



The New Constitutional Deficit Rule for Germany

A New Model Governing Deficit and Debt ?

Presentation at the Institute for Government

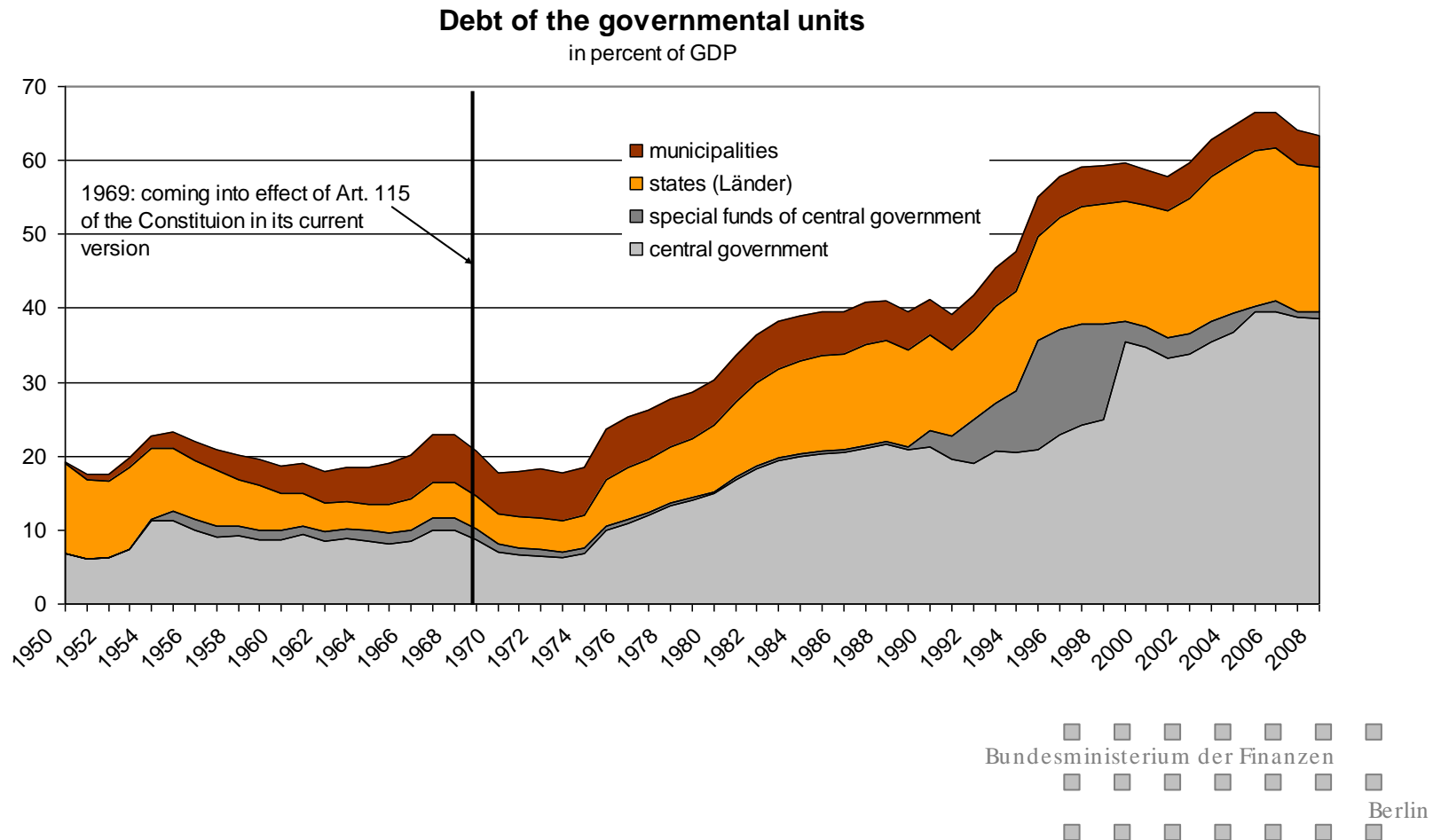
Dr. Christian Kastrop

London, 30 November 2009

Context and **Reasons** for the Reform

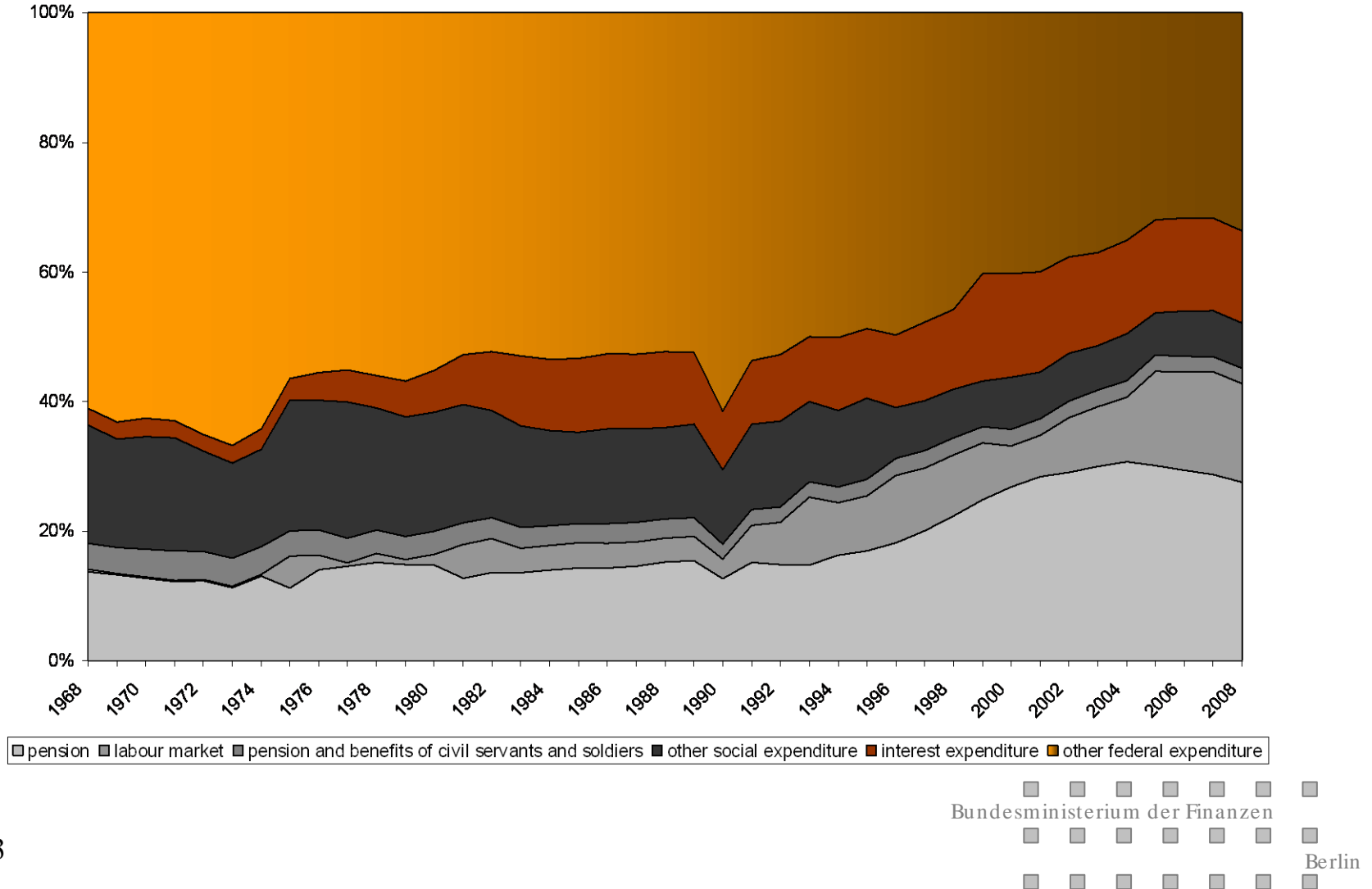
Unsustainable development of public finances ...

...partly due to the shortcomings of the current budget rule



Context and **Reasons** for the Reform

Erosion of the expenditure structure (federal budget)



Context and Reasons for the Reform

- Economic and political background
 - ⇒ Euro zone / globalisation / ageing / climate change
- Growing European and international debate on fiscal rules
 - ⇒ Swiss Debt Brake (2003 / 2007)
 - aims at structurally balanced budget by cyclically adjusted expenditure ceiling
 - corrections of future targets for past deviations from projected fiscal balances
 - ⇒ Reform of the SGP (2005)
- National reform debate (e. g. Federal Constitutional Court decisions)
 - ⇒ broad political and scientific consensus on flaws of the current budget rule
- Grand Coalition (2005)
 - ⇒ had the majority to change the constitution
 - ⇒ Decision to start federalism reform II as a result of the federalism-reform-I-compromise

New joint debt rule as centrepiece of federalism reform II

Art. 109 GG

- guarantees the independence of Federation's and States' fiscal policies
 - commits Federation and States to fulfill SGP obligations jointly
- ⇒ **Revision of Art. 109 to get a joint reform of the budget rules**

Art. 115 GG

⇒ **Revision of Art. 115 to reform the federal budget rule**

closely tied with:

- **assistance for budget consolidation to individual Länder** (Art 143d GG)
- establishment of a “**stability council**” (Art 109a GG)

➤ politically unrealistic issues (a reform of the fiscal equalization system or greater tax autonomy for the Länder) were put off the agenda right from the start.

Context and Reasons for the Reform

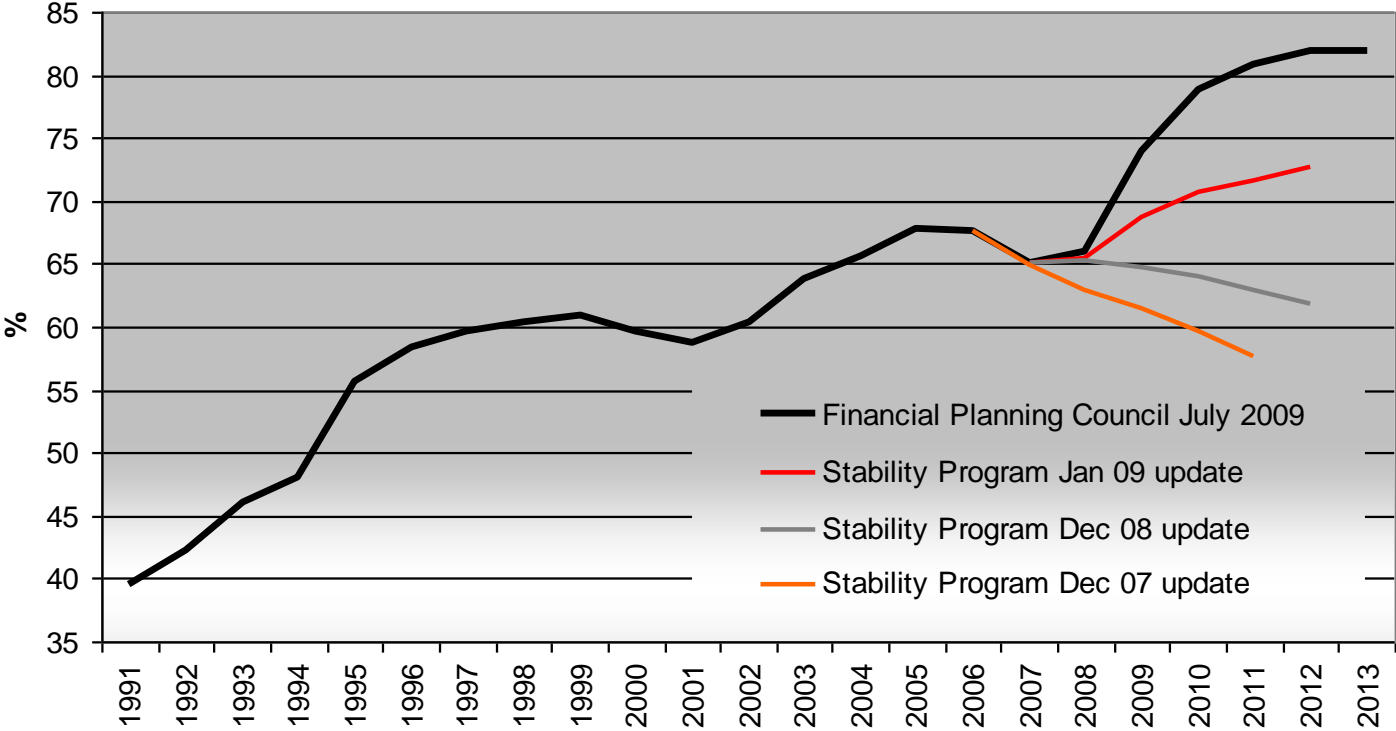


The New Budget Rule

- Core elements
 - overall limitation of the **structural public deficits** (federation: 0,35 % of GDP; Länder: 0,0 % of GDP)
 - symmetrical **stabilization** over the business cycle
 - ⇒ if cyclical component is foreseen
 - ⇒ federal rule: cyclical adjustment analogous to SGP
 - **enforcement** (federation): ex post control of compliance is ensured (deviations from allowed limits during the execution of the budget will be put on a control account)
 - **exception** for natural disasters and emergency situations
 - ⇒ only possible with a binding amortisation plan
- Deficit rule will come into effect in 2011 with transitional periods for the federal level until 2015 and for the states until 2019, due to the point of departure (crisis)
- Constitutional status will ensure the credibility of the rule

German Budget Rule and Crisis

Forecasted development of debt ratio in the Maastricht definition
at different points in time



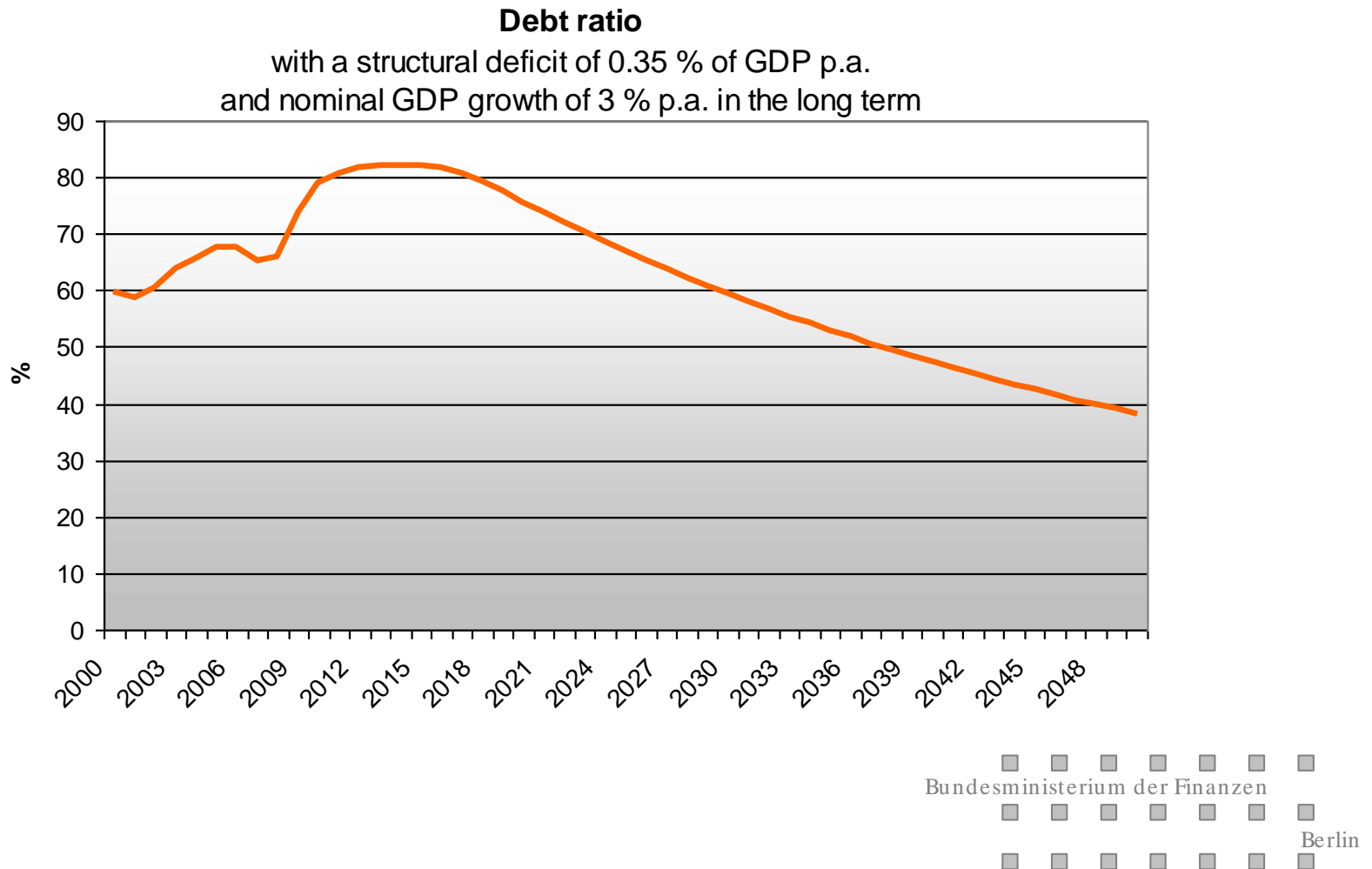
⇒ The new budget rule constitutes the framework for the German exit strategy



Compatibility with SGP:

- limited structural deficit: 0,35 % of GDP → **binding MTO** at the national level
- sufficient scope for **automatic stabilizers** to take full effect (3% deficit criterion guaranteed in conventional downturns)
- correction of fiscal balances for **financial transactions** (e.g. one-off-measures)
- cyclical adjustment according to **production function approach** (estimation of output gaps as for SGP)
- reduction of public debt in relation to GDP → consistent with 2005 reform of SGP: aim of **debt sustainability!**

reduction of public debt in relation to GDP



- Reform of budget rules will have a strong impact on future reforms of fiscal federalism in Germany
 - ⇒ German fiscal equalization system has to be reformed by 2019 at the latest / Solidarity Pact II
 - ⇒ maybe leading to greater (tax) autonomy for the Länder
- Reform of the budget rules might trigger further institutional changes (e. g. strengthening the role of finance ministries)
- Formalising the preventive arm of SGP on the national level the rule could work to strengthen the European fiscal framework
- German budget rule as a role model for other countries?



Annex

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Criteria and Proposals for a New Rule

Economic and fiscal comparison: **deficit** vs. **spending rules**

Criteria	Deficit rules	Spending rules
Compatibility with SGP	yes ; simplicity and straightforward monitoring	more difficult without explicit budget/deficit target
Reduction of deficit bias	direct (positive) effect	indirect effect (also depending on tax development)
Macroeconomic stabilization	cyclically adjusted balance rules: risk of procyclical bias is low	maximum counter-cyclical contribution: rules defined in nominal terms and cyclically sensitive items excluded
Sustainability	fixed anchor if budget target is compatible with SGP-MTO	binding character often loosens in the political process
Quality	dependent on the treatment of productive items (e. g. public investment , human capital ?)	positive in case of multiannual perspective and strict prioritization

Criteria and Proposals for a New Rule

- 2 proposals for a new deficit rule
 - ⇒ SGP-consistent budget rule (the „winner model“)
 - ⇒ budget rule similar to Swiss model but with net investment concept (proposed by the German Council of Economic Experts - CEE)
- CEE-model only partially compatible with SGP
- SGP-modell avoids problems in conjunction with investment concept
 - ⇒ conceptual flaws
 - ⇒ net investment difficult to implement (correct depreciation?)
 - ⇒ political discussion of investment could widen debt limit

New Budget Rule (Federation)

structural component

+/- balance of financial transactions

+/- cyclical component

- obligation to reduce debits of the control account
(when appropriate)

= maximum permissible net borrowing

New Budget Rule (Federation)

➤ structural component

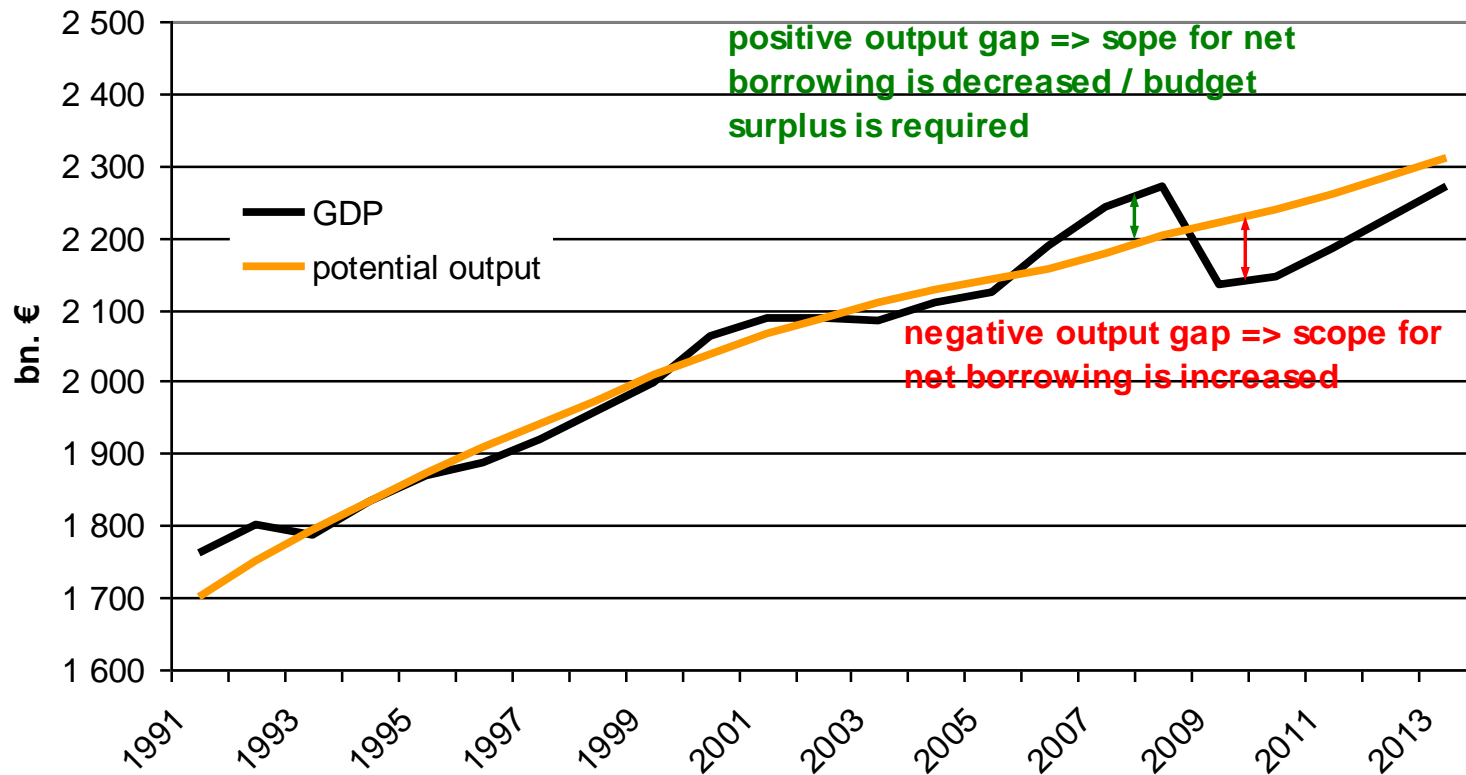
- max. 0.35 % of GDP (about € 8 ½ bn.)
- in principal balanced budget, but sufficient flexibility for one-off effects of reforms
- should also serve as a buffer with respect to uncertainties when calculating the cyclical component

➤ correction for net financial transactions

- ⇒ privatization gains can no longer be used to comply with the budget rule
- ⇒ granting of loans does not enlarge structural deficit

New Budget Rule (Federation) : Cyclical Component

cyclical adjustment according to production function approach

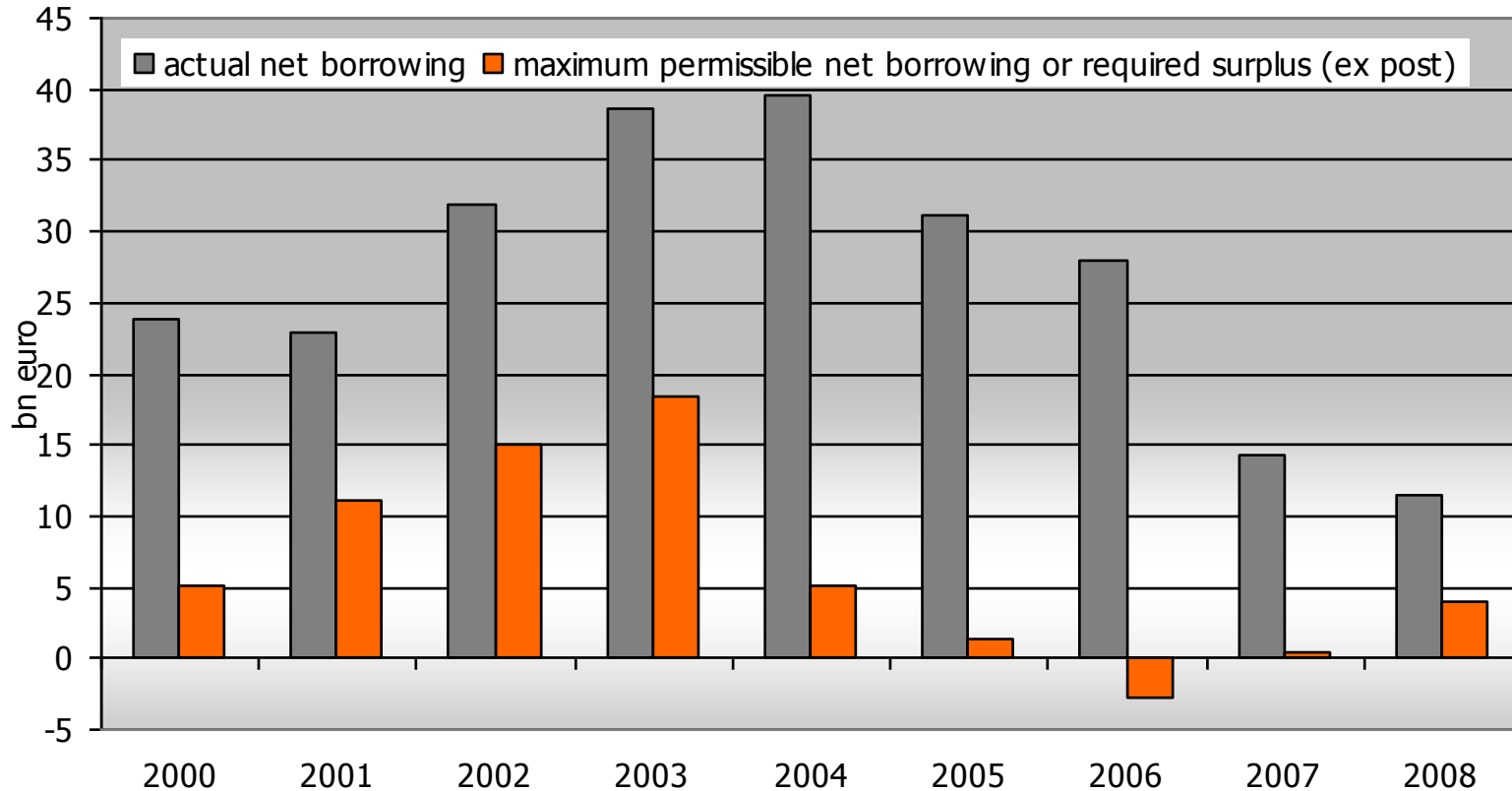


New Budget Rule (Federation) : **Control Account**

- need for monitoring and setting incentives not only for the formulation but also for the execution of the budget
 - ⇒ ex post control of compliance
- structural deviations from the allowed limits in the execution of the budget will be put on a special account
- accumulation over the years
 - ⇒ if the debit side of the account exceeds a threshold of 1% of GDP consolidation measures have to be introduced (i. e structural component will be reduced; but no procyclicality)

New Budget Rule (Federation)

New budget rule places a substantial limit on the scope for net borrowing



German Budget Rule and SGP

SGP as the fiscal framework of the EMU aims at ensuring budgetary discipline through two main requirements:

- treaty requirement to avoid excessive deficits (3% deficit and 60% debt of GDP)
- requirement to achieve and maintain the medium-term budgetary objective (MTO)

MTO: generally “close to balance or in surplus” in structural terms, i.e. net of cyclical or other temporary effects

→ provisions of the **preventive arm**:

- annual Member States Stability and Convergence Programmes
- two policy instruments: policy advice and early warning (Council and Commission)

Reform of SGP (2005) stresses the importance of **sustainability** under the provisions of the **preventive arm**

➔ country specific MTOs (within a range of “close to balance or in surplus”) including the need to deal with implicit liabilities and demographic challenges

➔ information on sustainability is part of Member States Stability and Convergence Programs (Code of Conduct)

Conceptual Framework

The new budget rule: The **core** of our “**Quality**”- concept

Goal: Long-term economic growth

expenditures

- shift resources towards growth stimulating areas (e.g. R&D, education)
- increase effectiveness and efficiency of public spending

institutions

- fiscal rules
- budget procedure
- accounting and performance information

revenues

- growth oriented design of tax systems (incentives to work and invest)
- broaden the tax base, lower rates if possible

The new **constitutional** budget rule enforces

- an **immediate** rearrangement of the budget process
- more **gradual** adjustments in the medium and long term (expenditure and revenue system, institutional reforms)

Implications for Budgetary Procedure

budget preparation

➤ Strengthening of **government** competences

- ⇒ calculation of fixed annual net borrowing (structural and cyclical component; manipulation considerably reduced in comparison to “Golden Rule”)
- ⇒ finance minister with chancellor’s support: define guidelines (or expenditure ceilings) regarding expenditure categories

➤ Modified role of **parliament**

- ⇒ budget committee may decide on additional spending
- ⇒ but need for shifting between or within the categories if limit (0,35; 0,0) is reached

→ problems of implementation (complexity, transparency)

→ ”creative budgeting” still possible, but would be sanctioned via control account

Implications for Budgetary Procedure

budget preparation

- Consolidation pressure in a **top-down**-budgeting process:
 - ⇒ expenditure control, strict **prioritization**
 - ⇒ growing interest in quality and effectiveness of public spending:
Inputs (spending) → **Outputs** (performance)

- Link to further **budgeting reform**:
 - ⇒ stronger focus on **performance** and efficient use of **resources**
 - ⇒ **budgetary product**: new basis on which spending is legally authorized
 - ⇒ expected effect: **budgetary control** over **broader** areas of work (instead of single expenditure items)

Implications for Budgetary Procedure

budget execution

➤ New **control and sanction** mechanism

(federation – no explicit rule for the Länder)

⇒ **budget preparation** and **execution** are **linked** for the first time!

- **control account** acts as a “memory and buffer” if non-compliance with the rule is established ex post
- documentation of **non-cyclical deviations** from the general threshold that arise during implementation of the budget
- Basic Law: negative balance on the control account exceeds a **threshold of 1.5 %** of GDP → **reduction of excess** required
- ordinary law: Structural deficit will be reduced if the debit side of the control account exceeds a **threshold of 1.0 %** of GDP; but only in upswing

➤ **Supplements to the budget plan**

➤ recalculation of the cyclical component

⇒ update only of GDP, not of potential output

➤ additional scope for net borrowing up to 3 % of tax revenue (as estimated in the budget plan)

⇒ booked on the control account (depending on outcome ex post)

➤ no additional scope for “new measures”

The new budget rule constitutes the **framework** for the **German exit strategy**

- binding annual reduction of the **structural deficit** (federal budget 2010) during the transitional period (**Basic Law**: maximum leeway **0,35 % of GDP** from 2016 onwards):
 - strict monitoring and unwinding of the stabilizing discretionary measures: **timely, targeted, temporary...?**
 - funds due to the **crisis** → obligation to redemption
 - stringent **expenditure discipline**: nominal expenditure cuts from 2011 onwards (medium-term finance plan 2009-13)
 - generally: **expenditure path** well below nominal GDP-growth
 - no **tax cuts** possible without **additional significant consolidation efforts**
- compliance with consolidation path: key **contribution** to a restoration of confidence in **sound public finances!**

Demographic Challenges

EU Ageing Report 2009 (projection for Germany):

overall **increase of age-related expenditure** (pensions, health and long-term care, unemployment benefits, education) by **4,8 %** of GDP from **2007 to 2060**

- Long-term compliance with **limited structural debt** component
 - prevention of excessive contribution increases → need for a far-reaching political strategy combining **social security** and **structural reforms**
 - continuous **monitoring** of age-related expenditure paths and sustainability gaps
 - protection of an **efficient** and sustainable **revenue system**
 - periodical **sustainability reporting**: reform progress or “roll back”?

Demographic Challenges

- Positive **impact** of compliance
 - sufficient **primary surpluses** are **ensured**
 - sustainable **retrenchment** of the **debt ratio** and **relative interest charge**
- Long-term **reduction** of the relative **interest charge**
 - for compliance with 0,35 % - limit: necessary **primary surplus** can be **reduced** gradually
 - leeway for **financing** remaining **age-related expenditure** and future **growth-oriented expenditure increases**

The constitutional budget rule: A binding **national stability pact**

- **Common responsibility of federation and states for European obligations (Stability and Growth Pact)**
 - structural deficit limits at the federal and state level → compliance with national **Medium-Term-Objective (MTO)**
 - **stability council**: improved budgetary surveillance (individual reports based on common assumptions, agreement on specific **consolidation programs**)
 - deviations from structural balanced budgets → **clear identification of accountability**

The constitutional budget rule: A binding **national stability pact**

- **Increasing** territorial authorities' **individual** responsibility
 - **states**: structural balanced budgets → abolition of deficit autonomy
→ implementation of **greater tax autonomy** necessary?
 - **reform pressure**: revision of governmental functions, strengthening of economic incentives
 - changes in the **fiscal equalization system** possible after **2019**
 - phase-out of **Solidarity Pact II** at the same time