A new budget rule for Germany
The concept proposed by the Federal Ministry of Finance

1. Point of departure

In the year 2007, the general government budget in Germany showed a small surplus again for the first time since 1989: in recent years the federal government and the Länder have made considerable efforts at consolidation. A majority of the Länder have already achieved a budget in balance or in surplus. The Financial Plan provides for the federal government to achieve a balanced budget without any net borrowing in the year 2011. Against this background the aim should be to make the consolidation success permanent: Institutional frameworks and rules are necessary to support the long-term sustainability and short-term stabilisation function of the public budgets.

Reforming the constitutional rules that limit government deficits has become the central goal of the current stage 2 of the federalism reform in Germany. At the end of February the Federal Minister of Finance presented a proposal for a new budget rule to the Committee on the Modernisation of the Financial Relations between the Federation and the Länder. This paper provides an overview of the main elements of the proposed concept.

The purpose of the new rule is to avoid the weak points of the current budget rule laid down in Article 115 of the Basic Law. This rule, which in a similar form is also contained in the constitution of many of the Länder, allows net borrowing up to the amount of (gross) investment as uniformly defined for the federation and the Länder in the Law on Budget Principles. Gross investment, however, does not reflect the actual value added, for depreciation and asset sales are not taken into account. In addition, grants to private parties or to the public sector, that is payments for which the central or state government making the payment does not itself create any assets, are also counted as gross investment.

Over and above that, the exception allowed in Article 115 Basic Law is framed in very broad terms. Whenever a “disturbance of macroeconomic equilibrium” is deemed to exist, or in order to avert an impending one, it is permissible to borrow in excess of the limit described above. Since, however, there is no corresponding obligation to reduce borrowing or create a surplus during economic “good” times, the rule in force does not make any binding provision for ”bad” times. Lack of such a provision, however, means that during a downturn either pro-cyclical cuts must be made, or steadily growing debt must be accepted. Thus, the asymmetrical reaction over the business cycle is maybe the biggest problem of the current rule at all.

2. Key elements of the proposal

The proposed new rule is oriented on the provisions of the preventive arm of the European Stability and Growth Pact (SGP). It takes account of the goal of an approximately balanced budget without net borrowing over the whole course of a business cycle.

- With a view to intergenerational equity, the rule should permit structural debt only within very narrow limits (structural debt component).
- The rule should facilitate a symmetrical approach to taking the cyclical situation into account. That is, it should permit new borrowing in a downturn in line with cyclical requirements – in order not to have to make pro-cyclical cuts or raise taxes – and in a recovery it should correspondingly reduce the scope for borrowing or require surpluses to be achieved (cyclical debt component).

Over and above that, an exception should be allowed, albeit a very narrowly formulated one, in order that the state can remain capable of taking effective action when there are special financing needs, for example in the case of natural catastrophes. In order for use to be made of this exception, a raised quorum in the Lower House of the German Federal Parliament should be required. Finally, there must be a mechanism of controls and sanctions in place in order to ensure that the budget as it is actually implemented does not habitually violate these principles (control or compensatory account).

2.1 Components of net borrowing

The debt leeway which the proposed budget rule still allows can be summarised in a formula which in essence consists of a structural component and a cyclical component. In addition the new borrowing ceiling will be adjusted for net financial transactions, analogously to the procedure employed under the SGP. This adjustment takes account of the change in the assets position of the government authority, and, for instance, equates sales of assets with net borrowing, thus narrowing the leeway for net borrowing. This prevents the budget rule from being circumvented by means of so-called “one-off measures”.

New borrowing ceiling =
(structural component – balance of financial transactions)
+ cyclical component

Structural component

The solution suggested here follows on from the “close-to-balance or in surplus” principle of the SGP that focuses on the long-term sustainability of public finances. Within the framework of the SGP, the medium-term budgetary objective set for Germany tolerates a maximum general government deficit of 0.5 % of GDP defined in structural terms (thus adjusted for cyclical or other temporary effects).

In accordance with this, the proposal of the German government provides for Germany as a whole annual leeway for structural net borrowing of a maximum of 0.5 % of GDP. In line with the allocation rule for possible sanctions for violating the Stability and Growth Pact in Article 109 paragraph 5 Basic Law and the actual accumulated debt stock of the federal government in relation to that of all the Länder taken together, the federal government claims for itself structural new borrowing leeway of 0.35 % of GDP, that would be at the present time about € 8 ½ bn. The share of the Länder would accordingly be 0.15 % of GDP.

It is intended that the structural debt component of 0.35 % of GDP accorded to the federal government should also suffice to finance one-off outlays in individual years – for example up front financing of reforms (such as, currently, the reform of business taxation). It is thus also to be viewed as a buffer which is not meant to be used systematically in practice for regularly recurring expenditure.

Cyclical component

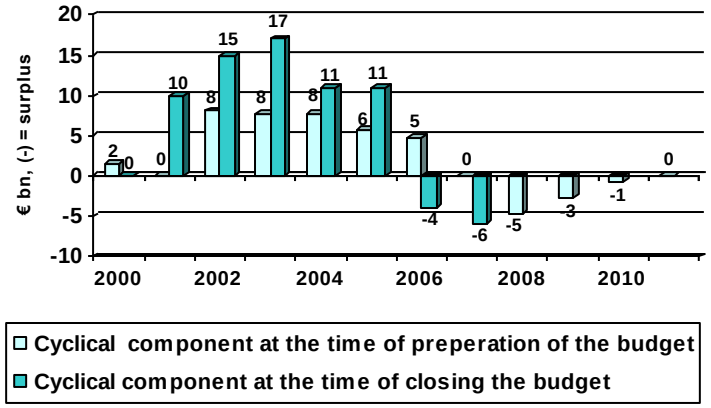
The new budget rule is also meant to ensure that budgets have a stabilising effect over the course of the business cycle. Cyclical changes in revenue and expenditure should entail corresponding additional or lesser leeway for net borrowing. This symmetrical consideration of the business cycle allows the automatic stabilisers embedded in public budgets to work. In good times the scope for borrowing is limited, or budget surpluses are achieved; in bad times an increase in borrowing is accepted.

In order for a budget rule intended to take account of cyclical effects to work, there must be a definition of the normal situation as a point of reference for the business cycle. Only by calculating deviations of the actual situation from the normal situation can the cyclical effect be identified, a distinction made in this way between “good” and „bad” times and thus the amount of the permissible cyclical deficits or of the required surpluses be determined.

In order to ensure that the budget rule is consistent with the Stability and Growth Pact, we suggest using the cyclical adjustment procedure agreed and applied at European level. With the aid of this procedure, when the budget is prepared an estimate is made of how large an influence the business cycle will have on budget planning (cyclical component). In the case of

positive deviations from the normal cyclical situation, the scope for net borrowing will be restricted, and in the case of negative deviations it will be expanded, and in each case the respective orders of magnitude will be calculated in concrete terms.

Figure 1: Size of the cyclical component at the time of preparation / closing of the budget (federal budget)



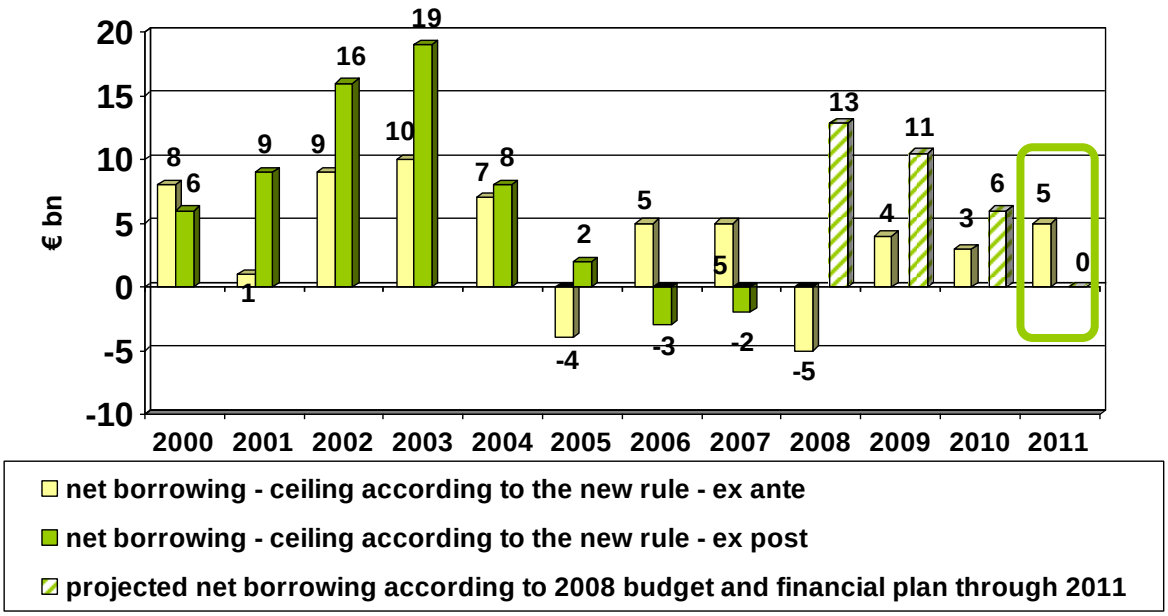
Typically, errors of estimation occur when forecasting cyclical developments in the following year at the time of preparation of the budget. As Figure 1 shows, for example, the weak growth of the years 2001 to 2005 was underestimated. Nor was the turnaround in the business cycle in the year 2006 anticipated in the form in which it occurred. Until now, budgetary policymakers have had to cope as best they could with the consequences of such incorrect estimates, for example the impact on tax revenues, unaided by any cyclical component. In future, account is to be taken of the actual development of the economy at the time of the closing of the budget.

Total leeway for net borrowing

In Figure 2, the debt leeway of the federation is depicted as it would have resulted until the new rule in the period 2000 to 2007 at the time of the preparation and at the time of the closing of the budget. For the years 2008 through 2011, planned net borrowing according to the current financial plan is set off against the borrowing ceiling which would be permissible under the proposed rule.

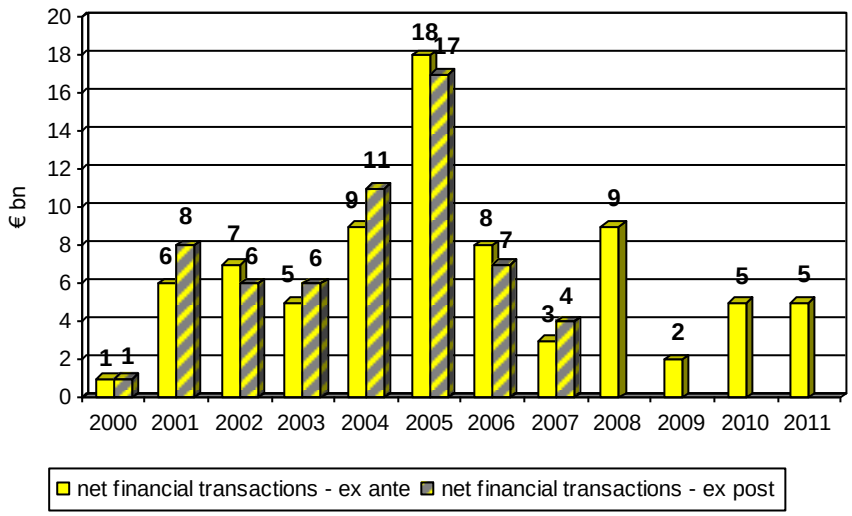
The total leeway for net borrowing ensues from the cyclical component which was shown in Figure 1, from the structural component, which tends to stay rather stable at about € 8 bn, and the balance of the financial transactions.

Figure 2: Leeway for net borrowing according to the new rule



Net financial transactions had a crucial impact on the debt leeway especially in the period 2004 to 2008 (cf. Figure 3). The balance of financial transactions reached a peak in the year 2005 at a planned figure of € 18 bn and an actual figure of € 17 bn. As already explained above, in future it will no longer be possible to use sales of assets in order to keep borrowing within the set limits. The importance which attaches to the balance of the financial transactions is therefore likely to diminish significantly once the proposed debt rule is put into effect.

Figure 3: Development of net financial transactions



In recent years, the regulatory limit provided in Article 115 Basic Law, depending on the amount of gross investment budgeted, has permitted borrowing of € 20 to 30 bn a year. Added to this was borrowing allowed to avert a disturbance of macroeconomic equilibrium. In contrast, the new rule allows much narrower leeway. The fluctuations of the cyclical component should to a large extent balance each other out over the course of the business cycle. Thus in the long run borrowing will be shaped solely by the structural debt component, which at a level of 0.35 % for the federal government at present makes up about a third of annual gross investment. By limiting structural debt to a maximum of 0.5 % for the federal government and the Länder together, we ensure that the aggregate public-sector debt ratio will be brought substantially below 60 % – the reference value of the SGP (cf. Figure 5).

2.2 Involvement of the implementation of the budget by way of the control account

The Stability and Growth Pact does not require only that the Member States should respect the Pact when they prepare their budgets, but also, and especially, when they are actually implementing them in practice. The rule contained in Article 115 Basic Law, however, is a rule which applies exclusively to the preparation of the budget. In future, therefore, a control account is to be employed in order to make the debt rules more binding for the implementation of the budget as well.

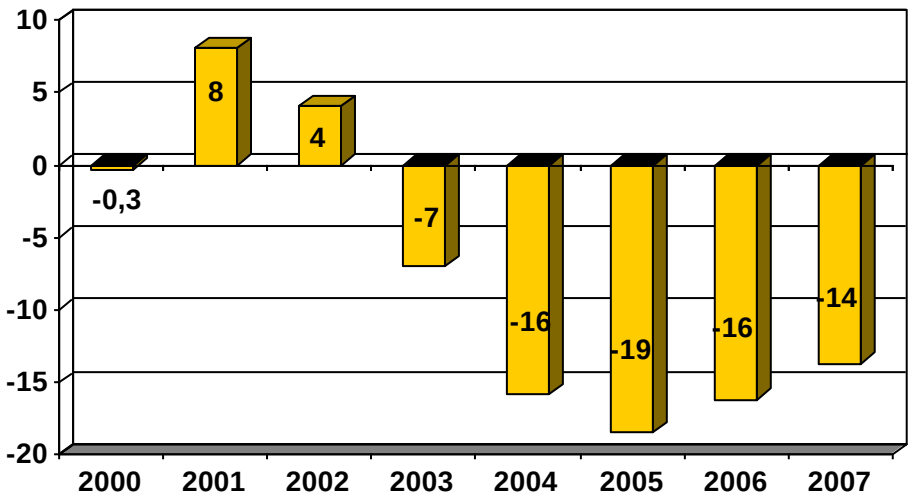
This control account will document for each individual budget year those deviations in the implementation of the budget which are not due to fluctuations in the business cycle. Whenever in the course of the implementation of the budget the limit of structural net borrowing is exceeded which is in principle permissible, this will result in a debit on the account, and in a credit when structural debt is kept below that limit.

It will not always be possible to avoid debits on the control account, especially since there are uncertainties involved in distinguishing structural developments from cyclical developments. In future this additional new borrowing, netted out with any credits, will be stored as “memory” on the control account and will thus be subject to an obligation to balance it out. This will ensure that structural debt keeps “close to balance” in actual ongoing practice, and not just in theory. The control account will be equipped with a threshold value which triggers a standardised balancing requirement (1 – 2 percentage points of GDP).

Cyclical deviations from the permissible volume of new borrowing, however, will subsequently be factored into the cyclical component in the form of adjusted automatic stabilisers and will thus not appear on the control account. On the other hand, any net borrowing which is first planned as cyclically necessary and which afterwards turns out no longer to be justifiable on cyclical grounds, but which is made anyway, will have to be entered in the control account as structural debt.

A backward calculation for the period 2000 through 2007 shows that if such a control account had existed since 2000 it would, based on the estimated-actual deviations which in reality occurred, have reached a negative balance of about € 15 bn in the year 2007. This means that the budgets prepared under the proposed rule would have required on balance € 15 bn more to be borrowed during implementation than the new rule actually permits. Exceeding a threshold which still has to be fixed would then trigger measures which would successively reverse this rise in debt.

Figure 4: Development of the control account from 2000 to 2007 - balance in € bn -



2.3 Exception to the rule

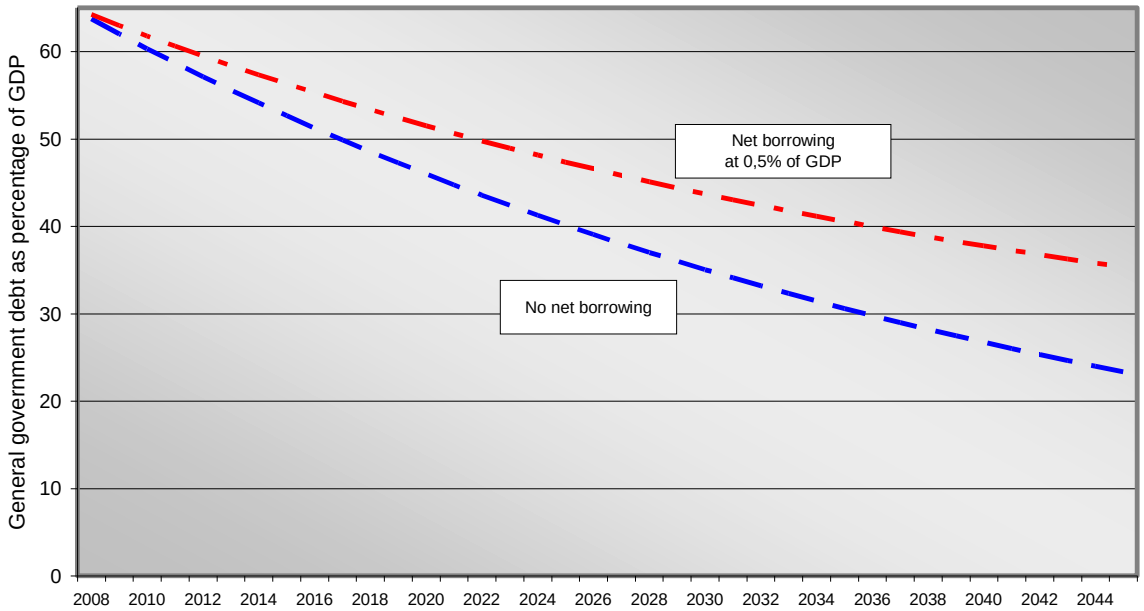
There will be a provision on exceptions for special situations such as natural catastrophes which will permit additional borrowing to cover special financing needs. The method used to ensure that the scope for this provision is as narrow as possible will not be to draw up a concrete list of conceivable emergency situations, rather, a large parliamentary majority, which will have to be larger than the "chancellor majority" (which is 50 % of the deputies plus one), will be required to allow an exception.

2.4 Effect of a common rule for the federal government and the Länder

In the context of the binding rules of budget management set forth in the Basic Law, the principles of the new budget rule should be anchored in a corresponding implementing statute uniformly for both levels of government. Starting conditions and therefore also the time paths to approximately balanced budgets as a necessary prerequisite for introducing and adhering to the new budget rule, however, differ between the federation and the Länder as well as throughout the Länder. This could be accommodated by having different transitional arrangements for the federation and each of the Länder.

If the federal government and the Länder then keep within the structural debt leeway of 0.5 % of GDP, the government debt ratio, that is, aggregate public debt in relation to GDP, will go down quickly (cf. Figure 5). Assuming nominal growth of 3 ¼ %, in the long term debt would converge to a value of a good 15 % of GDP. This could make an essential contribution to sustainable fiscal development.

Figure 5: Long-term development of general government debt - assuming a nominal GDP growth rate of 3 ¼%



The crucial point is that the new budget rule defines as the bacic principle that the budget should be virtually balanced – viewed over the entire business cycle. This also ensures that the general government deficit is compatible with the rules of the European Stability and Growth Pact and with the requirements of a sustainable public finances.

3. Summary

The proposed new rule would be a big improvement over the provisions now in force. Its advantages are above all the following:

- **Intergenerational equity**: The state must not be strangled by interest burdens which increasingly narrow the room for manoeuvre. Therefore the basic principle of the new debt rule is the balanced budget.

- **In line with cyclical requirements**: The state must, however, remain able to act when we slip into a downturn or even into a recession. Therefore, the basic principle of a balanced budget must be supplemented by a rule which breathes with the business cycle. Under this rule, additional borrowing is allowed in a downturn, debt which then must automatically be paid off during the recovery.

- **Compatible with the Stability and Growth Pact**: The medium-term budgetary objective of the preventive arm of the Stability and Growth Pact limits the structural general government deficit for Germany to 0.5 % of GDP. The new debt rule incorporates this principle into a national scheme.

- **Stricter implementation of the budget**: Any deviations in the implementation of the budget from the budgetary planning which affect net borrowing will in future be recorded in a control account. If the deviations exceed a certain magnitude, it will be obligatory to take countermeasures.

- **Flexibility in exceptional situations**: Exceptions are allowed to deal with unanticipated occurrences and emergencies.