to be used for public investment would be endogenously determined and likely substantially higher, at least in mature, highly developed economies, as compared to the case of intergenerational allocation of debt burden according to the standard economic perspective.

While both the 'sound finance' and 'functional finance' orientations lead to a 'golden rule' guideline in principal - *a 'balanced or surplus budget' cannot be economically justified* - there are clear *differences in foundation and quantification*. While the post-Keynesian 'functional finance' position functionally justifies the structural budget deficit and thus demands an endogeneity that renders the fixation on a specific magnitude as a maximum - for example, 0.5% as in the case of the ESGP or 0.35% as in the case of the German debt brake - implausible, the 'sound finance' position must rely on subjective (generational justice) considerations. Above all, the magnitude of the justifiable structural deficit is likely to differ significantly: In the understanding of the state underlying the 'sound finance' concept based on liberalism<sup>12</sup>, limiting structural indebtedness to the small magnitudes envisioned by the ESGP or the debt brake is evident. In the 'functional finance' rationale of the interventionist state, however, significantly higher needs can be expected (cf. Table 2 and Table 3): John Maynard Keynes, in his considerations on a 'Capital Budget,' which closely aligns with the structural deficit according to the 'functional finance' concept (cf. Keynes 1945), projected magnitudes of the structural deficit for mature, highly developed economies that will be significantly higher than what we have experienced in the past decades<sup>13</sup>.

Finally, it should be noted that the 'sound finance' argumentation assumes a long-term growth path unaffected by fiscal policy. Applying Domar's financial arithmetic (cf. Domar 1944) leads to the conclusion that the debt-to-GDP ratio, which is to be kept cyclically constant (as indicator of fiscal sustainability), can be calculated when structural indebtedness has been established as an expression of intergenerational justice (cf. Table 2).

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<sup>12</sup> Usually, a distinction is made between a *liberal* and an *interventionist* understanding of the state (cf. e.g., Sened/Watson 2014). According to the liberal understanding of the state, only a few consumptive (social) and allocatively oriented productive public goods should be provided. In contrast, the interventionist understanding of the state implies a much greater need for consumptive and productive provisions with a focus on stabilization.

<sup>13</sup> See Keynes (1943), where he predicts magnitudes ranging from 7.5% to 20% of the net national income.

**Table 2: Deficit and debts from a ,sound finance' perspective**

Nom. GDP growth in %	Structural Deficit ratio as % of GDP	Sustainable debt ratio as % of GDP
5	0,35	7,0
5	0,5	10,0
5	1,0	20,0
3	0,35	11,7
3	0,5	16,7
3	1,0	33,4

If the actual debt-to-GDP ratio exceeds the one defined as sustainable, consolidation should be pursued. However, due to the Barro-Ricardo Equivalence Theorem (BRET), this would have no consequences for real economic development. Expectation effects indicate that a credible, long-term restrictive fiscal policy, through 'crowding-in' of private consumption and investment expenditures, leads to so-called 'non-Keynesian results' of consolidation (cf. e.g. Blanchard 1990, Giavazzi/Pagano 1996). To meet the conditions – *the credibility of fiscal austerity* – rule-based constraints are recommended on this theoretical basis.

**Table 3: Deficit and Debts in a ,functional finance' perspective**

Nom. GDP growth in %	Debt ratio as % of GDP	Sustainable structural deficit ratio as % of GDP
5	20	1,0
5	60	3,0
5	80	4,0
3	20	0,6
3	60	1,8
3	80	2,4

The situation is different when adopting the 'functional finance' perspective: Here, permanent effects of fiscal policy on the growth path of an economy must be allowed, and their magnitude depends on various factors, such as the composition of government spending, the development stage of an economy, the level of the already expired government debt, and coordination with other macroeconomic policy areas (cf. Heise 2002b: 324ff.). Even if all these factors could be clearly determined, either the debt-to-GDP ratio or the structural budget balance must be set - quasi-exogenously - to determine the other variable using Domar's

financial arithmetic. So, for example, if a debt-to-GDP ratio of 60% is deemed adequate as an expression of intertemporal considerations, and an over-cyclical nominal growth rate of 5% can be expected if public deficits are exclusively used for investment purposes<sup>14</sup>, and other macroeconomic policy areas (primarily referring to monetary and wage policies) do not behave uncooperatively<sup>15</sup>, a sustainable structural deficit ratio of 3% of GDP would result (cf. Table 3).

#### **4. Maastricht Convergence Criteria, the European Stability and Growth Pact, and Germany's concerns about Fiscal Discipline in the EU**

Governments today possess limited fiscal sovereignty, a condition applicable universally given the power of international financial markets and particularly evident within the European Union (EU) due to shared governance rules aimed at disciplining national fiscal policies. To understand how Germany came to adopt a debt brake, it is inevitable to delve into the fiscal part of the EU governance system.

##### *4.1 The German stability culture and the Maastricht convergence criteria*

After years of stagnation in the European integration process in the 1980s, the transition to a European Monetary Union (EMU) was intended not only to advance the completion of the internal market but also, according to the neo-functionalistic integration theory, to generate momentum capable of triggering further integration dynamics. Especially the French government intended, with the creation of a single currency in the EU, not only the 'Europeanization' of the German *Bundesbank*, which was too committed to German stability culture, but also held the position that a monetary union should not merely 'crown' extensive real economic and, in particular, monetary convergence but could provide impulses for such convergence. German policymakers found themselves in a dilemma, unable to obstruct further integration steps as part of state doctrine but also constrained by the need to convey the abandonment of the *Deutsch-Mark*, a symbol of the strength of the German economy and the price stability orientation of German monetary policy, to the German electorate without risking voter disapproval.

With the 'crowning theory' – delaying the entry into a monetary union to an indefinite time when all potential participant states would have proven their ability to adhere to the German stability culture – it was long believed that this dilemma had been adequately addressed. Since experiences with the first unsuccessful attempt to enter a European Monetary Union (the so-called 'Werner Plan') suggested the inclusion of an accession automatism and the fixation of a timetable, Germany had to abandon its 'crowning approach' under the Maastricht Treaty to introduce a common currency. Still, it pursued nominal convergence as a condition for accession by making the fulfilment of convergence criteria mandatory. In addition to relative convergence criteria (price and interest rate developments), absolute control of fiscal policy over the limitation of new borrowing was intended to ensure that the newly created European

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<sup>14</sup> With a tolerated inflation rate between 2% and 2.5%, this would result in a real GDP growth rate of 2.5% to 3%.

<sup>15</sup> For the theory of cooperative economic policy, refer to Heise (2009), and Heise (2011)

Central Bank (ECB) would not be compelled to provide a 'monetary bailout' to financially unsound member states through expansive monetary policy.

As the convergence criteria were only entry barriers to the EMU and could not guarantee lasting fiscal 'solidity' within the EMU due to their point measurement<sup>16</sup>, Germany advocated for a regulation that would ensure fiscal orientation based on the convergence criteria even *after* joining the EMU: the *European Stability and Growth Pact (ESGP)* of 1997 obligatorily specified the numerical manifestations of fiscal convergence criteria as rule-based, with violations subject to sanctions. The ESGP thus became one of the few examples of '*hard*' *coordination* of national policies in the EU, intended not only to eliminate the incentive for excessively expansive fiscal policies in a monetary union but also to counter the 'deficit bias' to which re-election-oriented governments might be exposed, especially in the face of strong distribution coalitions. Therefore, Rotte/Zimmermann (1998: 403) conclude: "..., there is strong support for the hypothesis that governments actually use Maastricht as an instrument to impose fiscal restraint, and they are pretty successful in doing so".

#### 4.2 Toughening fiscal restriction – the European Growth and Stability Pact

In Germany, by the mid-1990s, broad political support, including that of academic economists<sup>17</sup>, had coalesced in favour of a rule-based, restrictive fiscal policy in a monetary union. This perspective encountered weak 'Keynesian' opposition, which saw the discretionary fiscal policy actions of national governments as overly constrained (see, e.g., Filc/Klär 2003). The rationale behind the specific reference values of the fiscal rule in the European Stability and Growth Pact (ESGP) is somewhat legendary (see, e.g., Dyson/Featherstone 1999, Tietmeyer 2005, James 2012). It is reasonably clear that the 60% limit on public debt lacks a comprehensible economic justification and was arbitrarily set during the drafting of the Maastricht Treaty. This value either corresponded simply to the average public debt of the EU member states at the time of the treaty's drafting or was the height predicted by the EU Commission's simulation model for Germany and France in the year of the convergence criteria assessment – setting these values aimed to ensure that at least these two countries could meet the convergence criteria, without which the EMU seemed inconceivable.

The origin of the 3% limit for net new borrowing is also unclear. On one hand, it is rumored that this value was suggested arbitrarily by a French ministerial official (Schubert 2013). On the other hand, it is said that German ministerial officials referred to the 'golden rule,' suggesting that the public investment ratio in Germany was around 3%, and therefore, this figure should be chosen as a benchmark (Dyson/Featherstone 1999: 411). Finally, some economic rationality might be assumed if one derives the 3% benchmark from Domar's

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<sup>16</sup> The compliance with fiscal convergence criteria was to be determined by measuring the variable values in the year preceding the final decision on the introduction of the Economic and Monetary Union (EMU) in 1998. Thus, a single year of reference (1997) was crucial.

<sup>17</sup> However, a significant portion of German academic economists considered the provisions of the Maastricht Treaty as not sufficiently credible, while a smaller faction supported the transition to the monetary union according to the Maastricht Treaty's regulations – both viewpoints were expressed in public appeals in the *Frankfurter Allgemeine Zeitung* (see Weske 2011: 163ff.).



financial arithmetic under the assumption that the public debt of 60% should be stabilized with an expected long-term nominal growth rate of 5%<sup>18</sup> – however, it would then be clear that this is the guideline for the *structural deficit*, not for the *maximum of the cyclically-unadjusted total deficit*. With the establishment of the ESGP at the insistence of Germany, it was then clarified that the structural new borrowing should be ‘around zero’, and the 3% threshold should indeed represent the *maximum upper limit of the overall state deficit* and, hence, indicating a distinct tightening of restrictive orientation of fiscal policy. The economic rationale was derived from the empirically measured fiscal elasticities of the EMU member states (see Moure/Poissonnier/Lausegger 2019): As long as a member state presents a balanced budget in the 0-position of the business cycle (i.e. provides a zero structural deficit), it is ensured that, with the measured fiscal elasticities, an overall deficit of -3% will not be exceeded when automatic stabilizers come into play<sup>19</sup>.

The restrictive EU fiscal regime, based on German concerns that unsound fiscal policies within the monetary union could undermine the price stability orientation of the European Central Bank (ECB) and thus damage a cornerstone of the German economic model, reflects the 'sound finance' understanding of mainstream economics, particularly advocated by the Deutsche Bundesbank (see Schlesinger 1991: 236f., Bundesbank 1990: 42ff.) and the *Sachverständigenrat* (SVR 1991: 215, SVR 1997: 227ff.).

## **5. The Global Financial Crisis and the discussion on the German Debt Brake in an agenda-theoretical perspective**

Before we delve into the details and conduct a political-economic analysis to understand how the constitutional institutionalization of a very one-sided understanding of fiscal policy in the form of the debt brake came about, let's briefly recall the economic conditions of the year 2009: As shown in Figure 1, government debt, after an initial increase in the early 2000s and a brief period of consolidation between 2004-2006, not only began to rise substantially but also remained permanently above the limit of 60% of GDP stipulated in the European Stability and Growth Pact (ESGP). The real economic backdrop to this development was, of course, the global financial crisis that erupted in 2007, leading to the deepest depression since the 1930s. Only through massive deficit-financed stabilization programmes, aimed at increasing aggregate demand for the real economy and stabilizing systemically important parts of the financial sector, did the crisis not culminate in a complete systemic collapse. At the same time, there was a discussion in politics and academia about how this crisis could have occurred,

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<sup>18</sup> The European Commission assumed an inflation rate of 2% targeted by the European Central Bank (ECB) and a long-term real GDP growth of 3%. In the 1980s, the annual real GDP growth in Germany, the most advanced economy in the EU, averaged 2.6%. Against the backdrop of an expected growth spurt in the Economic and Monetary Union (EMU) and an anticipated convergence process in the EU – conceivable only if less developed economies achieve above-average growth rates – 3% seemed quite realistic. However, retrospectively the GDP in the Eurozone merely grew at an average rate of less than 2% per year since the establishment of the EMU.

<sup>19</sup> This is true, at least within the 'normal' business cycle fluctuations. If more severe recessions with growth losses of -2% or more were to occur, special conditions would be in place under which the restrictions of the European Stability and Growth Pact (ESGP) would be suspended.

what contribution the prevailing economic science with its neoliberal advisory orientation had made, and whether there needed to be a resurgence of a more market-critical, regulation- and stabilization-friendly Keynesianism. So, at the end of the 2000s, the world economy was in a deep depression. Governments worldwide were engaging in a Keynesian-style debt policy, and the economic science was questioning its own mainstream summarized by the economic policy triad of deregulation, flexibility in goods, finance, and labour markets, and consolidation of public budgets. In this phase, it was not only pragmatically about stabilizing the vulnerable capitalist system, but also about the interpretative predominance over the causes and consequences of the crisis and the future paradigmatic hegemony within economic science—thus, about (scientific) ideas and their influence on vested (material) interests.

Several studies have explored why the economic mainstream in academia could largely maintain its hegemonic position (see, among others, Crouch 2011, Mirowski 2013) and why the economic policy consensus of a 'pragmatic Keynesianism' during the immediate crisis years (2008-2009) quickly gave way to a broad 'austerity consensus' in the years that followed (see e.g. Pühringer 2014, Farrell/Quiggin 2017). Here, we inquire into how, under these conditions, *it was possible to enforce an institutional reform that unilaterally codified a fiscal policy orientation (at the ideational level) serving the interests of the meritocratic elite*<sup>20</sup>. For analysis, the *Agenda Theory of Political Economy* is suitable<sup>21</sup>, providing a basis for examining the strategic positioning of political parties and the interplay of ideas and ideologies<sup>22</sup> in an environment of fundamental uncertainty about policies and instruments.

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<sup>20</sup> In Heise (2008a), it is demonstrated how neoliberal economic policies of supply-side flexibility, deregulation, and macroeconomic restrictions (including restrictive fiscal policy) serve the distributional interests of the meritocracy.

<sup>21</sup> cf. e.g. Jobert (1989), McCombs (2005), McCombs/Shaw (1972), Kingdom (1984). Carpenter (2023) nicely surveys the literature and highlights the relevance of agenda-setting and agenda-building for what he calls 'agenda democracy'.

<sup>22</sup> To our knowledge, only one alternative explanation has been given: Eisl (2020) argues that the debt brake was introduced because it is sufficiently ambiguous by focusing on the *structural deficit* to accommodate various ideologically inspired belief systems. While liberal-conservative political actors see it as an opportunity to curb expansionary, discretionary borrowing during an economic downturn, left-wing parties may connect hopes to limit tax cuts in the upswing, which would then force spending cuts in the downturn. A fiscal rule targeting a structurally balanced budget would thus be acceptable across ideological boundaries ('coalition magnet') because it is perceived as both debt- and expenditure-limiting and can be marketed accordingly. The proposed explanation appears implausible for two reasons: First, it disregards the significance of an endogenously determined structural balance within the framework of 'functional finance' for the long-run growth path of an economy. Left-wing political movements aim not only to finance an expanded welfare state ('Big Government') but also to address the inherent misalignments of capitalism, particularly expressed in persistent mass unemployment, through active interventions measured by the budget balance. Second, it seems unlikely to counteract the retrenchment of the welfare state precisely through limiting the structural deficit. The plausibility of this argument relies on expecting a loss of utility (declining voter approval) for conservative-liberal parties due to expenditure cuts induced by tax reductions. However, this assumes preferences of conservative-liberal voters that are more likely to be found among left-wing voters (see, e.g., INSA 2023). Additionally, it does not correspond to the observed willingness of conservative-liberal governments in Germany to keep the structural deficit low or to reduce it significantly after a crisis-related increase *even without the explicit enactment of fiscal rules*.

### 5.1 The agenda theory of political economy

The Agenda Theory rejects the gist of standard political economics ('public choice') which holds that the preferences of the median voter shape policies and political outcomes. Instead, Agenda Theory is based on the understanding that (economic and fiscal) policy considerations forming political agendas become dominant when they fit into a framework of different layers – a micro-framing and a macro-framing – in a way that ensures attention for acting political agents (i.e., the parties and their representatives vying for government participation, cf. Jones/Baumgartner 2005), stages a suasive goal-means system, considers the preferences of the respective ideological voter base<sup>23</sup>, and thus ensures the visibility and binding power of political agents.

In the agenda-building and agenda-setting processes, *micro-framing* is significantly shaped by science-based debates on different policy programmes and concepts, while *macro-framing* reflects dominant worldviews that set a short- to medium-term perceptual framework as 'political constraint' defining (and restricting) the 'scope of political conflict'. The more plural these two types of framing are, i.e. the more open the (economic) policy discourse as part of agenda-setting and agenda-building activities of the involved actors is, the more ideologically diverse the orientation of party-political agents ('shortlist of the possible') will be.

In this setting, (party) ideology as a 'positive vision of society' becomes a central tool of voter alignment. Moreover, it is not the preferences of a median voter that procure the electoral majority, but rather the preferences of a voter who possesses greater abilities and resources to manipulate the agenda-setting and agenda-building process through media influence on micro- and macro-framing in their favour.

### 5.2 The debt brake as part of a neoliberal modernization discourse

The convergence of major political factions at the end of the last century, occasionally interpreted as the de-ideologization of (economic) policy and manifested notably in the '*New Center or Third Way*' policy of Social Democracy (cf. Giddens 1994), reflects the increasing uniformity of the framing process in the age of globalisation since the 1980s (see Fig. 3): In the context of the increasing transformation of mass media from formerly diverse ideological representatives to business corporations and the growing global economic integration in the era of globalization, the solidarity- and interventionist-oriented national Keynesian welfare state (NKWS) lost its dominance in the neoliberal era. It gives way to a more individual-oriented and allocatively efficient Schumpeterian competition state (SCS) (see Jessop 2004). This shift in the hegemonic worldview (ideology and interests) is accompanied by a massive

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<sup>23</sup> Political voting decisions have structurally changed in recent decades: On the one hand, voter loyalty to political parties and the impenetrability of ideological voter bases have significantly decreased. On the other hand, new communication forums and channels have emerged with social media being the most important one, transforming the party-voter connection. Although the consequences of these changes are not yet sufficiently researched, framing processes may be somewhat 'democratized' in the sense that the previously dominant media – television and print media – lose their exclusive influence, increasing populist influences compared to the framing by political and societal elites (cf. e.g. Zhuravskaya/Petrova/Enikolopov 2020, Heise 2024). However, these effects are not of major significance for our observation period until the mid-2000s (cf. Falck/Gold/Heblich 2014).

shift in the dominant economic academic opinion (ideas) from the Keynesianism of the 1960s and 1970s ("we are all Keynesians now") to the neoclassical general equilibrium model from the 1980s onward ("no one took Keynes seriously anymore").

**Figure 3: Framing process in the neoliberal era**

<b>Political Constraint</b>	<b>Macro-frame:</b> <b>hegemonic worldview of neoliberalism</b>		
	Shift from Collectivism and Solidarity towards Individualisation	Shift from 'market correction' towards 'market marking'	Transformation of NKWS towards SCS
<b>Scope of political conflict</b>	<b>Political party competition in a media democracy</b> vying for attention in a discourse for modernisation and reform		
<b>Short-list of the possible</b>	Deregulation	Flexibility	Price stability and balanced budgets
	<b>Micro-frame:</b> <b>(Science-based) dominant policy programmes</b>		

The outcome is a hegemonic '*Pensée Unique*,' especially in economic policy<sup>24</sup>: With an extremely dominant *micro-framing of supply-side policies*<sup>25</sup> and *neoliberal macro-framing*<sup>26</sup>, additionally supported in Germany by a pronounced, *ordoliberal-based 'stability culture'* (cf. Howarth/ Rommerskirchen 2013), Social Democracy shifted away from its traditionally interventionist policies in broad economic and social matters.

This shift occurred with great vigour immediately after the intraparty struggle between the macroeconomic stabilization orientation represented by party leader and former Finance Minister Oskar Lafontaine and the 'left supply-side policies' favoured by Chancellor Gerhard Schröder had decisively favoured the latter under the label '*New Center or Third Way*' policy

<sup>24</sup> In this vein, social democratic Chancellor Gerhard Schröder claimed that there was no longer 'left' or 'right' but only (still) 'modern' or 'non-modern' economic policy (Schröder 1997a).

<sup>25</sup> Cf. e.g. Frey/Humbert/Schneider (2007); Pühringer/Hirte (2014). The dominance peaked during the first decade of the 2000s; cf. Plehwe/Neujeffski/Nordmann (2024: 36).

<sup>26</sup> Cf. e.g. Blankenburg/Schui (2002), Cerny (2008) and Walpen (2004), who extensively elaborates on the emergence (or, rather, manufacturing) of the dominance of the neoliberal worldview

(cf. Heise 2002a)<sup>27</sup>. This process of ideological skinning included reinterpreting the core values and objectives of social democracy<sup>28</sup>, as well as a change in means<sup>29</sup>. Thus, the 'New or Third Way' Social Democracy sought to demonstrate its ability to stage itself in the prevailing discourse of modernization, indicating that the 'modernizers' had prevailed within the party against the 'traditionalists' (cf. Egle/Henkes 2003).

Of particular significance is that this ideological and instrumental shift of the Social Democrats occurred not in opposition but 'in full swing'—meaning under government participation. Thus, it underwent not only programmatic changes but also concrete political implementation. The focus of political reporting and academic analysis was primarily on the standard economic (neoliberal) inspired labour market policy and welfare state reforms within the framework of the so-called '*Hartz legislation*'. Its specific social democratic governance structure – the neo-corporatist 'Alliance for Jobs' – was essentially without a significant echo<sup>30</sup>. The fiscal and budgetary policy shift of the SPD, undertaken mainly under Finance Minister Peer Steinbrück as part of their modernization staging, received much less attention in the academic literature. In this context, aspects of the 'Good Governance' concept were highlighted which originally developed as a benchmark for administrative activities in developing or emerging countries (see e.g. Goldsmith 2007). It turned out to connect well with the de-ideologized rhetoric of 'good economic policy' of the 'New Center' SPD in the context of a media-fueled reform discourse<sup>31</sup>: Economic and financial policy should be withdrawn from the influence of interest and instead subjected to scientific expertise through rule-binding and institutional autonomy (see Schelkle 2012: 38ff.)<sup>32</sup>. What had already become an unassailable dogma for monetary policy—the independence of a central bank focused on price stability as the basis for a healthy economic development—and had been successfully Europeanized through the Economic and Monetary Union (EMU) (see Heise 2005b), now became, with the 'policy of the balanced

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<sup>27</sup> This completed a development that had begun under entirely different framing conditions with the shift of the SPD from a Marxist-influenced class-based party to a Keynesian-inspired mass party in the 1960s (see Heise 2008b).

<sup>28</sup> Full employment was redefined as 'employability' instead of 'employment,' and social justice shifted from 'outcome-oriented' to 'access-oriented.'

<sup>29</sup> Macroeconomic control ('market correction') is replaced by microeconomic incentivization ('market making'). Therefore, Nachtwey (2009) refers to this transformation as 'market social democracy' (*Marktsozialdemokratie*).

<sup>30</sup> In the context of an agenda-theoretical examination, Heise (2005a) demonstrates that the realignment of social democratic economic policy proved unsuccessful for the SPD because voters (and large portions of the membership) of the SPD continued to adhere to more traditional values as an ideological compass despite the mentioned framing conditions. Meanwhile, the modernizers at the party leadership level (and their academic advisers; see, e.g., Streeck/Heinze 1999) pursued a type of voter (the 'qualified skilled worker') who did not correspond to the 'party-median voter.'

<sup>31</sup> Internationally, Germany was labelled as the 'sick man of Europe,' and institutional rigidity in the 'German model' was noted. As for the national discourse, the necessity for wide-ranging reforms was widely discussed in both academia and politics; see, for example, Müller (2003), Müller (2004), Turowski (2010: 261ff.).

<sup>32</sup> It must be emphasized once again that the apparent 'de-ideologization' is only a narrative, as every economic paradigm has a value-laden nature (normativity) and thus serves societal interests – whether intentionally or unintentionally (cf. Albert 1954).

budget', a prerequisite for sustainability, generational justice, and the maintenance or recovery of the ability to act for a leaner state facing the challenges of globalization:

*"With the anchoring of a new debt brake in the Basic Law, this second Grand Coalition does indeed have, 40 years after the first Grand Coalition, the opportunity to make a financial-constitutional and fiscal-policy decision of historical significance, a decision that is intended to secure, not restrict, the financial capacity of the state, especially from the perspective of intergenerational justice. (...)*

*Anyone who wants a capable state in the future, who wants to increase the ability of politics and subsequent generations of parliamentarians to shape, must ensure that the level of debt and interest burden is reduced. A capable state needs financially sustainable public finances in the long term. Financial sustainability in the long term is guaranteed only if debt grows more slowly than gross domestic product. That is precisely the core of this debt rule. That is the basis of the new regulation. In my view, this is also the basis of responsible, generation-just policy. Therefore, with our decision today, we must finally draw the consequences from the many speeches in which we pointed out the burden on future generations, our children and grandchildren. Today, you decide, regarding this debt rule, whether the important goal of intergenerational justice is constitutionally defined, substantiated, and supported or not." (Steinbrück 2009: 24866ff.; own translation)<sup>33</sup>*

However, not only is the 'good governance' modernization discourse aligned with the dominant fiscal narrative of the 'balanced budget,' but also, against the backdrop of the discussion about the toughening of the European Stability and Growth Pact, a budgetary position is claimed for the SPD that corresponds to German stability orientation – even among SPD supporters (cf. Howarth/Rommelskirchen 2013: 756f.) –, expects approval and lends weight to German demands for the legal anchoring of a debt brake in the other member states of the Economic and Monetary Union (EMU).

It is striking that in justifying such an economically one-sided, fiscally restrictive, and constitutionally anchored budgetary rule, neither the critical arguments of the 'functional finance' position are taken up, nor is an attempt made to address the trade-offs between current and future policy options (cf. Heise 2002: 320ff.) and between intergenerational debt and wealth. Of course, in political debate, one cannot expect scientific depth, but the resistance of the 'Traditionalists' in the party and parliamentary faction of the SPD<sup>34</sup>, expressed in dissenting votes in the parliamentary decision and which could fundamentally have cost the constitutional majority<sup>35</sup>, should have forced the proponents to establish not

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<sup>33</sup> The substantive congruence of this statement by the social democratic Finance Minister Steinbrück with the afore-cited statements of the two liberal top politicians Lindner and Buschmann is striking.

<sup>34</sup> Their institutionalization took the form of the intra-party group called the 'Democratic Left' (DL), which positioned itself clearly against the debt brake (see Merkel/Runde 2008).

<sup>35</sup> Indeed, the constitutional majority probably would not have been achieved if all parliamentarians of the DL or those close to it (over 40) had voted against the debt brake. However, since the Free Liberals (FDP) parliamentary group in the *Bundestag* strategically refused to approve the debt brake,

only the connection of the fiscal position to the dominant micro and macro frames but also to the ideological position of the party base and electorate<sup>36</sup>.

## 6. Conclusion

In the midst of the first decade of the 21st century, public debt in Germany and Europe seemed to solidify at a high level. Increasing new debt, especially amid the spreading global financial crisis, reinforced the 'deficit bias' myth of democratic governments. This myth instinctively fuels concerns about currency and economic stability in Germany. It might seem logical that a policy of budgetary consolidation not only gained broad societal approval as a temporary orientation of fiscal policy but was also constitutionally enshrined in the form of a debt brake. This was intended to permanently block the easy path of indebtedness for political actors in Germany and to set an example for the member countries of the Economic and Monetary Union (EMU).

However, this widely held narrative is challenged not only by the dysfunctionality of the debt brake introduced in 2009 revealed particularly in the current multiple crises, but also by the fact that the increase in debt is primarily due to specific historical circumstances in highly developed economies. These circumstances include accumulation-induced growth weakness with persistent underutilization of productive factors and a positive interest rate-growth differential. Additionally, the narrative does not sufficiently account for the fact that fiscal policy orientations in the political arena are always fiercely contested. This is because, on the one hand, their scientific foundation remains embattled, and on the other hand, they affect vested interests (such as financial capital, real capital, meritocracy, or labour). Representatives of these interests are supposed to vigilantly ensure that one-sided orientations are at least not removed from political debate through enforceable norm-setting.

Within an Agenda Model of Political Economy, it was illustrated that the purported depoliticization of fiscal policy through a constitutionally anchored debt brake could only succeed when, in the interplay of neoliberal macro-framing and massively dominant standard economic micro-framing, the political guardian of fiscal policy plurality – the Social Democracy – yielded under the pressure of a '*Pensée Unique*'. Its staging potential was now perceived in a supply-side policy agenda marketed as ostensibly 'leftist', which included the extensively analyzed labour market policies of the *Hartz* reforms under the 'Agenda 2010.' Moreover, part of this shift was the 'sound finance' position, marketed under the modernization theme of 'good governance,' advocating a balanced budget policy. Against the backdrop of debt developments in the Eurozone, to which Germany is connected through a common currency

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apparently, a number of DL members felt compelled to vote in favour due to party discipline – at least there were only 18 votes against from the SPD parliamentary group.

<sup>36</sup> Carsten Schneider (2007: 151f., own translation), budget policy spokesman for the SPD parliamentary group, warned accordingly: "For almost a decade, the SPD has been responsible for consolidating the federal budget, yet this policy has not become a hallmark of German social democracy (*sic! the author*). Indeed, many SPD supporters even view this success story critically. They see a 'neoliberal mainstream' at work, supposedly aiming to destroy the state. That's precisely why we need to better ideologically justify our policy of consolidation".

and where the ability to conduct sound fiscal policy is widely doubted, the leadership of the SPD in government offices believed it could counter political competitors in the prevailing reform discourse.

The 'Third Wayism' of the SPD as an adaptation strategy to a neoliberal discourse environment manifested itself in an ideological-programmatic shift and a conceptual-instrumental adoption of dominant economic, employment and fiscal policy orientations traditionally attributed to conservative-liberal parties. This transformation was the necessary precondition for a fiscal policy decision of 'historical significance': the constitutional anchoring of a restrictive 'sound finance' policy. Due to adverse effects of this reorientation on voter approval and loyalty, the party has since conceptually departed from the shortcomings of its 'Agenda 2010' policy and has partially corrected it in political implementation. However, the fiscal policy directions, despite changed insights, are not easily correctable unless the guardians of the 'sound finance' orientation can be motivated to revise their beliefs – a development that would be at least equally historic.

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