Releasing the brake: Germany's national fiscal rule no longer ensures compliance with European fiscal rules

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Abstract

This short paper highlights the role of the national fiscal rule, the so-called debt brake, for limiting Germany's general government deficit. It argues that Germany was only able to comply with the European deficit limit, after this rule has been introduced in 2011. However, due to the creation of large special budgets, the debt brake no longer ensures compliance with the European fiscal rules.

Keywords

Fiscal rules; medium-term budgetary objective; debt brake; special funds

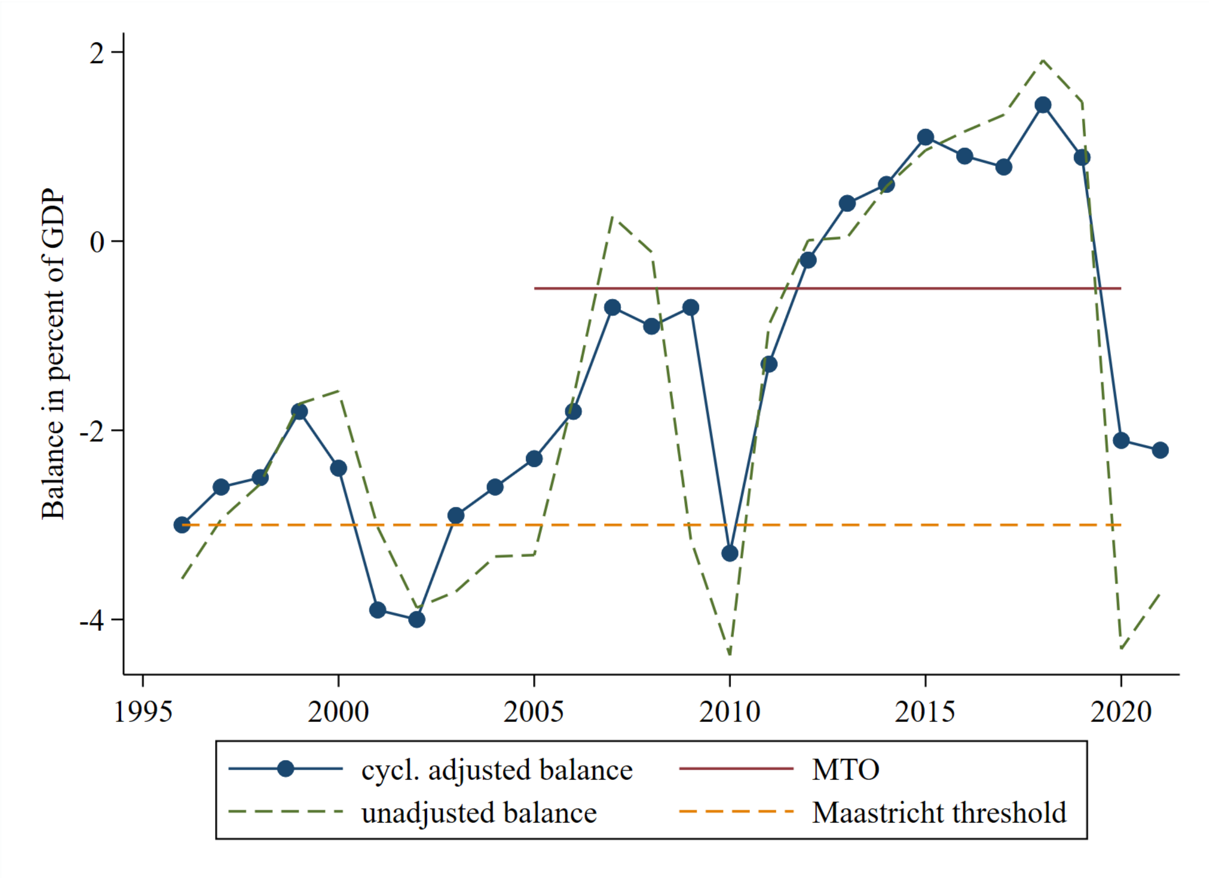
1. Germany's excessive general government deficits

For Germany and the other EU countries, ceilings for the general government deficit and the level of debt were agreed upon with the creation of the Euro. Specifically, it was determined that the deficit must not exceed a value of three percent of economic output. Setting a ceiling to the deficit was necessary to ensure the stability of the common currency, given the externalities that arise from the autonomy of the member countries in their fiscal policy.[1]

Figure 1 shows the general government fiscal balance for Germany for the years from 1996 until 2021. In 2001 and 2002 Germany failed to comply with the deficit limit. Subsequently, the Stability and Growth Pact was reformed.[2] Since 2005 the focus is no longer on the unadjusted fiscal balance, but on the "structural" fiscal balance, i.e. the fiscal balance after adjusting for business cycle effects and temporary measures. The key requirement is to ensure that the structural deficit is not exceeding the medium-term budgetary objective (MTO). For Germany the MTO has been defined as a structural deficit amounting to 0.5 percent of economic output (GDP). However, Germany exceeded this limit as well - even before the financial crisis hit the budget in 2010.

[1] For a discussion of the normative case for a deficit limit in the context of the creation of the Euro, e.g. Beetsma and Uhlig (1999), Chari and Kehoe (2007).
[2] For a discussion of the reform, see Schuknecht et al. (2011).

Figure 1: Germany's Fiscal Balance



The line marked with dots shows the cyclically adjusted general government fiscal balance for Germany in percent of economic output (GDP). The dashed line shows the unadjusted fiscal balance. Sources: European Commission, Cyclical Adjustment of Budget Balances, Spring 2020, and Advisory Board of the German Stability Council (2022).

2. Introduction of the debt brake

The continued difficulties in complying with European requirements have led to a comprehensive reform of national debt limits in Germany. In the year 2011, the constitutional restriction on borrowing in place since 1969, which proved ineffective, was replaced by the debt brake (*Schuldenbremse*). The aim was to ensure that Germany's general government deficit, which results from the financing decisions of numerous institutions, i.e. federal, state & local governments and the branches of social security, reaches the medium-term budgetary objective for Germany as a whole. Specifically, the debt brake stipulates that the federal government must have a structural deficit of no more than 0.35 percent. For the branches of social security balanced-budget rules apply. Since the municipalities are not taken into account and since special budgets of the Länder are exempted, an upper structural deficit limit of zero percent was enacted for the Länder.

The debt brake proved successful. Following its introduction in 2011, Germany met the upper deficit limit of the MTO in each year between 2012 until 2019. Moreover, on the eve of the Covid-19 crisis, the debt-to-GDP level was brought down to the Maastricht reference value of 60 percent.[3]

[3] Cf. Advisory Board of the Stability Council (2019).

3. Deficits in times of emergency

In the Covid-19 crisis, the requirement to meet the MTO has been temporarily suspended at the European level. While their budgets are still subject to the debt brake, Germany's federal and state governments have invoked the emergency clause under the debt brake and substantially increased borrowing. In view of the challenges associated with the epidemic and the measures to contain it, this was understandable. It is true that there were considerable reserves, at least at the federal level. As the Advisory Board of the Stability Council (2020) noted, retaining some of these reserves was reasonable in order to facilitate compliance with the debt brake ceiling when the emergency ends.[4]

However, German governments apparently saw the emergency rule of the debt brake as an opportunity to obtain more financial resources than were needed to fight the epidemic. This is already indicated by the magnitude of the deficits planned under the emergency rule. Under the impression of the first wave of the epidemic, in the spring of 2020, the Stability Council, the formally responsible oversight body for German fiscal policy, expected a general government deficit of about EUR 237 billion for the year 2020.[5] Ex post, i.e. two years later, the deficit in this year is calculated with EUR 145 billion - EUR 92 billion less. This discrepancy is not due to the forecast error of the cyclical deficit-component which amounts to around EUR 16 billion. In the second year of the Covid-19 epidemic the figures are even more striking. In spring of 2021, a deficit of EUR 286 billion was expected for the year 2021. The current estimate for this year's deficit amounts to around EUR 132 billion.

It is, of course, difficult to make an accurate estimate of the funds required to combat an epidemic. However, the decisions on the supplementary budgets implemented during the emergency already included funds for measures that are obviously not related to the fight against the epidemic. For example, in the second supplementary budget from June 2020, the federal government included EUR 26.2 billion for a special fund addressing energy policy and climate change.[6] In addition, when it became apparent that the substantial funds allocated in the budget were not needed, the borrowing authorizations were nevertheless used to create financial cushions. In particular, special budgets (*Sondervermögen*) were used. This refers to credit-financed funds outside of the budget. While European fiscal rules fully include these special budgets in the assessment of national fiscal policy, they are now effectively excluded from the German debt brake.

Debt-financed expenditures of special budgets were still counted toward the upper limit for the federal government's net borrowing under the debt brake until 2021. In order to gain more leeway, however, the current federal government has changed the accounting rules in January 2022.[7] As a result, the German federal government can now use the special funds for credit-financed spending, bypassing the debt brake. This explains why the German federal

[4] Cf. Advisory Board of the Stability Council (2020).

[5] This estimate assumed a very sharp economic contraction. Thus, the cyclical effect on the balance was estimated at around EUR 93 billion. Excluding this effect, the cyclically adjusted deficit was expected to amount to EUR 144 billion.

[6] The misappropriation of funds has already been established by the courts. For example, constitutional courts in Hesse and Rhineland-Palatinate found that emergency loans had been used for other purposes.

[7] Under the new accounting rules, outflows from special budgets are no longer considered under the debt brake, cf. Advisory Board of the Stability Council (2021).

government could now propose to setup a 100 billion debt-financed program to upgrade the armed forced (*Bundeswehr*) without resorting to the emergency clause of the debt brake.

The order of magnitude of debt-financed funds available in special budgets is considerable. The federal government alone has currently created funds of around five percent of GDP in special budgets and reserves outside the framework of the debt brake (Advisory Board of the Stability Council, 2022). The volume is thus 10 times the general government deficit limit implied by the MTO.

4. Conclusion

Due to the creation of special budgets and reserves, the debt brake no longer ensures Germany's compliance with the European fiscal rules. Even if the upper deficit limit of the debt brake is complied with by the federal government and all the Länder, the structural general government deficit may significantly exceed the medium-term budgetary objective. As a result, the task of the Stability Council will become more difficult in the future: If the general deficit exceeds the threshold, the federal and state governments must reach a political agreement on who will undertake consolidation measures and then ensure compliance with the agreement.

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