A new budget rule for Germany
The concept proposed by the FMoF

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Outline

• Problems of the existing budget rule

• Proposal for a new budget rule

• Federal aspects of a reform
Regulations restricting budgetary policy

_Status Quo - Art. 115 German Constitution:_

Revenue obtained by borrowing shall not exceed the total of investment expenditures provided for in the budget ("Golden Rule")

exceptions shall be permissible only to avert a disturbance of the overall economic equilibrium
Golden Rule - Art. 115 German Constitution

**problems and limitations of the existing rule**

- **Gross Investment Concept** – depreciations and sales are not taken into account
- **No clear definition** of the exception clause
- **No enforcement during execution**
- **Not in line with the objective of long term sustainability**
- **Asymmetric reaction** over the business cycle

☆ In almost half of the years since 1975 net borrowing was higher than gross investment
☆ Increase in (central) government's debt could not be prevented
Increase of public debt since 1970

Indebtedness (% of GDP)

- Länder and communities
- Federation (incl. special funds)
A new budget rule

criteria and requirements

- Effective limit for (structural) net borrowing
- Stabilisation over the business cycle
- Compatibility with SGP
- Limit one-off measures
- Enforcement (ex post correction)
- Flexibility - future viability (exception clause)
The new three components of net borrowing

<table>
<thead>
<tr>
<th></th>
<th><strong>cyclical element</strong></th>
<th><strong>structural element</strong></th>
<th><strong>financial transaction</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>calculated as the product of the budgetary sensitivity (elasticities of the budget deficit on a change in the output gap) and the output gap</td>
<td>structural deficit of central government max. 0.35% of GDP (about € 8 ½ bn.)</td>
<td>correction for net financial transactions (mainly privatization gains) in order to be compatible with the Maastricht definition</td>
</tr>
<tr>
<td>1.</td>
<td>symmetrical consideration of the business cycle according to automatic stabilizers</td>
<td>Reason: in principal balanced budget, but sufficient flexibility for one-off effects of reforms.</td>
<td></td>
</tr>
<tr>
<td>2.</td>
<td>cyclical adjustments in net borrowing in case of divergences from potential output</td>
<td>Size: SGP allows max. deviation of 0.5% (“close to balance”), Federal level with social security gets 0,35% according to its share in general debt.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>negative output gap ⇒ deficit</td>
<td>positive output gap ⇒ surplus</td>
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</tbody>
</table>
Stabilisation of the business cycle
cyclical element

Positive output gap: budget surplus is required

Negative output gap: deficits are allowed

Symmetric reaction over the cycle
Stabilisation of the business cycle

development of the cyclical component

bn €, (-) = positive output gap

cyclical component, ex ante

cyclical component, ex post
Limit for (structural) net borrowing

**structural element**

- limitation of structural net borrowing, maximum structural deficit of 0.5 % of GDP

- limit accords with medium term objective of the SGP ("close to balance or in surplus")

- need of distribution of structural net borrowing between the federal level and the Länder.

- Breakdown of 70:30, this means:
  - 0.35% of GDP for the federal level
  - 0.15% of GDP for the Länder
Limit for (structural) net borrowing

Size of the structural element

<table>
<thead>
<tr>
<th>Year</th>
<th>Limit (bn €)</th>
</tr>
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<tbody>
<tr>
<td>2000</td>
<td>7.2</td>
</tr>
<tr>
<td>2001</td>
<td>7.4</td>
</tr>
<tr>
<td>2002</td>
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<td>2003</td>
<td>7.6</td>
</tr>
<tr>
<td>2004</td>
<td>7.7</td>
</tr>
<tr>
<td>2005</td>
<td>7.9</td>
</tr>
<tr>
<td>2006</td>
<td>8.0</td>
</tr>
<tr>
<td>2007</td>
<td>8.5</td>
</tr>
<tr>
<td>2008</td>
<td>8.8</td>
</tr>
<tr>
<td>2009</td>
<td>9.0</td>
</tr>
<tr>
<td>2010</td>
<td>9.3</td>
</tr>
<tr>
<td>2011</td>
<td>9.5</td>
</tr>
</tbody>
</table>
Financial transactions

limitation of one-off measures

- **Existing national rule:** net borrowing limit as defined in national financial statistics does not include financial transactions (deficit ≠ net borrowing)
  - in the past net financial transactions have been strongly negative
  - negative incentive of one-off operations to comply with golden rule

- **New rule:** definition of net borrowing will still be based on national financial statistics, nevertheless full inclusion of financial transactions (i.e. privatisations, net changes in assets) in accordance with the methodology of national accounts ⇒ reduction of assets reduces net borrowing limit by the same amount
Development of net financial transactions

<table>
<thead>
<tr>
<th>Year</th>
<th>bn €</th>
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</thead>
<tbody>
<tr>
<td>2000</td>
<td>1</td>
</tr>
<tr>
<td>2001</td>
<td>8</td>
</tr>
<tr>
<td>2002</td>
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<td>2008</td>
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<td>2009</td>
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</tr>
<tr>
<td>2010</td>
<td>5</td>
</tr>
<tr>
<td>2011</td>
<td>5</td>
</tr>
</tbody>
</table>
Substantial restriction of net borrowing

![Bar chart showing net borrowing new rule and effective/projected net borrowing from 2000 to 2011.](chart_image)
control fund

enforcement and viability

- need for monitoring and setting incentives not only for the formulation but also for the execution of the budget – ex post control of compliance

- deviations from the allowed limits in the execution of the budget will be put on a special account

- the account should only track structural deviation, cyclical deviations due to another economic development than ex ante expected should not be accounted

- accumulation over the years with ex ante specified threshold – i.e. maximum debit of 1% of GDP –
If the debit side of the account exceeds the threshold consolidation measures have to be introduced
Exception clause *flexibility*

- exception clause for specific emergency cases (i.e. a natural disaster)
- coupled with a high quorum of the parliament (e.g. two-thirds majority or even higher)
Decreasing debt ratio underlines sustainable public finances

nominal GDP growth 3 ¼ %
Federal aspects of a reform

- Länder themselves started discussion about a reform, voicing different proposals.
- No technical or legal problem to translate the proposed rule into the states’ level of government.
- But: Heterogeneous starting conditions (from distressed to balanced budgets).
- Ongoing discussion in the Federalism Reform Commission; linked to other themes (“debt service assistance”; “early warning system to prevent budgetary distress”)
Thank you for your attention.
Leeway for net borrowing according to the new rule

- Net borrowing - new rule size - ex ante
- Net borrowing - new rule size - ex post
- Projected net borrowing

Mrd. €

Net borrowing according to the new rule

Size and development of the different components
Stabilisation of the business cycle

*calculation of the cyclical component*

The cyclical component could be calculated by different approaches:

- **Hodrick-Prescott filter**
  - Statistical approach, used in the Swiss model
  - Cyclical adjustment more restrictive than production function method
  - Easier to implement: HP-filter (with $\lambda = 100$) can be calculated more easily than production function method.
  - Cyclical factor: potential GDP/GDP

- **Production function approach**
  - European approach – SGP, our choice - adoption of the agreed method of cyclical adjustment of fiscal balances
  - Cyclical component: budget sensitivity $\times$ output gap
  - Cyclical components of the budget according to SGP: tax revenues, social security contributions, labour market expenditures.
  - Federal level and social security take about 70% of cyclical fiscal balance – as measured by tax revenues.
  - Less prone to disputes as method agreed by EPC
Development of the control account

![Bar chart showing the development of the control account from 2000 to 2007. The account balance ranges from a high of 8 in 2001 to a low of -19 in 2005.](chart.png)