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Jan Priewe

European Fiscal Rules and the German Debt Brake – Reform Options

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About the author

Jan Priewe was Professor of Economics at the HTW Berlin University of Applied Sciences until 2014, and Senior Research Fellow at the Macroeconomic Policy Institute of the Hans Böckler Foundation from 2014 to 2020. He is specialised in the fields of macroeconomics, fiscal policy and development economics. In recent years, he has published extensively on reforms in the Eurozone.

Responsible for this publication at the FES

Markus Schreyer, Advisor for Economic and Financial Policy and for European Economic and Financial Policy in the Friedrich-Ebert-Stiftung's Analysis, Planning and Consulting Division.

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FOREWORD

The political, economic and social development in Germany and Europe are currently marked by several crises, the management of which also poses great challenges for fiscal policy. The focus is currently on surmounting the Corona pandemic, dealing with the consequences of the war in Ukraine and the fight against climate change, all of which go hand in hand with massive public financing demands – e.g. for comprehensive economic and social policy stabilisation and economic stimulus measures, for public investments to accelerate necessary structural transformation processes or also for measures to nurture and strengthen resilience in a variety of policy areas. The unanimous view is that these public tasks cannot be adequately performed without public borrowing and a steeper increase in public debt. As a consequence, applicable fiscal rules – the debt brake in Germany and the Stability and Growth Pact at the European level – have been temporarily suspended from 2020 onwards by means of using an escape clause in order to provide Germany and the EU Member States with greater fiscal policy latitude, especially to better combat the Corona pandemic. At the European level, a new type of debt-financed anti-crisis fund was also created in 2020 with the Next Generation EU Programme, which is also being used to pursue both economic support measures and transformative goals in Europe.

The fact that there was a willingness on the part of policymakers in Germany and Europe to suspend current fiscal rules at the beginning of 2020 was probably due not only to the particularly great challenges posed by the Corona pandemic, but also to an increasingly widespread realisation that fiscal policy is of particular importance for stabilising the economy, shaping transformation processes and bolstering resilience. This volte face came about not least on the heels of negative experiences on the part of many EU Member States in the years following the outbreak of the global financial and economic crisis in 2008/2009 in connection with the application of fiscal rules. Although policy-makers in Germany and Europe also adopted extensive bank rescue and economic stimulus programmes to surmount the crisis, they decided as far back as 2010 to reduce the crisis-induced surge in public debt far too quickly in order to comply as quickly as possible with the fiscal rules, which had been tightened even further at the time. The rapid swing towards a pronounced austerity policy consequently led to a new recession in the Eurozone in the years 2011 to 2013, bringing monetary union to the brink of collapse, ultimately only being prevented by massive intervention on the part of the European Central Bank (ECB), which took conventional as well as unconventional monetary policy measures.

Only when fiscal policy was relaxed somewhat once again beginning in 2014/2015 – as a result of a more flexible interpretation of applicable European fiscal rules by the EU Commission – did an economic upswing take shape in the Eurozone in combination with the expansive monetary policy of the European Central Bank, an upswing which nonetheless remained feeble in many Member States. Looking back, the 2010s are hence considered to be a lost decade due to disappointing economic development in Europe, including in international comparison, all the more so due to the fact that many countries also failed to significantly reduce their national debt levels. Thanks to high current account surpluses, Germany had far fewer problems complying with the rules of the Stability and Growth Pact (SGP) and the cap on the debt-GDP-ratio and was able to markedly reduce the public debt ratio. This was only achieved at the price of extremely weak public investment, however, as was reflected in the decade following 2010 in the form of a widening public investment gap, especially at the level of the German “Länder” and municipalities, with all the associated problems this portended.

Even in the years before the outbreak of the Corona pandemic, these developments considerably fuelled the debate over whether and how the fiscal rules should be reformed in Germany and Europe. This discussion has continued down to the present day. In the opinion of a large number of experts, current European fiscal rules are too intransparent and complex, while at the same time they are not binding enough or effective enough, especially when it comes to achieving the aim of reducing national debt. Moreover, these rules are held to be excessively hostile to investment and procyclical, ultimately too rigid as well and not sufficiently aligned with the individual needs of individual EU Member States, thereby exacerbating economic divergences within the Eurozone. Not least for this reason, many experts warn against putting the European fiscal rules back into force in unchanged form beginning in 2024. Veering prematurely in the direction of a more restrictive fiscal policy would not only undermine economic recovery in Europe – there would also be a danger of EU Member States not being able to carry out necessary public investments in coming years – for example in the areas of infrastructure, health, education, climate, digitalisation and defence – due to lack of sufficient fiscal latitude, especially given that financial aid under the Next Generation EU programme is also scheduled to terminate at the end of 2026.

The overwhelming majority of experts are now calling for a reform of the European fiscal rules. Many reform proposals have accordingly been developed and presented in recent years. Because similar weaknesses and deficits are ascribed to the German debt brake ("Schuldenbremse"), many experts also argue that it needs to be reformed. Although reform proposals have also been forwarded in this connection, the discussion surrounding reform of the debt brake in Germany has in recent months come to a grinding halt for the time being, not least as a result of the fiscal policy decision by the new "traffic light" coalition (i.e. made up of the SPD, FDP and Greens) to leave the debt brake intact in the new legislative period and to manage major upcoming challenges by using "innovative" financing methods. The measures adopted by the "traffic light" coalition, however, such as the establishment of public funds or special assets or increased use of public investment companies, are considered by many experts to lack transparency, to be extremely unreliable and, in the long term, to be insufficient and unsustainable. Since fiscal challenges in Germany will not diminish in coming years, the debate over a reform of the German debt brake is likely to return to the agenda soon, especially if tax hikes are rejected in the future.

Against this background, the Friedrich-Ebert-Stiftung commissioned Prof. Dr. Jan Priewe, former professor of economics at HTW Berlin – University of Applied Sciences, to carry out research on this topic. The aim was to analyse how the fiscal policy framework in Europe and Germany could be most effectively reformed so that fiscal policy in the EU Member States, especially in the Eurozone as well, is equipped to meet current and future challenges better than in the past while at the same time ensuring the sustainability of fiscal policy over the long haul. Based on the weaknesses identified in the current fiscal rules as well as the question of why and for what purpose European fiscal rules are necessary in the first place and how these relate to national fiscal rules, the study was to analyse in more detail in particular several prominent reform proposals regarding the European Stability and Growth Pact and for the German debt brake and to compare these proposals with each other. The objective was not only to look at their respective strengths in comparison to the fiscal rules that have been in force to date, but also to explore their weaknesses and deficits, if such indeed exist.

This study presented offers an array of facts to demonstrate that many, although not all, of the reform proposals for European fiscal rules would enable significant progress to be made compared to sticking to the status quo. In spite of all the improvements possible, however, according to the author, the proposals also in part display weaknesses that need to be taken into account in the ongoing political debate and, ultimately, in policy decisions. Above all, the new fiscal rules must not lead to a new austerity policy in many EU Member States due to the intended reduction of high national debt levels. The necessary consolidation of public finance, it is argued, should instead be achieved primarily through positive growth effects. Hence, reform proposals that offer EU Member States as much fiscal leeway as possible while taking the macroeconomic framework into account are preferable. Sound and sustainable public finance also requires that national fiscal policies be buttressed by European monetary policy, especially by the European Central Bank exercising its lender-of-last-resort function, as well as the creation of permanent fiscal capacities at the European level in order to expand fiscal policy latitude in this manner as well. Looking at Germany, the author also recommends a reform of the debt brake, which he believes should use reform of the European fiscal rules as an orientational framework, not only to increase the discretionary scope of fiscal policy in this country, but also to avoid inconsistencies between German and European arrangements, or also to permanently preclude an overly restrictive fiscal policy in Germany, which can lead to macroeconomic imbalances with negative consequences for Europe and the rest of the world.

Fiscal policy plays a crucial role in trajectories of growth, prosperity and the quality of life in an economy. This is one of the reasons why this study calls for a substantial reform of European and German fiscal rules. At present, reform of the Stability and Growth Pact is particularly urgent and crucial. It is therefore to be hoped that the debate over the future of the European fiscal rules and the associated question of reducing national debt will be less ideological and that political decision-makers in Europe – especially against the background of current challenges – can get together and agree on an effective and appropriate reform package. This study seeks to contribute to this.

In this text, recent developments in 2022 were included, but the manuscript had to be concluded in mid October 2022. Apart from the updates and the inclusion of two additional recent reform proposals for the EU fiscal rules, this publication is a translation of the German version published in May 2022 as FES diskurs.

We hope that readers enjoy this study and find it interesting and insightful!

Markus Schreyer
Analysis, Planning and Consulting Division
Friedrich-Ebert-Stiftung

SUMMARY

The study explores the following five questions: (1) How should sharply higher debt levels characterising about half of the Member States be dealt with after the derogation activated in the EU's Stability and Growth Pact (SGP) has ended? (2) What are the consequences of low interest rates in the EU for fiscal policy and the relationship between monetary and fiscal policy? (3) Should the ratio of tax and credit financing in government spending, especially in public investment, be altered in view of high pent-up demand and future needs? (4) How can fiscal policy in the EU be made more counter-cyclical? (5) Is a new EU fiscal capacity needed after the termination of the Next Generation EU programme? Since the EU fiscal rules, summed up in the SGP, are closely related to the debt brake laid down in the German Basic Law as well as the planned credit financing of public investment through subsidiary budgets in Germany, both sets of problems are discussed in this same context. The study analyses twelve reform proposals for the SGP – including a brief proposal of the German coalition government from August 2022 – and several reform proposals for the debt brake. The proposals are discussed, compared and conclusions drawn.

There are three groups of proposals for EU reforms. Some actors would like to return to the old rules, streamline them somewhat and institute measures to ensure better enforcement. A second group of actors would like to measure the cyclical component of budget balances, and hence, indirectly, structural components, differently by substituting an expenditure rule for the measurement of potential output to date; furthermore, this group wants to institute a Golden Rule to allow greater debt financing of public investment; furthermore, it is argued that the ceiling for government debt should be raised or, as an alternative, the period for debt reduction to 60 per cent of gross domestic product should be extended to up to 50 years. The third group, which the author favours, would like to change the yardstick for sustainable government debt by applying the interest burden ratio (interest payments on government debt) instead of the gross debt ratio, the limits for which should be set on a country-by-country basis over the medium term. This creates greater fiscal breathing space that can be changed in a flexible manner. On top of this, it is argued that a spending rule should also be devised for the cyclical component. Some proposals are in favour of an amendment to Protocol 12 to the Treaty on the Functioning of the EU (TFEU) in the so-called simplified procedure, while others lean more towards reforms below the threshold of treaty amendments. Four proposals advocate the creation of a central European fiscal capacity, which would require amendment of the Treaties.

Criticism of the German debt brake can be heard frequently, but the obstacles to amending the Basic Law are formidable. Nonetheless, the implementing law (the so-called "Article 115 Law") stipulates that the way the cyclical component is calculated can be changed by simple majority vote. Otherwise, only credit financing via special off-budget funds and state-owned enterprises remains as a second-best alternative as long as tax increases and spending cuts are precluded. If substantial reform of the SGP is carried out, which this study would welcome, sooner or later German fiscal rules including the debt brake will also have to be adjusted. ←

1
TWIN RULES AND TWIN REFORMS

The debt brake ("Schuldenbremse") laid down in Articles 109 and 115 of the German Basic Law (GG) has formed the bedrock of German fiscal policy since 2009. The amendment to the Basic Law came about two years before the EU Fiscal Compact, which was concluded as an international treaty outside EU law by almost all the EU countries – upon Germany's initiative. The so-called Six-Pack was adopted at the same time, i.e. five EU regulations and one directive tightening up the Stability and Growth Pact (SGP) in comparison to its predecessor, and is still in force today. The German debt brake and the SGP are closely related; indeed, they are twin rules: one laid down in the constitution (the German Basic Law) of the largest and most influential EU Member State, the other one set out in EU secondary law, but linked to primary law, namely the Treaty on the Functioning of the EU (TFEU). The debt brake and EU regulatory frameworks nevertheless differ significantly in some respects. They are not identical twins. Any change in Germany will have consequences for EU law and vice versa.

Both rules are difficult to change – the debt brake because it requires a two-thirds majority vote in the Bundestag and Bundesrat, while a SGP change requires a normal EU legislative procedure that affects European secondary legislation (usually requiring a qualified majority, i.e. 55 per cent of EU Member States representing 65 per cent of the EU population). Unanimity in the EU Council is required for any change in the reference values for budget deficits and debt ratios as laid down in Protocol 12 of the TFEU. If the reform is limited to the 19 Eurozone countries, the competent Eurozone Council decides this. If the four big countries with 75 per cent of the Eurozone's population concur, they can secure the required majority – provided that six more countries join them; so they always have a blocking minority. Any further-reaching treaty changes will face extremely tough going, however, given the required consent of all EU Member States, including a referendum in some countries.

Among the three traffic light parties (SPD, FDP and Greens) making up the governing coalition in Germany, one has advocated reforming the debt brake in its election platform (Greens), with one being vehemently in favour of retaining it (FDP), and one party (SPD) not even mentioning the issue in its election platform. At the EU level, the situation is different. Many countries, especially three of the four largest – France, Italy and Spain – advocate reform, but are opposed by a conservative alliance of a few smaller countries – above all Austria, Denmark and Sweden – after the Netherlands broke away from this group in the wake of a new government being formed. Germany has not yet adopted a clear position, besides a general statement issued in August 2022. If the SGP is changed, something will have to change in Germany as well. Whether and what changes ultimately take place also depends on the German position. It is probably sufficiently evident to everyone that greater discrepancies than hitherto between EU rules laid down in the SGP and provisions in German law would encourage other countries to do what they want. This is not in Germany's interest, nor is it in the interest of EU cohesion.

The current rules for European fiscal policy were established in the early 1990s, when completely different conditions prevailed compared to today – higher economic growth, higher inflation, higher interest rates, few Member States. The only reason these are still in existence today is that they are firmly enshrined in the EU Treaties, amendment of which requires unanimity. Even back at the time, the rules were controversial. The "hawks" prevailed with their prescription of balanced budgets, only being inclined to allow small deficits in exceptional cases when countries were in recession (cf. Priewe 2020, 2020b). Reality changed, however, upon the founding of the European Monetary Union (EMU). Some Member States entered the EMU with high debt levels, others with very low ones. The financial crisis of 2008/2009, triggered by high-risk private debt, caused sovereign debt to skyrocket; the turn to austerity from 2011 to 2013 led to a double-dip recession that brought EMU to the brink of collapse. Only the volte face by the European Central Bank (ECB) brought about an upswing, although it remained feeble in many countries. The EU only made it through the Covid-19 crisis thanks to a suspension of the rules by leveraging the emergency clause in the SGP. The return from emergency to normal is proving difficult, as it would translate into severe austerity from 2024 onwards if the rules remain unchanged – from one extreme to the other. Despite numerous reform proposals, a long-term orientation capable of gaining majority support is lacking.

Such an orientation must pay heed to the need for fiscal policy action. Five challenges are at the top of the political agenda:

1. How should high debt levels – not even close to 60 per cent of GDP – in about half of the EU Member States be dealt with?
2. What role should fiscal policy play in EMU if monetary policy can no longer provide an expansionary

impetus near the zero interest rate limit? And what happens if monetary policy tightens in the face of severe inflation? It is obvious that fiscal policy has a greater role to play in macroeconomic stabilisation than in the past. But how is this supposed to work in a monetary union that does not have an overarching state apparatus possessing fiscal authority and competences (to levy taxes, take on debt, with democratic decision-making competence based on "the-majority-decides" principle)?
3. What should the relationship between tax and debt financing look like in view of multiple reform backlogs in public investment, health policy, climate policy, digitalisation and defence as well? At what level do structural budget deficits make sense, regardless of the economic cycle? What criteria should we apply?
4. How can recessions be better combated in the EMU without stifling or dampening subsequent upswings?
5. Do we need a European "fiscal capacity" like the Next Generation EU (NGEU), which initially was merely conceived as an emergency solution as a result of the pandemic? What, then, is the relationship between central and national fiscal policy?

In view of a large government sector with tax and levy ratios of 40 to over 50 per cent of GDP in the EU Member States, the financial bearing of the state plays a major role, on the one hand in terms of economic stability, on the other in terms of the quality of life of its citizens.

The next section first posits the question of why and to what end we need European fiscal rules in the first place and how these relate to national rules. The issue at stake is the lack of balance between monetary and fiscal policy in the construction of EMU. The answer to these questions essentially shapes the requirements that are to apply to any reforms. Following this, the legal scope available is explored. Against the background of how relevant variables develop empirically over time, various proposals for a reform of European rules are first presented and discussed (including a proposal by the author). The same procedure is then applied with regard to the debt brake in Germany. Reform of the German debt brake remains on the agenda even if it would not obtain parliamentary majorities at present, especially since it is by no means certain that the debt brake as well as the extensive financing of state tasks using techniques outside core budgets is in conformity with European law. ←

2
WHY DO WE NEED COMMON FISCAL RULES FOR THE EMU?

Leaving aside the five fiscal policy challenges for the moment, there are some special features inherent in the design of the EMU that distinguish EU Member States from countries with their own currency and which also have implications for monetary and fiscal policy. The EMU is designed to have a single monetary policy for a heterogeneous structure of Member States, but no central fiscal policy, all the more so because there is no central government. This means that the EMU has a greatly constrained steering capacity when it comes to economic policy, which every larger nation-state with its own currency wields. This problem is exacerbated by the fact that the ECB – in its capacity as the only supranational steering institution – does not perform any lender-of-last-resort function with regard to government bonds, i.e. in an emergency it can neither buy bonds of Member States directly on the primary market, nor indirectly – regarding specific countries – on the secondary market[1] or refinance national banks whose states are in danger of losing access to capital markets as a result of high-risk premiums on interest rates for government bonds (cf. BIS 2014)[2].

Because such risks exist, there are country-specific risk premiums between member countries which can skyrocket in critical situations. Exit risks then arise, which countries with their own currency do not have to face and which entail contagion risks for other countries in the EMU while also impairing the impact of a single monetary policy. Initiatives in the direction of a common capital market exist in the EU, but there are no schemes for a common bond market. The ECB may only intervene in secondary markets and is obliged in principle to treat all countries equally. If, however, all member countries want to demonstrate their creditworthiness to financial markets through a restrictive fiscal policy – reducing debt levels, lower budget deficits or increase surpluses – then fiscal policy in the EMU as a whole will be skewed along a restrictive gradient. The ECB can mitigate this by keeping key interest rates low, but this in turn can have negative side-effects – just like with the zero interest rate policy (e.g. rising real estate prices, rising share prices up to the point of bubbles forming, negative impact on savers holding low-risk securities or simply saving accounts).

Moreover, exchange rate adjustments are no longer possible in the EMU, although higher or lower national unit labour costs can lead to appreciation or depreciation in real terms. This causes considerable mischief, especially in countries with negative current accounts (for instance, problems like sluggish domestic demand when wages are lowered), which means that fiscal policy often has to compensate by running higher deficits. Considerable imbalances are the result, especially since the stronger countries want to avoid real appreciation by means of unit labour cost increases. These disincentives could be alleviated by some sort of supranational wage coordination, or by fiscal transfers between Member States, but the EMU has not yet produced any viable institutional solutions allowing this to happen. Wage coordination in the EU or the EMU is considered taboo de facto.

Both problem zones – lack of a lender of last resort, no viable substitute for exchange rate adjustments – drag down growth and employment and hamper the desired convergence of member countries in terms of per capita income. Fiscal policy needs to react to this in an appropriate manner. In the absence of any central fiscal policy, it must be more expansionary at the member country level. The weaker countries with greater deficits must be given the opportunity to carry their old debt burden that they brought into the monetary union without losing fiscal latitude. The undervalued countries that consistently run a surplus would have to reduce these surpluses by means of expansive wage and fiscal policies and thus become growth engines in the EMU as a whole. If they do not want to or are unable do this, they should participate in some form of risk-sharing, i.e. assume the costs of risks in the EMU, or make financial transfers just like in a federal state. A reform of fiscal policy in the EMU that fails to address the flaws in its constitutive design will sooner or later lead to the next wave of reforms – in the wake of reform would loom the next reform.

The construction of the EMU places fiscal policy in the domain of national sovereignty of the Member States. At the same time, however, it is a matter of common interest – hence, national sovereignty is saddled with constraints. So central fiscal rules would have to set the framework, for example spell out red lines or employ precepts or rules. The fathers of the Maastricht Treaty saw

1 Primary market refers to the issue of government bonds, secondary market to purchases on the bond markets after issue. Intervention in secondary markets is – with some exceptions – only possible according to the capital key (share of the ECB's capital) for all Eurozone Member States. In extreme cases – such as during the pandemic – the ECB has deviated slightly from the capital key in bond purchases.

2 Some argue for a market-maker-of-last-resort function for central banks as a substitute (cf. BIS 2014, De Grauwe 2021) based on targeted secondary market interventions.

this right: No member country should cause harm to the community in the form of high inflation or national insolvency, which would harm the currency as a whole. This view is too narrow, however: deflation in a country is just as problematic as inflation; no developed industrialised country has experienced sovereign insolvency with its own currency since the end of the Second World War, although this has become possible again in the EMU (cf. the Greek crisis). There must be preventive means to ensure this does not happen, especially by averting high current account deficits and banking crises, but also by the central bank acting as lender of last resort for states – or by wielding resilient substitute mechanisms. However, the European Stability Mechanism (ESM) does not suffice for this. In a monetary union, responsibility also lies with the community as a whole. In other words, contractionary fiscal policy does not afford sufficient protection against sovereign insolvency crises, so the ECB must provide support to protect countries running high debts, and obligations must be imposed on the stronger countries, because they too can have damaging effects on the community if their domestic demand is dampened by excessive export surpluses and a contractionary fiscal policy.

The EU‘s current system of fiscal rules has rightly been criticised as being too complex. It sometimes interferes too much with the national sovereignty of the Member States, in other cases too little. There are too many levers and far too many rules, which often do not work in a coherent fashion with one another and tend to follow the notion of centralised fine-tuning. What is needed is a debt anchor that ensures sustainability of debt and one or two operational variables with which to set the limits for the general government balance (Eyraud et al. 2018). Furthermore, sanctions are needed when such rules are not respected. If this were laid down in European law, for example in the form of a directive, it would only require transposition into national law, but no specific national law. It would certainly not require – as in Germany, Luxembourg, Latvia and Hungary – a constitutional provision that is by and large so difficult to amend that transposition of possibly amended EU directives into national law would be extremely difficult, thus hindering European legislation.

If, on the other hand, it is primarily national fiscal rules that are desired, which can differ from one another, this would make European rules either superfluous or they would need to be limited to very general guidelines. In view of the tasks and problems outlined in the foregoing, the former option is probably the better one for the EU.

On 21 July 2022, the ECB Governing Council decided to use a new “Transmission Protection Instrument” (TPI), also called Anti-Fragmentation Policy. In case there are disorderly market dynamics not in line with fundamentals which lead to hikes in the interest rate spreads of specific Member States, and which hinder the transmission of monetary policy to all members, the ECB can purchase assets of the specific Member State to bring spreads down. This opens the door to country-specific asset purchases – which is a big step forward in a heterogenous monetary union. The measures require some kind of conditionality which has not yet been fully outlined (cf. ECB 2022). This is not a full lender-of-last-resort function of the ECB, but perhaps a light version of it. ←

3
THE LEGAL SCOPE FOR REFORM

The German debt brake was enshrined in the Basic Law (the German Constitution) in 2009 in Articles 109 and 115, adopted by a two-thirds majority vote of the Bundestag and Bundesrat and supplemented by a federal law, which was passed by a simple majority. It served as a sort of blueprint for reform of the SGP (initially adopted in 1997) in 2011 – in the wake of the first reform in 2005. Almost at the same time, it was followed by the European Fiscal Compact outside EU law in 2012.

As far as the European regulatory framework is concerned, there are basically four sets of rules that are not fully compatible with each other:

1. Article 126 of the TFEU with Protocol 12, which sets the “reference values” at three per cent of GDP for government budget deficits and 60 per cent of GDP for the government debt ratio; furthermore, the no-bail-out clause (Article 125 TFEU) and the ban against ECB purchases of government bonds in primary markets (Article 123 TFEU);
2. the SGP in EU secondary legislation;
3. the Macroeconomic Imbalances Procedure (MIP), which includes fiscal rules, and also secondary legislation (from 2011); these rules are a core component of the European Semester along with the budgetary policies of the Member States;
4. the European Fiscal Compact (“Treaty on Stability, Coordination and Governance in the Economic and Monetary Union”) of 2012.
5. Since 2015 a number of “flexibility clauses” have been added to the SGP by the EU-Commission easing under specified conditions and only temporarily the rules of the SGP for specific countries (EU-Commission 2015).

On top of these, there are two “instruction manuals” issued by the EU Commission – comprehensive manuals that are binding on implementation of the legal framework and which are updated at regular intervals (“Vade Mecum” of the SGP and “Codes of Conduct”).

Protocol 12 to the TFEU could be amended by the so-called simplified procedure under Article 48 of the TEU, i.e. unanimity in the Council of the EU followed by consent being provided by the parliaments of the Member States[3]. The SGP can be amended without any treaty amendment provided that Protocol 12 remains unchanged; provisions of the Fiscal Compact are not binding for European institutions. The Fiscal Compact is a sort of provisional arrangement; under the provisions of the Compact, it should have long since been transposed into European law.

Germany, Luxembourg, Latvia and Hungary are the only EU Member States that require a two-thirds majority in parliament (or in both chambers of parliament in Germany) to reform the national debt brake.

The much maligned complexity of rules in Europe is also related to the complex legal web. A fundamental reform is needed to render the rules more uniform and consistent. Otherwise, only minor reforms are possible, which might bring improvements, but will leave many problems unsolved.

Let us now take a cursory look at the current system of fiscal policy rules in the EU, leaving aside the rules contained in the corrective arm of the SGP (see Table 1). The key rules are the first three shown in the table. The first rule concerns the government budget deficit, which is not allowed to exceed three per cent of GDP (No. 1). It is set in a certain way for the state as a whole (general government) in the definition of system of national accounts (SNA in the variant “European System of Accounts” – ESA 2010), which also includes so-called extra budgets. The general government is broadly defined here, but so-called financial transactions are not included in the measurement of the deficit. According to the second central rule, general government gross debt may not exceed 60 per cent of GDP (No. 2). Gross debt is also defined very broadly, as it on the one hand includes debt resulting from financial transactions and valuation changes, but on the other hand excludes any form of government assets, including financial ones. This rule also makes reference to the definition of general government in national accounting. The third central rule relates to the structural deficit (No. 3), which is limited to 0.5 per cent of GDP for most member countries if the debt level is 60 per cent or somewhat lower. If it is higher, a higher medium-term structural budgetary objective (MTO) applies, which gradually approaches the 0.5 per cent target. The second key target, the debt ratio of 60 per cent, is to be achieved if higher than 60 per cent by employing the 1/20 rule (No. 5). For Italy – with its debt level of around 150 per cent – this would mean a debt-reduction path with annual reductions of 4.5 percentage points. This requires a high structural budget surplus, which would have to be achieved through budget cuts or tax increases.

3 The Treaty on the European Union (TEU) is the treaty establishing the EU concluded in Maastricht in 1992. It is often confused with the Treaty on the Functioning of the EU (TFEU).

Table 1: **The most important fiscal rules in the EU**

No.	Rule	Source
1	3 per cent ceiling for government budget deficits, as a per cent of GDP; sanctions for "excessive" deficits; delimitation of general government according to national accounts, interpreted by Eurostat; deficit without financial transactions	TFEU. Protocol 12 ESA 2010, Eurostat
2	60 per cent of GDP, upper limit for gross government debt, incl. uniform delimitation of the government sector as in #1; debt resulting from financial transactions is included in gross debt; national "debt caps" at 60 per cent, laid down in national law or in constitutions	TFEU. Protocol 12 TSCG, ESA 2010, Eurostat, national law
3	Maximum structural deficit of 0.5 per cent of GDP if debt is at or slightly below 60 per cent	TSCG, SGP
4	Maximum structural deficit of 1.0 per cent of GDP if debt is significantly below 60 per cent	TSCG, SGP
5	1/20 Rule: if debt > 60 per cent, the debt level minus 60 must be reduced by 5 per cent annually	TSCG, SGP
6	Country-specific medium-term budgetary objective (MTO), related to structural deficit, is determined by a matrix, depending on the output gap; if net borrowing is below the MTO, a step of at least 0.5 percentage points p. a. must be achieved	SGP
7	Primary government expenditure (corrected) must not increase faster than output (more slowly if the debt level exceeds 60 per cent) ("expenditure benchmark")	SGP
8	Measurement method for potential output determined by the EU Commission ("production factor approach")	SGP
9	Cyclical budget balances (without one-off revenues or expenditure) are permissible as automatic stabilisers; discretionary temporary stimulus is not permissible except in severe recessions	SGP
10	Procedural rules for the European Semester and the excessive deficit procedure	SGP
11	Derogations in the SGP relating to EU-funded investments and "structural reforms" as parts of "flexibility clauses"	SGP, EU Commission
12	Two default clauses temporarily suspending application of the SGP	TSCG, SGP
13	No-bail-out clause	TFEU
14	European Stability Mechanism (ESM), including country-specific support for countries without access to capital markets, tied to conditionality	Treaty on the ESM
15	Prohibition of direct state financing by the ECB with respect to primary markets (criteria laid down by the European Court of Justice)	TFEU
16	Requirements for collateral for refinancing banks defined by the ECB; at least "investment grade" by specified rating agencies	ECB
17	Binding guidelines for action by the EU Commission: "Vade Mecum" pursuant to the SGP and "Code of Conduct" for implementation of the SGP	EU Commission

Source: author's own compilation; without rules in the corrective arm of the SGP.

One key problem with the third central rule is the measurement of the structural budget balance, which together with the cyclically induced change of the budget balance yields the total budget balance. The cap of 0.5 per cent for the structural deficit results from the doctrine that in a normal cyclical situation – i.e. when production potential is fully utilised – a "nearly balanced" budget should apply. Cyclical increases and decreases in expenditure should then balance each other out over the course of the economic cycle, i.e. in a symmetrical fashion. If this were to be maintained over a longer period, the debt ratio in all member countries would converge at 33 per cent of GDP (if a structural deficit of one per cent is allowed), assuming a trend of real economic growth of 1.0 per cent and two per cent inflation. For this target value there is no reasonable economic justification – neither for the upper limit of 60 per cent, which happened to be the mean value in the EU Member States back at the beginning of the 1990s (cf. Priewe 2020).

Table 1 does not list the rules of the Macroeconomic Imbalances Procedure (MIP), although these overlap with those of the SGP on some points and were part of the package of reforms (the so-called Six-Pack) that led to the 2011 SGP. At the heart of the MIP is an annual scoreboard with 14 indicators including associated thresholds and which feature the debt ratio, the current account balance, private sector debt, unit labour cost developments and the international net asset position. These indicators reflect the fact that government debt can only be meaningfully interpreted in a broader context. Of particular importance is the current account balance (CAB), the critical threshold of which has been set by the EU Commission at minus four per cent and plus six per cent of GDP – asymmetrically to the benefit of surplus countries.

The current account balance is the sum of net lending/borrowing for the private sector (households and corporations) and for the government. With a constant private sector balance, an increase in the budget balance causes the

Table 2: **Debt brake and SGP in comparison**

	Debt brake laid down in the German Basic Law	SGP/EU rules
Sectoral demarcation	Federal government + off-budgets established since 2011, German Länder (partly with extra budgetary accounts)	All local authorities + social security funds, all extra budgetary accounts
Basis for measurement	Financial statistics	National Accounting (ESA 2010)
Budget balances	Net new debt structural deficit max. of 0.35 per cent at the federal level, 0 per cent at the Länder level	Net lending/borrowing cyclical deficit of a max. 3 per cent, structural deficit max. of 0.5 and 1.0 per cent, respectively
Financial transactions	Excluded from net lending/borrowing	Excluded from net lending/borrowing
Cyclical adjustment	No method prescribed in the Basic Law, method of the SGP in the implementing law; symmetry requirement for deficits and surpluses in the Basic Law.	Uniform cyclical adjustment method specified by EU Commission; no symmetry requirement
Deviation planning/implementation of the budget	Adjustment account, compensation beyond a threshold value	No arrangement
GDP for calculating the deficit ratio	At the federal level: GDP 2 years before the budget year	Expected GDP in the financial year
Debt cap	None	60 per cent of GDP, no adjustment for financial transactions (gross debt)
Deficits with the escape clause	Repayment in absolute amount with repayment schedule	No rules
Replenishment of reserves/funds	Treated as an expenditure (since 2022)	Treated as a financial transaction

Source: based on Rietzler 2021; own additions.

current account balance to rise – and vice versa (the U.S. current account deficit and the corresponding budget deficit are often referred to as "twin deficits", which are offset by "twin surpluses"). For many years, the EU Commission has been urging Germany to reduce its chronically high current account surplus of over six per cent by increasing public and private investment (e.g. EU Commission 2020). The German current account balance contributes considerably to the overall EU surplus. Although the EU Commission's warnings are regularly included in negotiations within the framework of the European Semester, these surpluses are not assessed as "excessive" even though they have often exceeded the threshold, so no formal proceedings are brought against Germany. In particular, high German budget surpluses in the general government budget in the years before the Covid-19 crisis fuelled the EU current account surplus.

The debt brake set out in the German Basic Law differs not insignificantly from European rules (cf. Table 2). A debt cap is not mentioned in the German debt brake, but EU rules also apply in Germany. For the structural deficit, a cap of 0.35 per cent of GDP is provided for the federal budget; for the German Länder, a structurally balanced budget applies. Municipalities and social security schemes are not covered by the debt brake. EU rules, on the other hand, apply to the entire state ("general government") as defined by the national accounts, i.e. to the federal government, the Länder, municipalities, social security schemes and their extra budgetary accounts, including special funds. These are accounted for (according to Eurostat) as part of the general government sector if they are controlled by the government, cover less than 50 per cent of their costs through sales revenue, or if more than 50 per cent of these costs are covered, but more than 80 per cent of this is through sales revenue to the "core government" and other extra budgetary accounts (Schmidt et al. 2017). The inclusion of extra budgetary accounts and special funds at the federal and Länder levels differs considerably from the EU criteria with regard to the German debt brake.

In principle, the German debt brake uses data from German fiscal statistics, which differ substantially from ESA 2010 with national accounting data. The budget balances in German fiscal statistics (total public budget) in the period 2012-2019, for example, are on average 0.5 percentage points lower than those in EU statistics for Germany, which means that the limits are stricter in Germany in this respect than with regard to the criteria set out in the SGP.[4] The German federal government applies the same cyclical adjustment procedure as the EU Commission, but individual German Länder can deviate (cf. Scholz 2021). In contrast to the SGP, the German debt brake contains a "control account" that is intended to balance frequently occurring deviations between target and actual balances in absolute amounts ("symmetrically"). The debt brake contains the same escape clauses as the EU rules, but emergency loans are required to be repaid in contrast to the possibility of a roll-over under EU rules. A roll-over of maturing government debt is normally the rule, both in Germany (outside the emergency clause) as well as in the other OECD countries. With a roll-over, debt is repaid by taking on new debt in the same amount. The debt brake's repayment rule is based on the notion that government debt should be repaid in absolute terms with budget surpluses; this clashes with the standard precept that what matters for government is the debt-to-GDP ratio, and not the absolute amount of government debt. The debt brake also deviates from the SGP in terms of other technical details that are not insignificant.

By limiting the structural deficit to 0.35 per cent of GDP and de facto prohibiting the Länder from borrowing, Germany is unable to use the one per cent option for the structural deficit under EU rules if the debt level is "significantly" below 60 per cent. The Basic Law thus tightens at this point the EU rule. With a nominal GDP growth trend of three per cent, an average deficit of 0.35 per cent converges to a debt level of eleven per cent – a level that is void of any rational justification.

Since the obstacles to an amendment of the Basic Law are high, there is little room for manoeuvre in the implementing law (Article 115 Law), which lays down important technical details regarding the debt brake and can be amended by a simple majority. The Länder also have some leeway, especially in the calculation of the cyclical component and repayment periods for Corona-related debt. ←

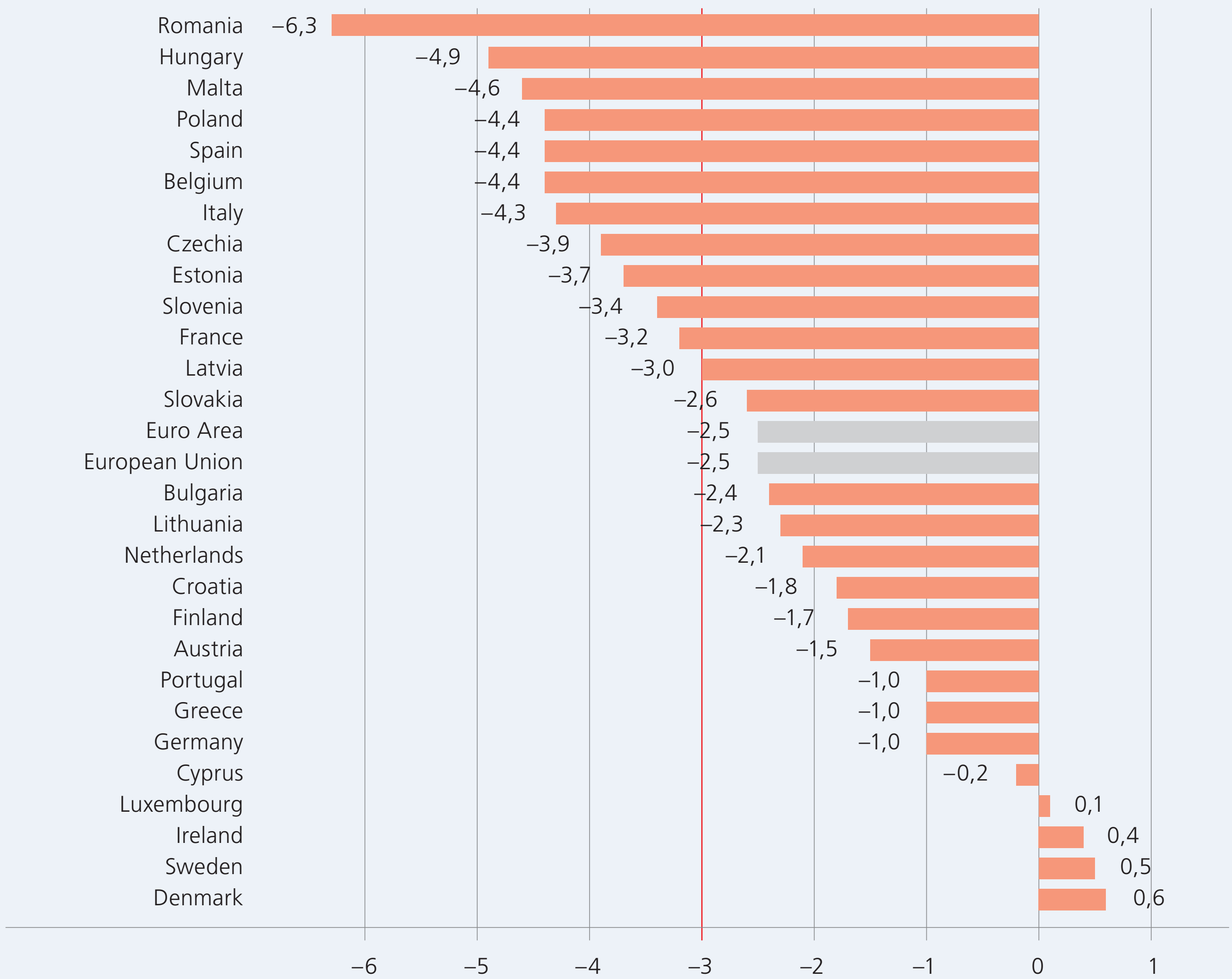
4 A zero deficit in EU statistics amounts to a deficit of 0.5 per cent in the German cameralistic financial statistics for this period. For the financial statistics, data from the German Federal Ministry of Finance (2021) were used for the general government budget, for the EU figures data from Eurostat, upon which the EU Commission's AMECO database is based (in this case the UBLG series).

4
GOVERNMENT DEBT IN THE EU AND THE EMU – AN OVERVIEW

In the following overview we look at the extent to which deficits and debts of EU Member States have moved away from the EU's targets and rules in the aftermath of the great financial crisis of 2008/2009, the European double-dip recession and the Covid-19 crisis, and how great differences are between Member States.

Figure 1 shows that even in 2023, according to the EU Commission's forecast (May 2022), the average budget deficit both in the EU and the EMU will be 2.5 per cent. In 11 EU countries deficits will be well above the reference value laid down in Protocol 12 to the Lisbon Treaty (TFEU), among them three of the four large EU economies. This will

Figure 1: **Fiscal balances in EU countries 2023, as percentage of GDP**



Source: AMECO, UBLGE series; EU Commission estimate from May 2022.

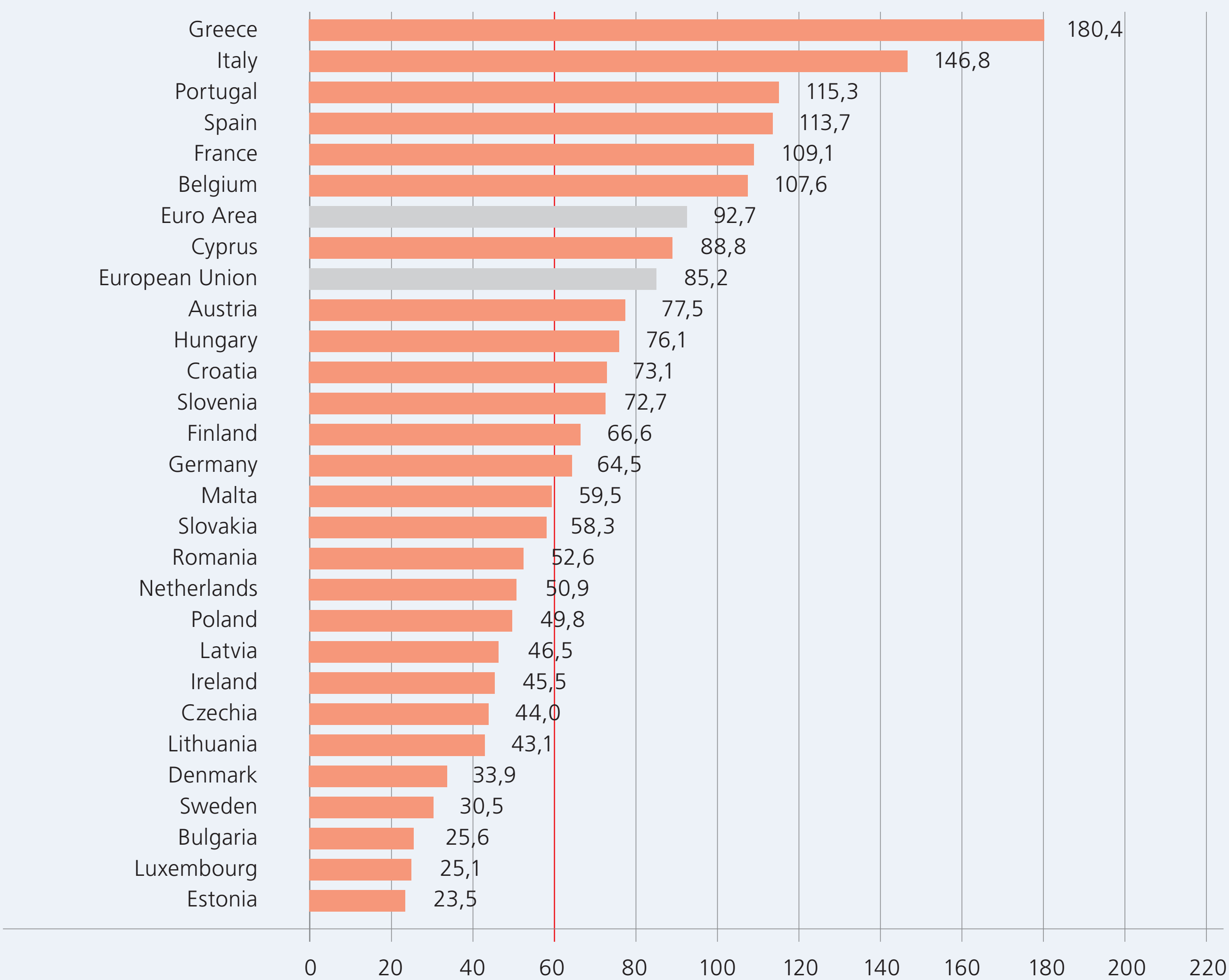
occur despite the support from the Next Generation EU programme, but the impact of the war in Ukraine is factored in, too. So the estimation is subject to more uncertainty than usual. This shows that the EU is still far from a return to normality: In May 2022 the Commission had proposed that the fiscal rules not be reactivated in 2023, among other reasons due to the war in Ukraine and its uncertain economic repercussions.

According to the estimate by the EU Commission, in 2023 the gross debt of EMU-countries will be around 93 per cent of GDP, with 13 countries above 60 per cent (cf. Figure 2). Six countries will have debt above 100 per cent, including France, Italy, with Spain and Greece leading the list at 180 per cent. Germany would be slightly above the 60 per cent level.

In the course of the ECB‘s bond purchases from 2014 until February 2022, the ECB (including national central banks) purchased 21 per cent of government bonds with the aid of the PSPP programme (see ECB 2022 and AMECO for gross debt 2022; see also De Grauwe 2021). For Germany the figure is 24.3 per cent, for France 17.7 per cent, Italy 15.4 per cent, Portugal 18.6 per cent and Spain 20.2 per cent. Average remaining maturity in the Eurozone is 7.2 years. At maturity, the ECB first wants to use the proceeds from redemption payments to once again buy bonds. This takes about one-fifth of government debt in the Eurozone out of the capital market. Proceeds flow into central bank profits and in part back to the governments. This puts the high debt ratios somewhat into perspective.

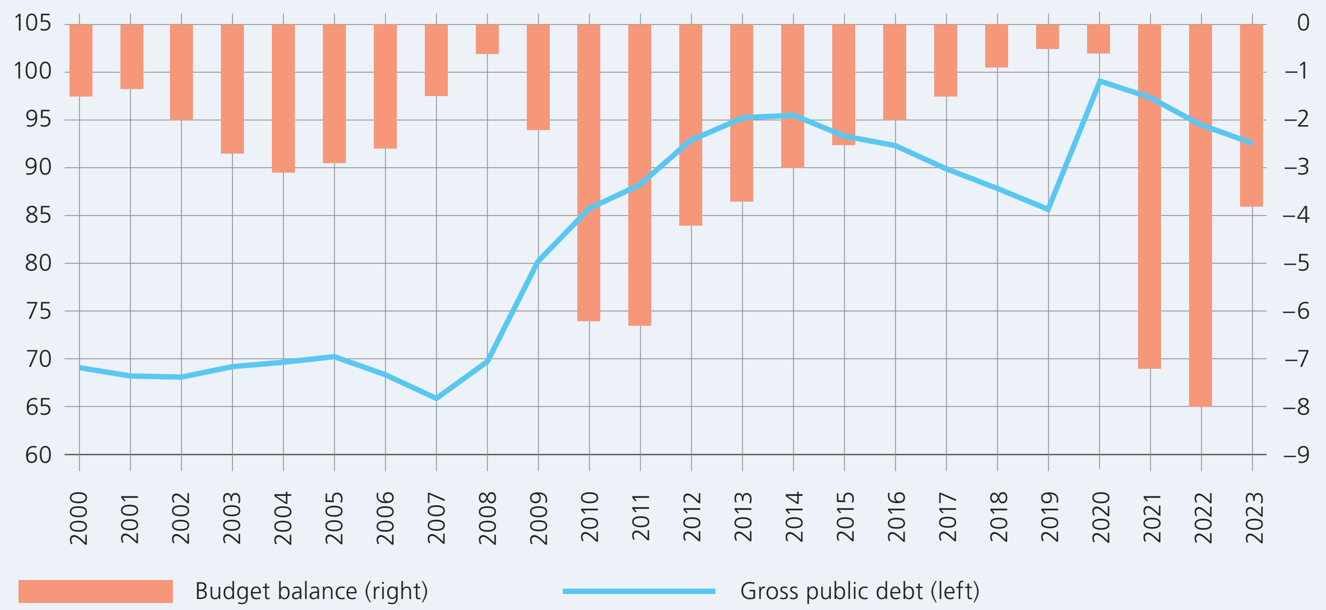
Looking at the EMU as an economic unit, the deficit limit of three per cent was missed by a wide margin in the severe crises, but overall it was adhered to in 16 of the 23 years over the period 1999-2022 (see Figure 3). When the Maastricht Treaty came into being in 1990-1991, the figure

Figure 2: **Gross public debt in EU countries 2023, as percentage of GDP**



Source: AMECO, UDGG series; EU Commission estimate from May 2022.

Figure 3: **Eurozone: gross public debt and budget balance 2000–2023, as percentage of GDP**



Source: AMECO, UDGGLR and UBLGE series. Data for 2022 and 2023 estimate from the EU Commission in May 2022.

of 60 per cent aligned with the average debt level for the EU-9 group at the time, which therefore set this figure as the upper limit for the EMU. Time has long since rendered this figure obsolete.

Trends in the debt ratio in the large Member States of the Eurozone and some other smaller Member States since 1999 illustrates the heterogeneity of the EMU (cf. Figure 4). Italy came into the monetary union with a very high debt level and was subsequently – like France and Spain – massively affected by the financial and economic crisis as well as by the Corona pandemic. The main reason why Germany, the Netherlands, Ireland and Luxembourg fared much better is primarily due to their chronic current account surpluses and/or lower growth of domestic demand, which contributes significantly to the creation of these surpluses.

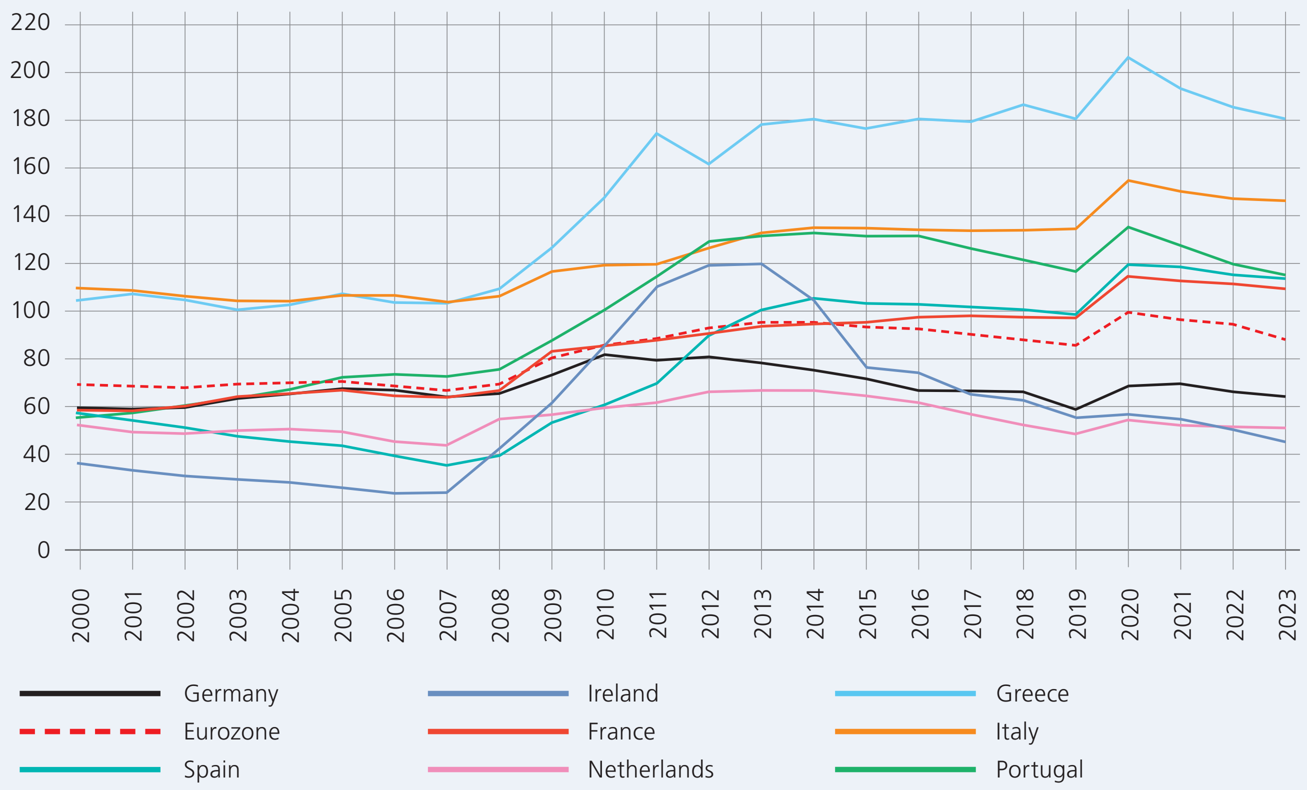
Figure 5 reveals the weakness of gross public investment in the EMU. Levels are clearly below those for the U.S. and the UK, i.e. countries that are less welfare-state oriented. Germany carried out particularly significant cuts in public investment following the financial crisis, but investment picked up again from around 2016, although it remains well below the EU average in 2022.

In spite of rising government debt in the Eurozone, the interest burden in the Member States – interest payments effected on total government debt (cf. Figure 6) – fell almost continuously from four per cent in 1999 to 1.4 per cent in 2021 (excluding central bank profits)[5]. Even in Italy, a country with a high level of debt, the interest burden ratio has been cut in half since 1999; at 3.4 per cent, it is slightly below the level for the U.S., but clearly above the EMU average. So there can be no question of any lack of debt sustainability whatsoever at present, especially not for Germany. Here, the interest burden ratio fell from 3.2 per cent in 2000 to 0.5 per cent in 2021. This decline did not just materialise since the onset of the ECB's low interest rate policy and the bond purchases made from 2015 onwards – rather, this trend began as far back in the 1990s. Similar trends can be seen in all other OECD countries. It is often said that the low interest burden ratio is offset by lower central bank profits distributed to governments. This is not true across the board, because as a result of bond purchases – including for older bonds with positive coupons – the ECB receives more interest income that would otherwise have accrued to private bondholders.

For the purposes of the discussion of reform proposals for EU fiscal rules, it is of key importance whether rising interest rates should be expected again in the future. After all, the interest burden determines debt sustainability. With this in mind, a distinction needs to be made between two kinds of interest rates: The interest rate on government debt is an average interest rate for old and recent government bonds, the so-called implicit interest rate, which only changes slowly because interest rates remain constant until the end of the term; in contrast to this, the capital market interest rate for long maturities is the current market interest rate on government bonds, and this can change rapidly as a result of changes in the interest rate policy of the central bank or changes in risk expectations on the part of holders of government bonds. It can rise with inflation and

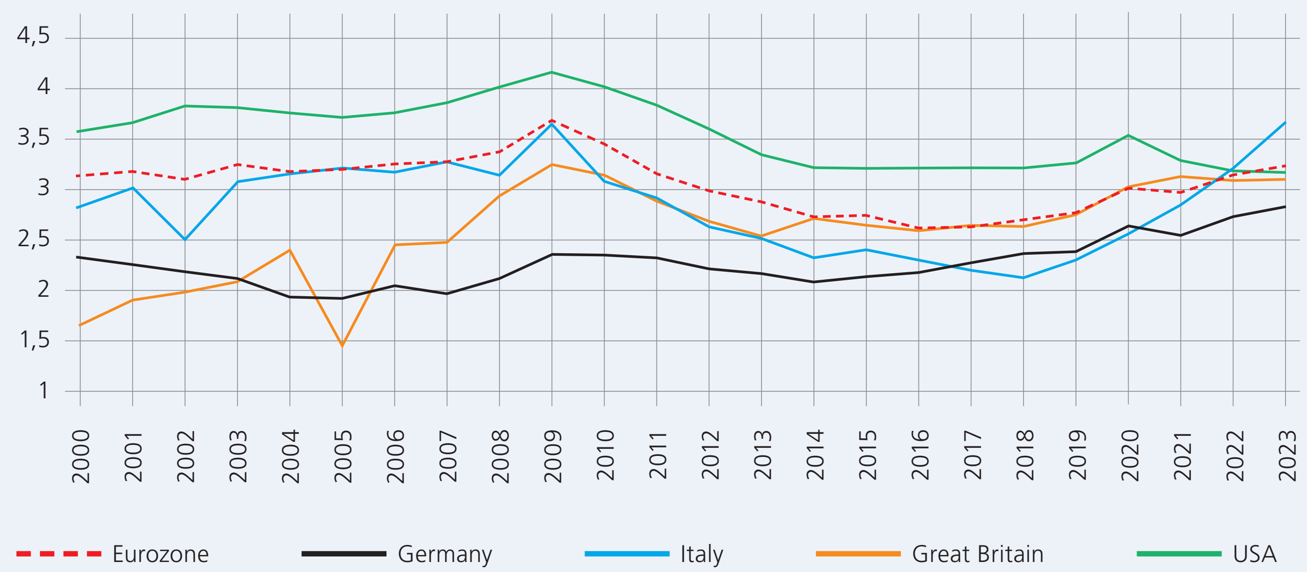
5 When the Eurosystem (ECB and national central banks) holds government bonds, interest paid by the states flows into central bank profits, which are then distributed to the national governments. Figure 6 lists gross payments without distributed central bank profits.

Figure 4: **Public debt in 8 countries of the Eurozone 2000–2023, as percentage of GDP**



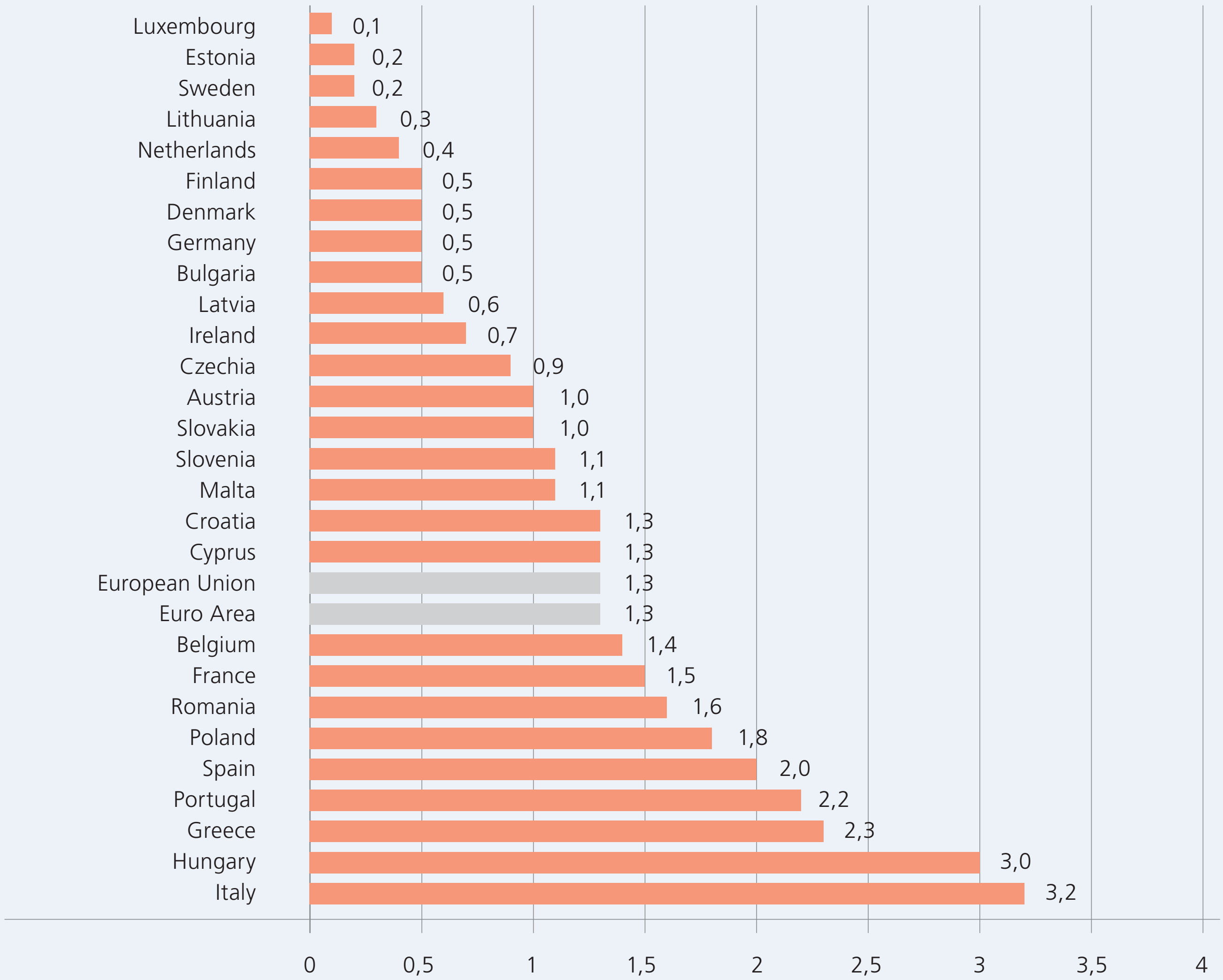
Source: AMECO, UDGGLR series. Data for 2022 and 2023 estimate from the EU Commission in May 2022.

Figure 5: **Gross public investment in selected countries 2000–2023, as percentage of GDP**



Source: AMECO, UIGG0 series. Data for 2022 and 2023 estimate from the EU Commission in May 2022.

Figure 6: **Interest payment on public debt in EU countries 2023, as percentage of GDP**



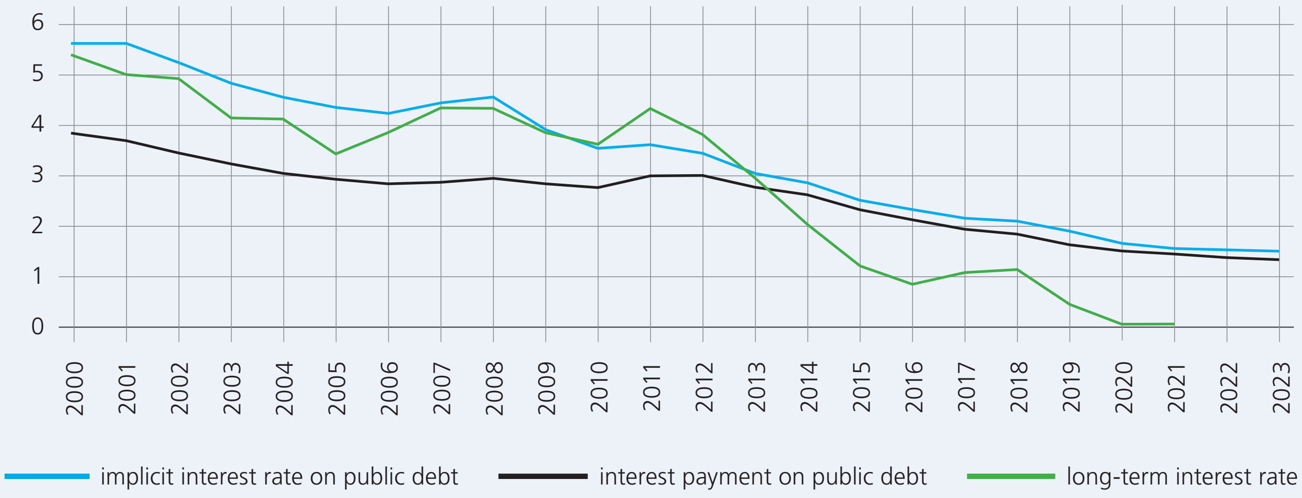
Source: AMECO, UYIG series. Data for 2023 estimate from the EU Commission in May 2022.

fall with more favourable interest rate expectations. The implicit interest rate and debt ratio are decisive factors underlying the government‘s interest burden. Figure 7 shows that the implicit interest rate in the Eurozone fell from 5.5 per cent in 1999 to “only” 1.9 per cent in 2020, despite a current long-term interest rate of zero. The declining interest burden largely follows the implicit interest rate, and less so the capital market interest rate. If capital market interest rates rise as a result of expectations of temporary inflation, this has only moderate and merely temporary effects on the interest burden, especially if the state is indebted with long-term bonds. It also has to be factored in that the denominator of the debt ratio, nominal GDP, rises in line with inflation, and moreover, government revenues normally rise faster than nominal GDP.

The debt ratio of an economy depends on four factors: the debt level in the previous year (old debt), the average interest rate on government debt (so-called implicit interest r), the growth rate of nominal GDP (g) and the primary balance relative to GDP. The primary balance is equal to revenue minus expenditure excluding interest expenditure (see Box 1; the equation there follows the so-called Domar equation [Domar 1944]).

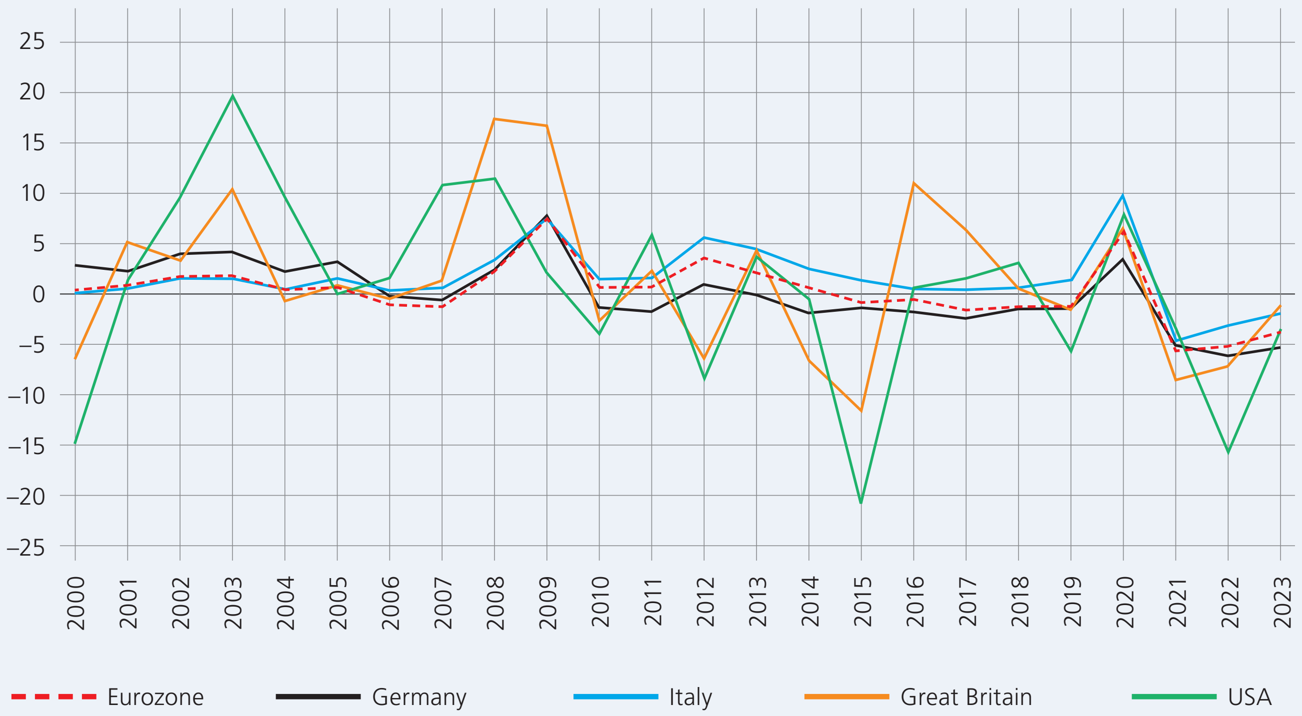
Figure 8 shows the interplay of r-g for the EMU, Germany, Italy, the UK and the U.S. A high value of r-g, i.e. r > g, was “generated” four times in the Eurozone in the period 1999-2022, namely at the beginning of the 2000s, when growth was almost stagnant, in the financial crisis of 2008/2009, in the euro crisis of 2012/2013 and in the pandemic crisis of 2020. In the short-lived “good” economic phases, on the other hand, g was greater than r due to an economic upswing and low interest rates, not least as a re-

Figure 7: **Implicit interest rate on public debt, interest payment on public debt and long-term interest rate in the Eurozone 2000–2023, as percentage of GDP or in per cent**



Source: AMECO, UYIG and ILN series. Data for 2022 and 2023 estimate from the EU Commission in May 2022.

Figure 8: **Interest rate growth rate differential (r-g) in selected countries and the Eurozone 2000–2023, in percentage points**



Source: AMECO, UYIG, UDGGLR and UVGD series. Data for 2022 and 2023 estimate from the EU Commission in May 2022.
Note: nominal values for r and g.

sult of the ECB's low interest rate policy. The values for Italy are less favourable than for Germany due to higher interest rates and lower growth in Italy, while the curve for the Eurozone lies between these poles. In Germany, g has been greater than r since 2013, with the exception of the pandemic year 2020. The U.S. and also the UK have had much clearer phases with a negative interest rate-growth differential as a result of stronger countercyclical fiscal policy (Priewe 2020c).

For the future development of the debt level in the Eurozone, it is now decisive how the interest rate-growth differential will develop. The International Monetary Fund (IMF) expects a real interest rate on government debt of one per cent in the Eurozone, i.e. a nominal interest rate of three per cent with a target inflation of two per cent. This would be a significant turnaround in monetary policy from 2022 onwards, which is expected with the return of inflation in 2022. Real growth for the period 2023-2026 is estimated at 2.0 per cent, so the interest rate-growth differential would remain negative at 1.0 percentage point (IMF 2021), but much less negative than for 2022 as can be seen in Figure 8 (-4.4 percentage points). In its latest Baseline Scenario for the Eurozone, the EU Commission expects real growth of only 1.2 per cent for 2021-2031, while the real implicit interest rate averages -0.5 per cent (EU Commission 2021: 37, Table 3.2). This would minimally reduce the debt ratio to 98 per cent by 2031 if the (structural) primary deficit is slowly reduced from -2.3 per cent to zero per cent by 2031.

The general decline in interest rates since the high interest rate policy of the early 1980s follows declining real interest rates far more strongly than declining inflation rates. It is to be hoped and expected that currently negative real interest rates will one day rise again, but not that implicit interest rates will return to the old level (cf. also Lee/Werner 2018). The EU Commission expects a long-term rise in real interest rates to two per cent by 2050, whereas three per cent was previously assumed (EU Commission 2021: 8). The war in Ukraine and its economic aftermath has blurred the short- and medium-term outlook. ←

Box 1

WHAT DETERMINES THE LEVEL OF THE PUBLIC DEBT?

Let the amount of a country‘s public debt at the end of year t be D_t, in relation to the GDP of the same year let the debt ratio be $d_t = D_t / GDP_t$. Let the change in the debt ratio compared to the previous year be $d_t - d_{t-1}$; r is the average interest rate on government debt (implicit interest rate), g is the nominal GDP growth rate and p_t is the primary balance, i.e. tax revenues T minus government expenditure G without interest costs rD, in relation to GDP: $pt = [T_t - (G_t - rD_t)]/GDP_t$.

The following applies to the change in the debt ratio:

$$d_t - d_{t-1} = \frac{r-g}{1+g}\, d_{t-1} - p_t \quad \text{resp.} \quad d_t = d_{t-1} + \frac{r-g}{1+g}\, d_{t-1} - p_t$$

For the sake of simplicity, let us assume that all variables are nominal, especially since the national debt is calculated with a nominal value. The higher the amount of interest on government debt that has to be paid annually, the greater is the budget deficit if the interest is not financed by cutting spending or raising taxes, which would increase the primary balance p. If GDP grows, then the debt ratio falls, when the other factors remain given. To simplify this, we can leave the denominator (1+g) aside, as the value is close to 1 when interest rates are low. So: the debt ratio increases if r increases in relation to g and/or the primary balance p decreases. In the opposite case, the debt ratio falls. The higher the debt level of the previous year (“inherited burden”), the greater the weight of the interest rate growth difference.

In other words: the debt ratio d_t remains constant at p* if

$$p^* = \frac{r-g}{1+g}\, d_{t-1} \quad \text{or approximated} \quad p^* \approx (r-g)\, d_{t-1}$$

If r-g is zero, a primary surplus is not needed, but a primary deficit cannot be afforded, either, if the debt level is to remain constant. The most favourable situation is when g > r, because then the debt ratio can remain constant despite the primary deficit (i.e. p < 0) or one can grow out of the debt with a primary balance of zero (for more details cf. Priewe 2020b: 30ff.). The economists of the EU Commission have always assumed that r > g in the long run, so that “sustainable” government budgets with debt > 0 must always have a primary surplus. This view has proven to be empirically untenable, however.

Let us assume that the average cyclically adjusted – i.e. structural – budget balance in relation to GDP is h* = (T - G)/GDP. If the average interest burden ratio is z* = rd, then:

$$h^* = p^* - z^* \qquad \text{or} \qquad p^* = h^* + z^*$$

The primary balance is important for budgetary policy because it can be directly influenced by policy, as the interest rates and the old debt from the previous period are given. Although budgetary policy can also change tax rates, tax revenues depend heavily on g, i.e. on the business cycle and longer-term growth prospects. Domar has argued that more attention should be devoted to growth- and employment-oriented use of primary government expenditure than to the budget balance and the level of debt.

If we assume a constant debt ratio d, then p = (r - g) d. After some transformations, this results in: -h/g = d. Here -h is the budget deficit. For example, the debt ratio would be stable at 60 per cent if the budget deficit were 1.8 per cent and nominal growth were at three per cent. Some of the authors of the Maastricht Treaty believed that the debt level in the European Community back then could be stabilised at 60 per cent if the budget deficit averaged three per cent and nominal growth five per cent.

Strictly speaking, the central bank profit, which is transferred to the government (s), must be deducted from the government‘s interest burden. If the central bank receives interest income from government bonds it has purchased, this income is included in the central bank profit. ←

5 THE MOST IMPORTANT FISCAL POLICY CONCEPTS

Before discussing the various reform proposals for the European and German regulatory frameworks, the most important basic concepts underlying fiscal policy will be briefly presented here. Without some orientation towards guiding principles, proposals are usually of a piecemeal nature. In the following, nine approaches are singled out, some of which overlap.

(1) *Balanced* budget means an orientation towards a budget balance without borrowing in "normal cyclical situations". Cyclical deficits or surpluses due to falling/rising tax revenues or unemployment expenditure are accepted, while deficits are sometimes limited – as in Protocol 12 of the Maastricht Treaty – to about three per cent. "The black zero", a German creation under Wolfgang Schäuble as the former Federal Minister of Finance, even means an annual budget balance without any deficits in a recession. Balanced budget is tantamount to a far-reaching ban on borrowing by the state (cf. Buchanan, presented by Tempelman 2007).

(2) This balanced budget concept boils down to *cyclical budget balancing,* which forms the basis for the Maastricht Treaty. Over the economic cycle, as symmetrically as possible, public budgets are to be balanced by building up surpluses in "good times" in order to plug the holes during "bad times". The concept implies structurally balanced budgets. In a growing economy, both variants (1 and 2) would lead to an ever-decreasing debt ratio in a growing economy in the long term, and ultimately to convergence at a debt ratio of zero.

(3) Cyclical deficits and surpluses are welcome in this conception, if taking place predominantly through *automatic stabilisers.* This conception primarily focuses on cyclical revenue fluctuations (if tax revenues fall and rise over the cycle), supplemented by unemployment benefits on the expenditure side as a result of statutory arrangements. In contrast, the most volatile aggregates, private and public investment, are not stabilised. Discretionary countercyclical fiscal policy is not used, so automatic stabilisers imply a rather passive, rule-bound and only partial stabilisation policy. This means that an underutilisation of the production potential, the material and the labour part, is accepted to this extent. Restriction of fiscal stabilisation to automatic stabilisers, i.e. the deliberate exclusion of active counter-cyclical policy, is characteristic of the Maastricht concept and the SGP, because otherwise cyclical deficits would exceed three per cent.

(4) An *expenditure rule* goes above and beyond automatic stabilisers. Here, primary government expenditure (or a certain part of it) is supposed to grow steadily in line with the growth trend of potential output, irrespective of the business cycle. Although potential output is difficult to estimate, the trend is supposedly less subject to errors than the absolute level of potential output. Cyclical deficits are to be accepted and cyclical surpluses are deliberately targeted to avoid pro-cyclical overheating and to reduce debt. There are many variants of expenditure rules, which are discussed below in the various reform proposals.

(5) *Counter-cyclical economic policy* goes beyond automatic stabilisers and spending rules (Oberhauser 1985, 1986). Here, fiscal policy countermeasures are taken in a deliberate and targeted manner, i.e. on a discretionary, case-by-case basis. The IMF (2008) has produced the short formula "temporary, targeted, timely". This was also the idea behind Karl Schiller's "global steering" ("Globalsteuerung") in the so-called Stability and Growth Law of 1967. Karl Schiller was a Keynesian minister of economics, later finance minister (1966-72), and a Social Democrat. Since business cycles are not as regular and uniform as previously believed, but differ in length and intensity, and moreover many other shocks overlap cycles, discretionary, i.e. situation-dependent, counter-cyclical fiscal policy is necessary in addition to automatic stabilisers. This is the traditional but outdated Keynesian view with public debt mainly limited to counter-cyclical policy.

(6) The *Golden Rule* of fiscal policy aims at structural, i.e. continuous, budget deficits – in addition to counter-cyclical policy – to finance public investment, which is usually understood in terms of national accounting as purchasing durable goods in the production process (Musgrave 1939, Truger 2015a, 2015b), regardless of the business cycle. In the past, people tended to think in terms of gross investment; nowadays they tend to think in terms of net investment (gross investment minus replacement investment). If only credit-financed net investments are targeted, depreciation and amortisation must be financed with tax revenues. There are three main reasons for the Golden Rule: first, invest-

ments can smooth out the cycle; second, they are considered "productive" in the sense of growth-promoting public goods with positive external effects, thus contributing to self-financing in the medium and long term; and third, credit-financed investments support intertemporal equity. Present and future generations that will use this infrastructure should share in the financing.

(7) *Functional finance* stands for a functional link between monetary and fiscal policy, with fiscal policy being in the driver's seat compared to monetary policy (Lerner 1944). Government spending can be financed by borrowing if there is underemployment and no danger of inflation. If there is full employment and a threat of inflation, tax increases or spending cuts would be necessary if no other instruments were available. The central bank focuses on setting the interest rate and provides money or credit to companies and the state, either indirectly via commercial banks or directly to the state. The central bank is part of the state, even if it is independent. The traditional sound money doctrine, associated with a balanced budget, is diametrically opposed to functional finance. Underemployment is interpreted primarily as a lack of economic demand for goods, as by all Keynesians. The so-called Modern Monetary Theory (MMT) is based, among other things, on functional finance, but goes beyond it.

(8) Meanwhile, the concept of *fiscal sustainability* focuses on limiting the debt level. All the concepts presented so far have concentrated on budget balances, i.e. on deficits, that is changes in the debt level, and have viewed the stock of debt as the result of these flows. The focus here is on the fiscal sustainability of government debt (avoidance of insolvency) and intertemporal equity (Escolano 2010). In essence, it is about ceilings on government debt. Economic research has not been able to identify a clear limit to government debt, however, to the extent that debt in the government's own currency is involved (Heimberger 2021). Reference is often made to the growing risks associated with high public debt.

(9) It follows that fiscal policy should reduce debt levels that exceed a ceiling, i.e. pursue a targeted *consolidation policy.* This stands in contrast to all the previously mentioned debt rules, however, because budget surpluses would be necessary, at least primary surpluses, if the debt-GDP ratio is supposed to shrink (see Box 1).

The European Treaties (TFEU) with Protocol 12 and the SGP in its current version are essentially oriented towards the principle of cyclical budget balancing (2), limited to automatic stabilisers (3) in the normal case, with discretionary fiscal policy in specified emergencies (5), in combination with consolidation policy (9). A small discretionary scope for the Golden Rule (6) through a small structural deficit under certain conditions is included. At high debt levels, consolidation policy predominates, but the rules implicitly lead – if they are abided by – to very low debt ratios that lack any justification.[6] In this respect, they are not oriented towards the goal of sustainability, as the aim is instead to minimise government debt in order to keep the state small. A key argument against consolidation strategies is that continuous contractionary policies are likely to dampen economic growth so that the debt ratio does not fall (or does not fall sufficiently). Until well into the 1990s, the dominant view was that structural deficits have an inflationary effect and crowd out private investment, the engine of growth. It is now widely accepted by the economic mainstream that public spending on infrastructure has positive external effects, promotes growth and private investment rather than excluding it, and that structural deficits do not necessarily lead to inflation and higher interest rates (Holtfrerich et al. 2015).

It is important to note, however, that all the aforementioned conceptions primarily use the central government of a currency area as the point of reference, while the middle and lower levels of government usually have much less discretionary scope. Since monetary union does not have a central fiscal state, but only a small central budget amounting to about one per cent of GDP without a debt option (except for the Next Generation EU programme), the "black zero" de facto dominates thinking at the European level, which is partially compensated by the fiscal policy of the Member States, but exacerbated by the dominance of consolidation policy in many Member States. This skews fiscal policy in the EU and EMU as a whole in a contractionary direction, which is mitigated by numerous breaks of rules, exceptions and the ECB's low interest rate policy. We see that fiscal policy is in a messy state in the EU. It seems to function best if the complex ruleset is circumvented, bypassed by flexibility clauses or dispensed with by applying the escape clause. ←

6 Some economists argue that there is a large hidden national debt in Germany in the form of large future expenditures for old-age provisions if the pension calculation formula remains unchanged. This means that much must be saved today so that the debt ratio does not exceed a sustainable level in a few decades. This concept of debt sustainability has been subject to sharp criticism.

Box 2

MEASUREMENT OF CYCLICAL AND STRUCTURAL BUDGET BALANCES

Fiscal balances are broken down into four components within the framework of European budget rules: a cyclical component, a structural component, one-off effects and financial transactions. One-off effects – e.g. revenues from privatisation of public property – are excluded, as are financial transactions. A credit-financed financial transaction, such as the purchase of a piece of land or a stake in a private company, is not considered government debt, as it constitutes an acquisition of assets with a positive market value.

The cyclical component arises from cyclical, i.e. temporary, changes in revenues and expenditures: in a recession through reduced tax revenues and additional expenditures for the unemployed, and vice versa in an upswing and boom. In a neutral cyclical situation the cyclical component of the budget balance is zero. If there is nevertheless a deficit, it is termed structural and must be consolidated if it exceeds the permitted limit.

The yardstick for the normal situation is potential output (PP), the maximum output that can be produced at which no inflationary pressure above the target inflation of 2 per cent arises (GDP - PP = 0). If utilisation is lower, there is a negative output gap (GDP - PP < 0). If utilisation is too high, there is a positive output gap (GDP > PP). The cyclical component is then the product of the output gap and so-called budget semi-elasticity. The latter indicates what effect a one-percentage-point change in GDP will have on net lending or borrowing.

So how is the PP estimated and thus the cyclical and structural components? The German Federal Ministry of Finance follows the method applied by the EU Commission for the federal German budget, which is calculated by an "output gap" working group of the EU Commission's Economic Policy Committee. The EU Commission favours multivariate econometric estimation procedures in conjunction with statistical filtering procedures. The neoclassical production factor method is at the heart of it all. It measures the use of the production factors labour and capital as well as their productivity. With an array of assumptions, it is estimated at which level of unemployment wage and price pressures (upward or downward) will come about. The production function ascertains the past trend in the development of the PP and extrapolates it into the future. Ultimately, however, it is not the PP that is estimated, but the trend in GDP, which indicates how actual GDP fluctuates upwards and downwards – under the assumption of symmetry of under- and over-utilisation of the PP. The trend itself is strongly dependent on the business cycle, however. A chronic – or prolonged – negative output gap is ruled out by definition. In the event of a prolonged period of weak GDP, the PP trend is therefore downwards and the cyclical component disappears, just like it does in the event of a long upswing.

The method systematically underestimates cyclical deficits (and surpluses) and overestimates structural ones. It follows that structural deficits are to be consolidated even in recession, which has a procyclical effect (cf. Heimberger et al. 2020, Tooze 2019, Heimberger 2020, Schuster et al. 2021, Ademmer et al. 2019, while Buti et al. 2019 defend the method; Lenk/Bender 2021 on the history of this method in the EU). Empirically, it has been shown that positive output gaps (according to the usual calculation method) by no means necessarily fuel inflation. Moreover, the estimation method, which relies on data updated at short intervals, leads to constant revisions of the results. Trend forecasting as a mere extrapolation of the past is more than problematic. Estimates of output gaps by the EU Commission, the OECD or the IMF differ considerably, but are beset by similar problems. Expenditure rules are often proposed as an alternative to measurement methods (see also Box 3). ←

6
REFORM PROPOSALS FOR EUROPEAN FISCAL RULES

6.1 TWELVE PROPOSALS

In the following, twelve reform proposals are briefly presented and commented on. The focus is placed on more recent proposals beginning in 2019, mainly from important institutions. Older, largely more far-reaching proposals related to the launch of euro bonds being called for in a wide range of variants are left out of the analysis here, although they could presumably solve many of the problems touched on in section 2. These have all been rejected by the German government, but also by several other Member States. A much-discussed proposal forwarded by Blanchard, Leandro and Zettelmeyer (2020) is also left out here. According to this proposal, fiscal rules should be replaced by general "norms" and "standards" that are to be interpreted by courts and experts. The proposal aims to reduce complexity, but in fact increases it and is therefore not acceptable in the European context. The position of Modern Monetary Theory (MMT), which is more influential in the U.S. than in Europe, must also be left out here for reasons of brevity (a concise discussion is provided by Ehnts 2022). The expansionary monetary and fiscal policy in the EMU during the suspension of the European rulebook due to the Corona pandemic (2020-2022) comes very close to MMT concepts and views.

Some terms are presupposed in the following, in particular cyclical and structural fiscal balances as well as expenditure rules – these are elucidated in Boxes 2 and 3.

DEUTSCHE BUNDESBANK – BACK TO THE STATUS QUO ANTE

Even before the pandemic, the Deutsche Bundesbank (2019) unambiguously stated its support for the current fiscal rules in all their details, with the exception of the flexibility options. It argued that these should be dropped, as they were held to be unclear and set the wrong incentives. The general problem in the EU, according to the Bundesbank, is that the rules are not sufficiently enforced. The authors advocated independent external fiscal committees with decision-making powers, as the EU Commission is considered to be too close to the political sphere. The fiscal rules should, moreover, exert more pressure on national budgetary policy. In addition, the financial markets should saddle highly indebted states with sanctions in the form of risk premiums on these states' interest rates and set incentives for a "sound" fiscal policy. "Sound" here means in accordance with the rules, although the authors do not take the trouble to provide justifications for the rules themselves.

Expenditure rules – a widespread reform proposal (see also Box 3) – are only held to make sense if they merely apply to the following year, are linked to targets for the structural balance and adjustment accounts, by means of which any differences between planning and execution are to be accounted for. Golden rules for investments financed by credit (see the comments on No. 6 in Chapter 5) are only advocated under very restrictive conditions (ceilings, no impairment of consolidation, somewhat more flexible for low debt levels below 50 per cent). The proposals are based on the concept of a nearly balanced structural budget with cyclical flexibility through automatic stabilisers which reduce the cyclical component to zero over the business cycle.

It is striking that the debt cap of 60 per cent is understood as a hard limit without justifying it. If the deficit limit of three per cent is also understood as a hard limit, and automatic stabilisers need up to about three percentage points of discretionary scope, the logical conclusion is that there is little or no room for credit financing for public spending (i.e. structural deficits). This amounts to a near ban on borrowing for public investment – a nonsensical rule for any accounting firm (this is how Blanchard/Giavazzi 2004 put it). So-called Rainy Day Funds, i.e. stabilisation funds for bad times, are only advocated if they are financed nationally by savings from budget surpluses.

The text is remarkable because it argues almost exclusively in terms of regulatory policy. The fact that strong and sustained austerity policies can have negative and counterproductive effects is not even addressed. Any analysis of demand is missing, expansionary fiscal policy is implicitly rejected outright, except in the form of automatic stabilisers. Particularly questionable is the hypothesis that significant risk premiums on government bond interest rates create positive incentives. Risk premiums usually come from debts in connection with "legacies" from earlier years or decades that cannot be eliminated in a short time, not even through budget surpluses. The authors of the Bundesbank report believe that low debt in the vicinity of 60 per cent is a basic prerequisite for EMU, since otherwise the currency as a whole and the independence of monetary policy would be jeopardised. Unspoken but looming behind this is the fear of "fiscal dominance", which undermines the desired "monetary dominance" of the ECB. Even a balance between monetary and fiscal policy poses a threat from this perspective. The fact that after three serious crises since 2008 there are very high levels of debt in the EU and that monetary policy has fundamentally changed, thereby facing fiscal policy with new tasks – this all goes unperceived. The Bundesbank‘s contribution unwittingly makes clear how important a reform of EU fiscal rules is: “We are no longer living in Maastricht!” as a French think tank – see below – puts it.

EUROPEAN FISCAL BOARD – FUNDAMENTAL REFORMS NECESSARY

The independent European Fiscal Board (EFB), commissioned by the EU Commission, submits an annual report on fiscal developments in the EU. In addition, it has repeatedly called for fundamental reform of European fiscal rules in wide-ranging reports (EFB 2019, 2020). In a nutshell, the EFB in its 2020 annual report calls for a simplification of the rules and the establishment of a debt limit that specifies country-specific debt adjustment paths, a single operational variable in the form of an expenditure rule, and a sanction mechanism in conjunction with independent national fiscal councils. For the sake of simplification, the Board proposes not to amend the treaties, although the 60 per cent debt limit is questioned, to combine an expenditure rule with an investment rule and, above all, to create a European fiscal capacity on a permanent basis following expiry of the temporary NGEU programme. Ideally, the latter should be established within the framework of the EU‘s Multiannual Financial Framework and outfitted with a significant volume of resources, have its own sources of financing (taxes, levies, debt option) if possible, and cover the three basic fiscal functions of the state: stabilisation, allocation (public goods) and distribution. The stabilisation function is intended to ensure that there is a countercyclical central fiscal capacity for the EU as a whole, as uniform countercyclical action by all the Member States cannot be relied upon, as well as to help out in severe recessions or in situations when monetary policy loses steam.

The expenditure rule is to apply to all Member States in order to avoid the problematic estimation of the cyclical component (cf. Priewe 2020b: 25ff.). As shown in Box 3, the aim is to define a growth path for primary government expenditure, adjusted for cyclical expenditure categories (especially unemployment benefits). Nothing is said about the level of aggregate expenditure in the base year relative to revenues, i.e. regarding the structural deficit. In the case of high debt levels, expenditures are supposed to grow somewhat more slowly than potential output. With specific countries, the adjustment period for debt reduction to 60 per cent is to be extended beyond 20 years to up to 50 years. Hence, the 1/20 rule is differentiated on a country-by-country basis, which is tantamount to a de facto increase in the debt limit over long periods of time. Thus, the primary surpluses necessary for consolidation are to be higher than in the past, but lower than if the present 1/20 rule were strictly applied. Country-specific adjustment paths are to be agreed for three years and should take into account the respective interest rate-growth differential. This proposal thus targets variable primary balances contingent upon possibly changing interest rate-growth differentials, hence moving away from fixed caps on structural balances as operational variables (at least implicitly).

Additional public investment is to be protected by not counting this as part of agreed aggregate expenditure. This can also deviate from the definition in the national accounts, but is to be precisely defined. The Board sees a dilemma here: primary balances reduced by additional public investment may impact growth and would thus not affect consolidation in Member States with debt above 60 per cent, but this is uncertain. Better monitoring is supposed to help, but the elucidation remains vague here.

As far as sanctions are concerned, countries not following the criteria of the reformed Fiscal Compact are to be denied access to the resources available through the central fiscal capacity.

At first glance, it would appear that the Board has found a workable, almost ideal arrangement within the legal framework of the current Treaties. However, the extension of the debt adjustment to up to 50 years shows how absurd the 60 per cent limit is if it does not have to be respected for another half century. Moreover, the primary surpluses needed for consolidation would be lower than at present, but would have to be sustained over an extremely long period of time. The credibility of this rule could therefore be small. A closer look, however, reveals another snag with the expenditure rule, which also goes for other versions. Although adjusted primary government expenditure can be controlled by national fiscal policy, its ratio (i.e. as a share of GDP) cannot, as growth g could decline as a result of lower growth in expenditures, which means that the ratio of r-g would rise and the debt ratio would increase. So growth of primary expenditure, which is usually in the order of 40-45 per cent of GDP (much higher in some Member States), must not reduce economic growth – or the reduction would have to be compensated for by the impact of the investment rule or the new European fiscal capacity that is recommended. The proposal sidesteps the issue of the size of the new capacity. This rules out the possibility of a counterproductive curbing of growth in expenditures leading to rising or at best constant debt ratios (also referred to as the “debt paradox” [Oberhauser 1985]).

Net government lending/borrowing is significantly influenced by the ratio between g and r, but in particular by g. It must therefore be implicitly assumed that the output gap caused by slower growth in adjusted primary government expenditure will be closed by some other factors (cf. Priewe 2021: 34ff.). Factors that are commonly cited in theory, such as a rising propensity to consume, higher private investment because of greater confidence in the state, falling interest rates because the risk premium could fall, or declining imports and an increased foreign trade balance are not addressed, perhaps because they are all highly uncertain. In this respect, the proposal for an autonomous investment component is helpful, but austerity with regard to the major item of consumptive government spending could have a counterproductive effect.

It also remains unclear what fiscal policy Member States should pursue if they have reached or the debt level of 60 per

Box 3

EXPENDITURE RULES

Rules that stabilise the growth of nominal government expenditure, that do not fluctuate heavily in cycles and that can be influenced by fiscal policy are referred to as expenditure rules. These are proposed in different variations. In most proposals, the expenditure aggregate that is to be stabilised independently of the business cycle relates to primary government expenditure (i.e. expenditure without interest payments on debt) minus unemployment benefits. This expenditure (in the basic variant) is supposed to grow at the same rate as real potential output plus the inflation rate. The latter is proposed by some authors as the expected inflation rate in the coming year, for others it is the central bank's target inflation rate. In recessions, deficits resulting from falling tax revenues are to be accepted; in upswings, revenues that grow faster than projected expenditures are to be saved or used to repay debt. It is easier to estimate potential output growth, basically speaking trend growth, than to estimate output gaps. Expenditure paths can be lowered in level or shifted upwards if tax rates or expenditures are permanently changed.

Three questions need to be answered. First, because the past growth trend is examined (trend extrapolation just like with the "output gap nonsense"), the approach is not forward-looking, but rather retrospective. Growth trends are not always stable, however. Just consider all the demographic changes, technology spurts or periods of upheaval. Second, the delta between the expenditure path and the trend exhibited by the revenue path, which determines the structural deficit, is hazy. This would need to be determined independently of growth of the expenditure aggregate, once again implying certain assumptions regarding the allowable structural deficit. Third, proposals that suggest an expenditure trajectory with a continuous growth rate below the growth of potential output are problematic for Member States with high debt ratios. This would lead to increasing demand gaps year after year, i.e. to austerity, which sooner or later would also lower potential growth and worsen the interest-growth differential r-g (Priewe 2021). ←

cent or fallen below this level. Application of the expenditure rule does not say anything about the primary balance in a normal situation, i.e. with an output gap of zero. If the targets for structural deficits of a maximum of 0.5 and 1.0 per cent (cf. No. 3 and No. 4 in Table 1) were to remain in place, debt levels would converge to 33 per cent at a growth trend rate of three per cent in nominal terms, a level that is void of any economic justification. Such a trend would only be unproblematic if it were accompanied by minor current account imbalances and full employment. Almost all countries vehemently calling for a return to the old unchanged fiscal rules (above all Denmark, Sweden and Austria, but also some Eastern European Member States) are relatively small, some of them running high current account surpluses of over six per cent; as small countries they are relatively less dependent on domestic demand, but heavily dependent on exports[7]. They would grow at the expense of neighbouring countries or the rest of the world without suffering the disadvantages associated with austerity. If Germany were to join this group, it would not only be at the expense of the EU's neighbouring countries, but would also increase the current account surplus of the EU or EMU as a whole from its current level of about three per cent to the detriment of the world economy. This flaw in the EFB's proposal also goes for various other proposals, especially that of Grimm/Wieland of the German Council of Economic Experts (see below).

7 The fiscal multiplier is much lower here than in the big countries; in these countries austerity would not hurt, it might even have an indirect expansionary effect.

MACROECONOMIC POLICY INSTITUTE – FOUR COMPONENTS

The Macroeconomic Policy Institute (IMK) has presented a proposal for reforms (Dullien et al. 2020, which served later as a blueprint for the proposal of the European Economic and Social Committee (EESC) (Dullien et al. 2022). Four components are at the core of this proposal.

First, the debt cap should be raised from 60 to 90 per cent of GDP – given the now high level of debt and the secured debt sustainability with lower interest rates compared to the early 1990s, when the Maastricht Treaty was concluded. This requires amendment of Protocol No. 12 to the TFEU. In a more recent variant of the IMK proposal, which avoids amendment of the TFEU instead of an increase in the debt cap to 90 per cent by treaty change, the 1/20 rule should be extended to longer adjustment paths or temporary suspension is proposed (Dullien et al. 2021 and 2022). In this respect, the proposal strongly resembles that of the EFB (2020).

Second, instead of the problematic calculation of cyclical budget balances, a special expenditure rule is called for that applies to primary government spending excluding cyclical spending and also public investment. This aggregate expenditure should normally grow in tandem with the trend in nominal potential output, calculated with a target inflation of two per cent, for countries with debt close to or below the reference value (90 per cent in the proposal from 2020). Whether the trend growth is that of the past years (backwards looking) or the trend growth expected in the future is not entirely clear. In countries with a debt ratio above the reference value, aggregate expenditure is expected to grow more slowly than potential output, but not to fall in nominal terms. In countries with lower debt ratios, non-investment expenditures can also grow somewhat faster than potential output, which means that only the three per cent limit applies to the deficit ratio, which is supposed to remain unchanged. If the investment clause were to be used up to 1.5 per cent and at the same time the deficit is not allowed to exceed three per cent, there is, however, little cyclical latitude.

Third, net public investment amounting up to 1.5 per cent of GDP could be financed by borrowing. Simulations by the IMK show that the debt ratio in countries with high debt levels will nevertheless fall in the longer term under realistic conditions due to expected higher growth.

Fourth, in contrast to all other reform proposals, a complementary reform of the Macroeconomic Imbalances Procedure (MIP) is included (see below).

The expenditure rule is similar to the EFB proposals. Here as well, country-specific debt reduction paths are allowed, without there being any deadline for reaching the target; furthermore, country-specific expenditure paths are also possible for countries with debt below 90 per cent. Whereas the SGP allows a maximum of 1.0 per cent of GDP as structural deficit (if the debt ratio has fallen "significantly" below 60 per cent), the IMK proposal allows 1.5 per cent, but regardless of the level of the debt ratio. With a growth trend of nominally three per cent, the debt ratio would converge to 50 per cent with an average deficit of 1.5 per cent. The investment rule is clearer than in the EFB proposal. The reform of the MIP addressed by the IMK authors is long overdue, but has been pushed into the background in public debates. Yet this procedure, which is an important component of the European Semester and country-specific recommendations by the EU Commission, is of tremendous importance to fiscal policy.

It is argued that the large number of scoreboard indicators in the MIP (on public debt, the labour market, income distribution, real estate prices, etc.) must be reduced and indicators designed symmetrically for surplus and deficit countries, with a focus on growth of unit labour costs and current account imbalances. In plain language: surplus countries should reduce their current account surpluses in the same way as deficit countries reduce their deficits. The reduction of internal imbalances is important for the simple reason that deficit countries in the EMU no longer have a devaluation option and can only find a substitute for devaluation in the form of a wage policy that tends to be deflationary ("internal devaluation"). The resulting contractionary consequences for domestic demand are often countered by increasing public debt. A macroeconomic view of budget balances therefore always implicitly includes the balances of the private sector as well as the external sector ("rest of the world"). Almost all other reform proposals neglect these interrelationships and thus ignore important causes of high public debt as well as the negative consequences of current account surpluses for other countries.

Some ambiguities remain in the IMK proposal. With the expenditure rule, the expected trend of the future potential growth should be the benchmark, not an extrapolation of the past. It remains unresolved how low growth of non-investment expenditure should be for countries with high debt; in the proposal it can also decline in real terms if limits are not included. If rapid consolidation is pursued, counterproductive effects may occur that can no longer be compensated for by the Golden Rule. The priority assigned to public investment as defined in national accounting is no longer up to date if innovation is to be promoted as a priority. Extending the definition of investment can lead to arbitrariness, however. A new quantified cap for public debt in the Treaty is problematic and actually superfluous. It would be better to have medium-term targets that can be changed by qualified majority. Nevertheless, the proposal is a step in the right direction and goes far above and beyond current arrangements under the SGP.

EUROPEAN ECONOMIC AND SOCIAL COMMITTEE – THREE REFORMS, NO TREATY CHANGE

The European Economic and Social Committee (EESC 2021) advocates a reform of the SGP without changing the Treaties, although it contends that an amendment to Protocol 12 should at least be considered in order to raise the 60 per cent reference value for the debt ratio. The reformed SGP is to be integrated as at present into the economic governance of the EU within the framework of the European Semester, i.e. as one of the three pillars (alongside monitoring of macroeconomic imbalances and coordination of social and employment policies). The proposal has three main components: (1) the Golden Rule to promote credit-financed net public investment, (2) replacement of cyclical adjustment so as to separate cyclical and structural elements of the budget deficit with an expenditure rule, and (3) allowance of country-specific debt paths.

Moreover, net public investment should be excluded from the cap on structural budget deficits because otherwise priority could be assigned to cutting investment just like in the past. It sets high multiplier effects in motion and increases potential output in the medium term and should thus be prioritised in government spending, especially during recessions. The definition of investment should be defined more broadly than in national accounting, in particular to also include health expenditure, vocational training and environment-related digital expenditure. Development of a special taxonomy of investment expenditure is suggested, similar to the EU's reconstruction and resilience initiative. The previous investment clause in the SGP is to be replaced, as it could only be used in connection with EU-funded investments and, what is more, only temporarily. The new Golden Rule is intended to accept higher structural deficits, which could, however, shrink again in the event of subsequent growth effects.

The expenditure rule is roughly in line with the IMK proposals, but no special rule for highly indebted Member States is called for. The Golden Rule is not quantified; so there is no cap for debt-financed investment in this proposal, except the 3 per cent deficit cap for headline deficits.

The EESC agrees with the proposals forwarded by the EFB (2020) regarding country-specific adjustment paths. In the case of very high debt levels, it suggests that detailed debt sustainability analyses be carried out, based on a "comprehensive economic analysis" using many indicators (point 3.3.4). The Committee concurs with the EU Commission's expectation of stable or slightly declining debt levels by 2030 as a result of a favourable interest rate – growth rate constellation.

The strengths and weaknesses of this proposal can be readily identified. Despite preferential treatment of public investment, the expanded notion of investment remains vague and somewhat arbitrary, in any case difficult to operationalise. The expenditure rule is also based here on extrapolation of the growth rate of potential output. The proposals for countries with high debt levels requires a quantitative threshold; otherwise, a large number of Member States would have to undergo debt sustainability analyses. In principle, however, the EESC follows the IMK proposal and similar recommendations put forward by Truger (2015a, 2015b, 2020) in broad areas, but does not commit to a 90 per cent debt cap or a 1/50 rule so that the 60 per cent cap is maintained for all countries due to avoidance of a Treaty change.

GERMAN COUNCIL OF ECONOMIC EXPERTS – TWO VOICES

A study by the German Council of Economic Experts (SVR) contained in its 2021/22 Annual Report starts with a short theoretical introduction on the limit to public debt along the same lines that the EU Commission has always followed and which serve to justify a uniform 60 per cent ceiling for public debt (for a critical view, cf. Priewe 2020b: 16-20). Subsequently, two contrary proposals are put up for discussion (SVR 2021: 88-119).

The proposal by Veronika Grimm and Volker Wieland (SVR I) attests to the current SGP being sufficiently flexible due to numerous exception clauses. The real problem is, so their argument goes, that several Member States do not really follow the rules and the EU Commission has dispensed with disciplinary procedures – the rules are basically correct, but enforcement is not. Five reform proposals are put forward:

1. An expenditure rule should be introduced as an operational variable for the short run, focusing on expenditure that can actually be influenced by government: real primary government expenditure minus unemployment benefits plus the actual inflation rate, i.e. not target inflation. The growth of this aggregate should be lower than real potential growth plus actual inflation, depending on the delta from the 60 per cent target, so the primary balance will increase year by year. No specific figure is stated. For countries that have reached or are below the 60 per cent target, potential growth is the measure of expenditure growth. Potential output is measured with the usual – frequently criticised – production factor method (see Box 2).
2. The structural fiscal balance prescribed in the Fiscal Compact, defined as a medium-term, country-specific budgetary objective (MTO), is to remain unchanged as a medium-term objective.
3. In line with the proposals made by the European Fiscal Board, the 1/20 rule can be extended to more than 20 years on a country-specific basis.
4. The previous flexibility options are to be dropped.
5. Independent fiscal councils are to monitor the new rules.

The authors hope for a slower increase in expenditures during upswings with corresponding primary surpluses. It is clear that high – or even increasing – primary surpluses over a longer period of time are not seen as contractionary, but only as an increase in surpluses – a widespread view that fails to recognise that persistently restrained government spending has negative supply-side effects, i.e. it likely lowers actual and also subsequent potential growth. The fact that constantly rising primary surpluses can quickly become very high and counterproductive as a result of the wedge between potential and expenditure growth is not considered. Moreover, no reference is made to the increased need for investment as a result of current ecological and digital challenges.

In the other proposal, Monika Schnitzer and Achim Truger (SVR II) warn against an overly restrictive fiscal policy that consolidates too quickly and could lead to an economic setback like the one that took place back in 2011-2013. Their proposal is in line with the proposals made by the EFB (2020) regarding the expenditure rule and its calls for a longer consolidation period for highly indebted Member States, without any details being provided. At the heart of the proposal is the introduction of a Golden Rule for net public investment based on a broader definition of investment deviating from national accounting, and applicable to all Member States. A ceiling on net investment, to be combined with the expenditure rule to avoid pro-cyclical slumps, is called for but not quantified. The investment clause that the authors call for would not affect debt sustainability because of expected productive knock-on effects on growth. This relaxation is also necessary, the authors argue, because the fiscal rules would become completely unrealistic if the flexibilities introduced by the Juncker Commission were scrapped and no Golden Rule introduced. Whether the flexibility clauses should be dropped remains unclear in this brief proposal. The authors favour a reform without changing the Treaties, i.e. the three per cent and 60 per cent rules are retained in their recommendation.

The proposal by Schnitzer/Truger does not go beyond that of the EFB, but falls short of that of the IMK and the EESC, probably because of the brevity of their arguments. However, it once again stands in clear contrast to the partial tightening of the status quo called for by their colleagues Grimm/Wieland. Both proposals agree on an amendment of the 1/20 rule along the lines suggested by the EFB.

BRUEGEL INSTITUTE – GREEN GOLDEN RULE

Darvas/Wolff (2021) from the Belgian think tank Bruegel present a very detailed and rich empirical study arguing for retention of the Treaty reference values, but call for a "Green Fiscal Compact" promoting green investments, i.e. a green Golden Rule (similar to Pekanov/Schratzenstaller 2020). Their point of departure is that the EU countries need additional investments to meet the "Fit for 55" target – i.e. a 55 per cent reduction in greenhouse gases by 2030 – in the order of 0.5 to 1.0 per cent of GDP per year, in absolute terms about EUR 100 billion per year. Private green investment would also have to increase, whereby the share of public investment in the total green investment required would need to be 20 to 25 per cent, as these are public goods. The authors fear that if the SGP returns to the status quo, excessive deficit procedures would have to be initiated against 13 EU Member States in the corrective arm of the SGP. This could lead to a renewed recession, just like back in 2011-2013 (at that time, structural primary balances in the EU were increased by a total of 3.4 percentage points within three years), together with a sharp decline in gross public investment. In this respect, current rules are at odds with the EU's climate policy goals.

Darvas/Wolff call for retention of the flexibility clauses and to simply "ignore" the 1/20 rule, as this has de facto already been ignored by the EU Commission in the past. In conjunction with budget relief (until around 2026) through the EU's reconstruction and resilience programme, a moderately restrictive fiscal policy would continue for the highly indebted Member States under the assumption of an MTO like in 2019, which would be accompanied by green public investments and – at the time expected – low interest rates. However, as these investments have an expansionary effect, but are counterbalanced by contractionary impulses from disinvestment in the fossil energy sector, a positive bottom-line growth effect is uncertain. Therefore, by assigning priority to green investment, however, it would be ensured that, compared to a general relaxation of the rules, fiscal latitude would actually be steered toward the prioritised purpose. Otherwise, consumptive spending could also grow or Pandora's box could even be opened, causing all the rules to be cast to the wind.

Darvas/Wolff do not argue for a general relaxation of EU fiscal rules, but for a maximum use of existing flexibility margins. They want to continue the general consolidation of public debt in the wake of the financial, euro and Corona crises because this would be in line with the Treaties. They are sceptical about a continuation of the NGEU programme, as it would have to become significantly larger, the EU would become significantly more centralised and, in addition, a Treaty amendment would be necessary.

This proposal is impressive due to its clear contours, the pragmatism it shows and its strong empirical footing. Key questions remain unresolved, however. The problematic calculation of cyclical fiscal balances is not addressed, although some Bruegel authors had previously argued in favour of expenditure rules, which, however (as described in the foregoing) are plagued by the usual problems. Moreover, not only green investments are needed – there is also considerable pent-up demand for other investment targets, especially digital ones. The fundamental problem of high debt burdens in several Member States following expiry of the NGEU programme is not addressed, nor is the lack of a centralised fiscal capacity on the part of the EU or EMU when centralised monetary policy is dominant and overstretched. The flexibility rules are generally considered vague and non-transparent; they are seen as really only being a stopgap measure to avoid having to revamp the overly contractionary regulatory system as a whole. The disregard shown for parliaments with respect to their decision-making capacity in connection with issues of future gravity is also politically questionable from a democratic perspective. Many proposals by the European Parliament, for example, are more future-oriented than those of the Council of the EU or other EU institutions. Overall, the proposal is too unambitious and too defensive. It does not get to the heart of the problems at hand, nor does it directly tackle the five major challenges mentioned at the outset.

EUROPEAN STABILITY MECHANISM – 100 INSTEAD OF 60

Francová et al. (2021) from the European Stability Mechanism (ESM), the European rescue fund, call for the debt cap to be raised from 60 to 100 per cent. The proposal bears the signature of Klaus Regling, director of the ESM, who was also architect of the 2005 reform of the SGP, in which structural deficits were introduced as an operational variable instead of headline budget deficits (with the three per cent rule).

Raising the debt limit to 100 per cent is at the core of the proposal. The 60 per cent limit is said to have been arrived at by combining a growth trend of five per cent in nominal terms – with two per cent inflation – and a deficit limit of three per cent, resulting in a convergence of all Member States to a debt ratio of 60 per cent. What is not mentioned, however, is that this arithmetic implies that three per cent is the normal budget deficit in this case, hence no upper limit. As of the present day, on the other hand, the growth trend expected by many is about three per cent (i.e. about one per cent in real terms), so at an average deficit of three per cent, the debt level trends towards 100 per cent. Because of lower interest rates and the $g > r$ constellation expected, at least over the medium term, this debt burden is bearable and sustainable. So far, this is an impeccable rationale.

Countries with higher debt ratios should gradually approach the 100 per cent limit with primary surpluses, although the 1/20 rule remains in place here. This rule is not intended to target the structural primary balance, however, but rather the unadjusted headline balance. If special investment needs are claimed and demonstrated to the EU Commission, a temporary derogation is recommended, with financial support from the EU budget or the European Investment Bank also possibly being granted.

A simplified expenditure rule is to apply to countries with debt below 100 per cent: Primary expenditure should not increase faster than the actual GDP growth trend (except in the case of tax increases or expenditure cuts). This allows to completely dispense with the controversial calculation of potential output.

For both groups of countries, the three per cent limit for net lending/borrowing continues to apply. The structural targets of 0.5 and 1.0 per cent are lifted. This proposal is all the more surprising because it was Regling who "invented" the caps for structural deficits in 2005. The authors assume that countries will leverage the extended discretionary scope and not voluntarily adhere to the old ceiling. In this proposal, however, the cyclical flexibility needed is estimated at only 1.5 percentage points in the case of a mild recession, which means that an approx. 1.5 per cent structural deficit would be implicitly possible (cf. Francová et al. 2022: 23). On this point, the proposal seems inconsistent: In order to keep a 100 per cent debt limit constant, a nominal GDP growth of three per cent requires a three per cent budget deficit in a cyclically neutral situation, i.e. in recessions the three per cent limit has to be temporarily breached with the help of automatic stabilisers.

In addition, a stabilisation facility is to be set up at the ESM as a revolving fund if individual countries are particularly affected by asymmetric shocks. Regling has long called for a so-called Rainy Day Fund to this end. In the event of severe recessions, including in individual countries, exception clauses can be activated.

This proposal emphasises that Protocol 12 to the TFEU needs to be amended, which is possible through the simplified procedure for unanimity in the Council of the EU under Art. 48 TEU in conjunction with Art. 126 (14) TFEU. The Fiscal Compact would have to be incorporated into secondary European law in a slightly modified form or else amended (Franková et al. 2021: 23).

The ESM proposal displays a pleasing realism and probably satisfies the political desires of many countries from all country groups. It offers all Member States more fiscal space, including those with debt below 100 per cent, and seems to free everyone from the pitfalls involved in identifying output gaps (see Box 2). It also constitutes a considerable simplification. The proposal of the EFB is criticised by the ESM authors in strong words, as with debt reduction paths of up to 50 years, it is held to reduce the credibility of the rules ad absurdum.

Apart from the political barrier of amending Protocol 12 of the TFEU, however, four problems become apparent. First of all, inserting a quantified debt cap into the protocol once again, as if it were meant to last forever, is not really what the authors had in mind – they themselves write that in the long run the ratio of g to r could change. Therefore, it would be better to lay down the number 100 (or x) in secondary law. Secondly, the primary surpluses required by Member States with debt above 100 per cent are conceptually and practically unmanageable because they fluctuate strongly with the business cycle, as the cyclical component is not taken into account. The operative variable would have to serve as the structural primary balance if cyclical breathing space is to be granted. Thirdly, with regard to the expenditure rule, actual trend growth and potential growth can differ considerably. Non-cyclically adjusted trend growth is a poor measure of expenditure growth for two reasons: it is – as with almost all expenditure rules – backward-looking, as if the future were an extension of the past; and it includes cyclical "negative growth", which is precisely what is supposed to be buffered. Fourthly, cyclical deficits with a strong countercyclical effect can easily overshoot the three per cent limit, as the examples of the U.S. and UK show.

CONSEIL D'ANALYSE ÉCONOMIQUE – "… NO LONGER IN THE WORLD OF MAASTRICHT"

Philippe Martin, Jean Pisani-Ferry and Xavier Ragot (CAE 2021) of the Conseil d'Analyse Economique (CAE) adopt a different approach based on the following premises. The EU, and the EMU in particular, must avoid two negative "externalities" – i.e. the contagion effects of risks in one Member State spreading to other countries: firstly, risks of possible sovereign insolvency due to excessive debt and self-fulfilling negative expectations on the part of financial market actors; secondly, demand externalities in the Eurozone due to an overly contractionary or insufficiently expansionary fiscal policy, because countries with ample fiscal latitude – such as Germany or the Netherlands – generate too little domestic demand. Moreover, there are four new trends that have led Europe out of the Maastricht world in the long run: (1) higher public debt, but (2) much lower interest rates, (3) diminishing effectiveness of monetary policy at the zero interest rate limit, and finally (4) the possibility of joint public borrowing via the EU budget as in the Next Generation EU project. This would have to be responded to with "unconventional fiscal policy" (Isabel Schnabel, ECB). A complete break with the old SGP is argued to not be necessary, however.

Protocol 12 of the TFEU is to be amended (under the simplified procedure according to Article 48 TEU) for both thresholds on deficits and debt. Due to the great diversity of the Member States in the EMU, but also in the EU, the countries themselves should specify individual limits for sustainable debt levels that they would like to achieve. Furthermore, they should specify development paths with information on expenditure rules with which they can achieve their debt targets. The latter have priority, and the fiscal balances are derived from them. The methodology for the new rules is to be developed uniformly by the EFB, while the medium-term plans are to be reviewed by national fiscal councils as well as by the EFB and approved (or rejected) by the Council of the EU (in the euro format for EMU). The reference values from Protocol 12 are thus to be defined flexibly and possibly differently at the national level. Experience gained through the Recovery and Resilience Programme is to be leveraged to set up a European fund for national or supranational investment or innovation, characterised by joint financing with joint liability. It is recommended that normal counter-cyclical fiscal stabilisation continue to be carried out through national fiscal policy.

A Golden Rule for public investment is rejected because the investment concept based on national accounting is unsuitable. No single type of expenditure should be privileged. Conversely, this means that financing deficits must be sufficiently large for both cyclical stabilisation and net investment. As far as the management of demand externalities is concerned, the EU Commission should submit proposals on how domestic demand as a whole in the EMU can be stabilised equally by all member countries and at the same time for a counter-cyclical stance for the entire EMU.

This proposal still leaves many questions unanswered or shifts them onto the Member States and the EFB. Ultimately, assumptions for the interest-growth ratio and for necessary structural deficits must be made for the national debt and budget plans over a medium-term period (about five years) and expenditure plans derived from them. What would be new is that neither the three per cent nor the 60 per cent limit would apply anymore and that the assumptions for g and r would be set flexibly for only a five-year period in each case. The fact that the deficit limit of three per cent is also put up for discussion makes sense and is necessary if there is a deviation from the 60 per cent ceiling for the debt level: If, for example, a Member State targets a debt ratio of 90 per cent on a permanent basis (or over a longer period) and expects economic growth of 3.0 per cent in nominal terms, then the average budget deficit would be 2.7 per cent of GDP (see Box 1); if cyclical room to manoeuvre in a recession of the order of three percentage points is needed for automatic stabilisers, one would temporarily arrive at 5.7 per cent. Incidentally, this also applies to the IMK and EFB proposals. Article 126 TFEU and also the SGP allow for temporary deviations in exceptional cases, however. In various OECD countries, especially in the U.S. and Great Britain, cyclical deficits often exceed three per cent of GDP by far.

The coordinated shift of fiscal policy to the national level is likely to be appreciated by many Member States. However, according to the CAE proposal, the final decision would remain with the Council of the EU. It would be problematic if a group of countries, for example Germany and the "Frugal Three" – until recently the "Frugal Four" including also the Netherlands – defined their debt targets much lower than the countries with currently high debt ratios. Fiscal policy divergences among the Member States in the Eurozone and the EU would then become entrenched. The "thrifty" countries would contribute too little to the creation of domestic demand within the EMU or EU, i.e. they would generate a negative externality for the other countries. In the proposal it also remains unclear what role the common EU fund is supposed to play in relation to national financing.

In the CAE's view, deactivating the escape clause of the SGP only makes sense once pre-pandemic per capita income has been reattained and once the new rules have been adopted. This is not likely to be the case until 2024. The Commission has already agreed with this point.

INTEREST BURDEN INSTEAD OF GROSS DEBT – ANOTHER YARDSTICK FOR DEBT SUSTAINABILITY

Priewe (2021, 2021a, 2021b) seeks a different measure of government debt sustainability and derives from it a different anchor for government debt and a different operational target. The ability to sustain debt depends largely on the net interest burden ratio, which significantly influences interpretation of the gross debt ratio. The interest burden ratio is the product of the implicit interest rate on government debt and the gross debt to GDP ratio. The central bank profit that goes to the respective government must be deducted from the gross interest burden. Since the implicit interest rate is an average interest rate for older and younger bonds, it changes only relatively slowly, especially if the average remaining maturity on bonds is high. High interest charges could crowd out other government spending and raise doubts about creditors' ability to pay, leading to risk premiums. An interest burden of three per cent of GDP could be a line triggering an alarm, beyond which the burden is deemed to be excessive. In the EMU, only Italy has a (gross) interest burden ratio slightly above three per cent. Over a medium-term period, about five years (as with CAE 2021), the interest rate-growth differential could be relatively stable and manageable. Temporary interest rate hikes in tandem with higher inflation would hardly increase the interest burden ratio, instead tending to decline, as nominal GDP rises normally more strongly than the implicit interest rate.

Choosing a new metric for public debt avoids getting misguided by the gross-debt-GDP ratio. For example, the German burden of debt, measured as interest service to GDP, is as low as in the early 1960s – in the years of the "economic miracle" – but the debt level was in the recent peak twice as high as then. Even if we know that interest rates can change, we know that they do matter for the burden of debt. Therefore, a cap of 60 per cent or a cap of X per cent should not have a lofty status as eternal limits in our constitutions – limits which are so hard to change. Wrong limits which are almost unchangeable are considerable roadblocks for development and evolution. Furthermore, gross debt ignores public assets, be it liquid assets, financial assets or physical assets like land, roads or schools. Net debt is indeed difficult to measure since many assets have no market price. But ignoring what is not easily measurable is no solution. The debt of a country cannot be measured in a single figure. Lastly, there is a technical flaw that has scarcely been noticed in the metric used in the SGP and the Fiscal Compact. With regard to fiscal deficits, net deficits are measured by excluding deficits caused by financial transactions for the purchase of assets. Gross debt should be cumulative annual deficits, but they are not. Gross debt does not exclude cumulated financial transactions. Therefore, we have sizeable "stock-flow-adjustments" in debt statistics. Gross debt data are misleading. No private firm would only look at liabilities and ignore assets, although the latter are not easy to assess correctly. In other words, the false metric based on gross public debt discriminates against public investment. This is not to say that debt should only be incurred for public investment. The new metric has to define what is considered affordable.

The focus on structural deficits obfuscates what really is important about the change of debt. If one follows the Domar equation (see Box 1), then it is the average primary balance over this period that determines whether the debt level falls or rises. The operating variable is not supposed to be the structural balance (as in the SGP since the 2005 reform, designed by Regling), but rather the average primary balance; the structural balance is not controllable by fiscal policy at all, because implicit interest rates are given (the difference between the two variables is the interest burden ratio, see Box 1). If the interest burden is close to three per cent, a primary balance must be determined that stabilises or reduces the debt level. Example: with r-g = 2-3 = -1 and a debt level of 100 per cent (150 per cent), an average primary balance of -1.0 per cent (-1.5 per cent) would stabilise the debt level and lower it at any higher primary balance. The headline balance would be -3.0 per cent. Even with a primary balance of zero, there would still be a small margin for credit-financed net investment. Therefore, country-specific adjustment plans should be drawn up for five-year periods with a focus on the primary balance.

The proposal includes an expenditure rule instead of the previous determination of cyclical balances. This should be forward-looking (analogous to the ECB's monetary policy), i.e. not focus on past potential output growth trends, and set an acceptable structural primary balance for the starting year that leads to an acceptable interest burden. For countries with lower debt, a sustainability margin should be set with a debt ratio and an interest burden that is targeted over the medium term. For example, if one targets a debt ratio of 60 per cent (90 per cent) with an expected growth trend of three per cent (nominal), a permanent budget deficit of 1.8 per cent (2.7 per cent) is sustainable. The interest burden would be 1.2 per cent (1.8 per cent) if the expected implicit interest rate were 2.0 per cent (with a real interest rate of zero at target inflation). A uniform debt ratio in all Member States does not necessarily have to be sought. At least in part, this reform proposal could be realised without amending Protocol 12 because Article 126 (3) TFEU explicitly states that in addition to the reference values, "all other relevant factors" must also be taken into account, which certainly includes interest rates.

What is important with this proposal is that in order to avoid roll-over risks – when maturing bonds have to be replaced by new issues – the ECB stands ready to provide support should interest rate expectations in markets suddenly shoot up, driven by panic, speculative attacks or extreme sentiments not grounded in fundamentals. This is necessary and possible for the EMU's financial stability and to maintain the effectiveness of monetary policy transmission within the ECB's mandate (see the proposals by De Grauwe 2021 for the European Parliament and Blanchard 2022). In the meantime, the ECB has changed its policy in this direction with the new "Transmission Protection Instrument" from July 2022 (see section 2). The fact that a considerable share of the government bonds of EU countries is now held by the ECB can also contribute to a stabilisation of the bond markets. In addition, the EU budget should be maintained after expiry of the NGEU programme, similar to the proposals made by the EFB (see below).

Furman/Summers (2020) are also guided by the idea, albeit with a different justification, of using the interest burden ratio as a new metric for debt sustainability, as does Blanchard (2022). But they do not intend for this to be a proposal for the EU. Sigl-Glöckner et al. (2021: 24ff.) and Nielsen (2021) as well would also like to use the interest burden ratio as a leading indicator (however calculated as a share of tax revenues). Nielsen also calls for minimum ratios for public investment and, separately from this, also for education as a portion of government spending for all EU countries. No explicit Golden Rule is included in the proposal, but the expanded leeway can be used for investments or innovations as a matter of priority. National parliaments are to be granted sufficient competence to specify and prioritise future tasks. The public budget, however, is to be financed uniformly through tax, other levies and debt without earmarking debt-financing to specific expenditure categories.

This proposal avoids many of the problems afflicting the other proposals, in particular the blanket prioritisation of investment or broadening the definition of investment. Countries with high debts, often old debts, are offered the options of bearing them or moderately reducing them through higher primary surpluses. The expenditure rule does not include a special provision for countries with high debt. The proposal allows for different developments in the Member States, but does not guarantee that countries with a high current account surplus and relatively low debt ratios will opt for a more expansionary fiscal stance to promote their domestic demand. Supplementary proposals are therefore needed here, as implied in the IMK proposal for a reform of the MIP.

Objections revolve around the interest rate risk. A return to the permanently higher interest rate level of the 1990s is unlikely (cf. Blanchard 2022), however. Even with a moderate growth trend of three per cent per year and a real interest rate of one per cent, there would be a favourable ratio of r and g. The fact that the risk premium across Member States is levelled is of key importance. A temporary increase in interest rates in the case of inflation would increase both r and g; whether r increases more than g is not certain. If investors are guided by the target inflation for the long term, then the nominal implicit interest rate would not rise at all or would rise less than g, so the interest rate-growth differential could even improve.

The proposal leaves aside how the debt burden can be reduced in highly indebted countries like Greece and Italy if interest rates there happen to rise sharply on a permanent basis – even if this is unlikely – and if countries like Italy fail to return to growth after decades of stagnation. If the interest burden in some countries remains at a high level or continues to rise, carrying out a debt sustainability analysis (DSA) is advisable – as the IMF does in such cases – and then looking for country-specific solutions (similar to the proposal by the EESC, but only in special cases). In these countries in particular, the focus should be on improving the interest rate-growth differential by lowering risk premiums and boosting growth by means of structural change and transformation. If a net interest burden of 3 per cent of GDP were considered as an alarm line, presently only Italy and Greece would be close to it, despite their high debt levels. Any primary structural budget balance above the expected r-g-differential would reduce the debt level and the interest burden.

One positive aspect of the proposal is also that no new reference values are set in place of the old ones of three and 60 per cent of GDP along with a quasi-perpetual status. If this does not succeed because the reference values cannot be changed, one can reinterpret the existing reference values according to the latitude mentioned in the foregoing contained in the TFEU.

A PROPOSAL BY THE FEDERAL GOVERNMENT OF GERMANY

Unexpectedly, the German Government published on 5 August 2022 a short paper on "Principles of the Federal Government for debates on the reform of the EU fiscal rules" (Bundesregierung 2022). It is the first official statement from an EU member government to date. The German coalition government has so far not had a common position on this issue. The statement is brief and interesting in terms of what is explicitly addressed and what is not mentioned. The statement is agreed upon by all three parties involved, and hence a minimal consensus.

The most important aspect of the statement is that substantial reforms of the SGP are not mentioned. Basically, the present rules seem to be confirmed. Clear commitments to goals such as debt sustainability, sound public budgets, fiscal consolidation as well as an orientation toward growth and counter-cyclical fiscal policy abound.

More concretely, the statement suggests setting the following targets:

- Gradual reduction of deficits and debt levels, both in absolute terms – which would mean radical austerity – and as a ratio to GDP in order to reach a "sufficient" level.
- Strictly abiding by the 1/20 rule is considered unnecessary since the preventive arm of the SGP suffices to reach the target; this relates to the medium-term objectives set by the Commission and the norm that the MTO is to be approached by at least 0.5 percentage points per year if the structural deficit is above the MTO.
- A Golden Rule or similar rules for the promotion of public investment is not mentioned, with the flexibility clause of the SGP regarding investment expenditure instead being expanded. Indeed, these clauses, which have existed since 2015, are overly restrictive, bound to conditionality and only temporarily usable.
- An exclusion of certain expenditure categories from the rules, such as green investment, is rejected.
- Common rules for structural deficits are to be retained, which is probably a reference to the 0.5 per cent cap for countries with debt near and above 60 per cent.
- All member governments are to be treated equally, bilaterally negotiated application of certain rules is rejected. However, this is the essence of the flexibility rules.
- Simplification of rules is praised, but nothing is proposed.
- An expenditure rule for identifying counter-cyclical smoothing of expenditures is endorsed, but only in connection with the structural balance as the anchor for fiscal policy. This implies that the measurement of potential output and cyclical balances remains unchanged.
- The escape clauses should be better specified to avoid a rule-free interim in case of activation.
- Finally, the European Fiscal Board should become more independent from the Commission.

Overall, the statement corroborates the status quo. Since the 1/20 rule was mostly ignored and the MTOs functioned as a substitute, nothing has been changed in this respect. So the message of the statement is – except regarding more flexible investment clauses – there should neither be a step toward substantial reforms, nor an outright hardening of austerity. One can interpret this as a red line against any reform that has been discussed in the foregoing or as weakness of the German position in the face of a lack of unity among the coalition partners, with them stalemating each other. The paper is amazingly uninspired and reveals a dearth of ambition. Its author is unambiguous, as it bears the signature of the German Minister of Finance (FDP, the German liberals) and his advisor.

A VIEW FROM THE INTERNATIONAL MONETARY FUND

A recent paper by a team of 12 authors, mainly from the European and Fiscal Departments at the International Monetary Fund (IMF), was published in September 2022, after consultation with many experts at the IMF and from other institutions, including the EU Commission (cf. Arnold et al. 2022). One of the team members is Jeromin Zettelmeyer, now director of the Bruegel think-tank, formerly Chief Economist at the German Federal Ministry of Economic Affairs (2014-2016). The proposal is not an official IMF paper. The authors call for a major reform of the rules to be decided by end of 2023. The analysis describes the shortcoming of the present fiscal rules, proposes a new anchor for fiscal stability and three country-group specific operational rules. On top, a second escape clause and a new institutional setting is proposed, and the call for a new central EU fiscal capacity following termination of NGEU is endorsed. Whereas no change in the EU Treaty is proposed (hence the fundamental 3 per cent deficit cap and the 60 per cent debt reference value are to remain untouched), it is suggested that the Fiscal Compact be shelved in full and, implicitly, most of the present SGP.

The authors' assessment of the present flaws is staggering: in the period 1999-2020, the deficit cap is said to have been violated – on average – significantly, and even more the debt cap of 60 per cent with 10 Member States far above this margin at present. This has led to the rules being rendered inefficient, especially regarding countercyclicality as well with regard to the need for a proper mix of fiscal and monetary policy, resulting in general fiscal sustainability risks accompanied by spill-over risks originating in high-debt countries. The main cause behind this failure is, in the view of the authors, broad non-compliance with the rules by national fiscal policies. This critique seems to be more of a blanket reprimand since no differentiation is made regarding the period, now spanning more than two decades – replete with changes in the rules – and a wide variety of national performances. If the lack of fiscal discipline were the main cause of the problem, the fiscal framework would not need to be made the culprit and rebuilt.

The paper proposes a new fiscal anchor for the set of rules. It is to be the medium-term headline fiscal balance and no longer the structural balance, as was the case in the Fiscal Compact and the SGP since 2005. The new anchor is to be differentiated according to the different fiscal risks in three country groups:

- in countries with high debt-to-GDP ratios, going far beyond 60 per cent, the budget balance is to be on average zero or a slight surplus;
- in countries above but close to 60 per cent, it is suggested that the anchor be set so that the debt level contracts, potentially a budget balance less than zero;
- in countries below 60 per cent, the budget balance can be more flexible, without using numerical caps as long as the 3 per cent cap (and not the average) is adhered to.

So all three anchors are tied to the debt cap of 60 per cent, which serves implicitly as the hidden anchor in this proposal. For the high-debt countries, a proposal is made for debt sustainability analyses (DSA), which are commonly to be found in the general IMF approach to high public debt. This approach implies scrapping the 1/20th rule, which could require primary surpluses of up to 5 per cent in many high-debt countries – which is too austere according to the authors. However, in Member States like Italy that are paying interest on debt amounting to more than 3 per cent of GDP, the primary balance implicit in the proposal for high-debt countries would lead to medium-term balances above 3 per cent if the headline balance were zero or higher. There is no major difference here compared with the status quo that is being criticised! The proposal nevertheless avoids focusing on annual deficits as in the SGP by specifying the entire framework in the medium term – and in terms of headline instead of structural balances. This seems to avoid measuring the output gap.

The operational rules are defined as medium-term expenditure paths with a broad definition of general government spending. In all other proposals regarding expenditure rules, at least interest payments and unemployment benefits are exempted from the expenditure rule since these items cannot be controlled by governments. The spending rules are tied to the three anchors – hence they are differentiated according to the three country groups. The rationale underlying the spending paths is the need to implement countercyclicality and reduce debt, which is to say tolerating deficits in bad years and building buffers in good years. Buffers – not defined in the paper – can apparently be established by saving revenues or repaying maturing debt. The line of delimitation for good and bad years seems to be an output gap of zero. The authors' hope is that savings in above-zero years will match deficits in below-zero years or exceed the latter, without constraining growth in good times. In essence, the notion at work here is cyclically balanced budgets. Two arguments underpin the hoped-for expansionary effects of this kind of austerity: in good times the fiscal multiplier is lower than in recessions, so that efforts to curbing spending are less harmful to growth; furthermore, financial markets would honour fiscal saving by reducing spreads on interest rates, which could boost growth. In general, interest-rate spreads would rise with the debt ratio, so lower debt spurs growth – an empirically weak proposition. It is not mentioned that spreads normally rise in bad years, since financial markets act procyclically.

The paper includes a simulation of Italy's track record over the period 1991-2017. It shows – contrary to what the authors want to convey – that the bad years below potential output clearly predominated (figure 3 on p. 6, panel 3) and stricter compliance would have aggravated size and length of negative output gaps. The analysis in the paper follows the general equilibrium theory approach, according to which deficient output growth has no negative impact on potential output. Hence, a belief in the virtues of austerity is a conspicuous trademark of the paper. Furthermore, there is no shelter for public investment proposed, no golden rule or similar, despite the paper's rebuke of the poor performance of public investment in the EU. The present flexibility options are not mentioned, so they would appear to have been scrapped in the proposal.

In addition to the existing general escape clause deactivating the SGP rules for all Member States, a country-specific national escape clause is proposed for idiosyncratic risks in certain countries due to asymmetric shocks. This is to be activated under specifically defined conditions, which is a sensible proposal.

The main instrument to address non-compliance is the proposal to establish a system of independent national fiscal councils, independent from national governments and independent from the Commission. These councils should have more sovereignty to elaborate and monitor national fiscal frameworks for national fiscal anchors and expenditure pathways. The critical issue of decision-making by parliaments or the national treasury is not addressed. The vision behind the strong proposal for such councils in the paper would appear to be an implicit desire for de-politicisation of fiscal policy, similar to independence of the central bank regarding monetary policy. The EFB is to be replaced by a new council, less dependent on the Commission and tasked mainly with surveillance of national councils and elaboration of common standards for debt-sustainability assessments. Another reason for the strong emphasis on more national fiscal discipline is trust in the disciplining power of financial markets in order to reduce country-specific risk premiums.

Similar to the EFB proposal, Arnold et al. strongly advocate a central European fiscal capacity. The goals are twofold: firstly, macroeconomic stabilisation of the entire EU in the event that monetary policy is stuck at the zero lower bound for interest rates and loses steam for expansion, and in the case of symmetric shocks for the whole EU; secondly, for common public goods for which single countries' efforts are insufficient or impossible, such as a "climate investment fund" or investment in defence. Such a fiscal capacity is to be financed by common loans (or bonds), coupled with additional revenue to service and repay the debt. Just like in other similar proposals, many issues remain open, but the commitment is clear.

Overall, an evaluation of the proposal produces a mixed verdict. The proposals for anchors and expenditure rules according to different risks is not so very different from the status quo for high- and medium high-debt countries, but perhaps a bit easier to implement with headline balances rather than structural balances. It is always the primary balance together with the differential between interest rates on debt and growth, however, that matters in terms of rising or declining debt. It is not even mentioned or discussed that interest rates tend to be lower than in the past, irrespective of temporary hikes. These issues could be included in the proposal to have the new EU fiscal board establish a common DSA methodology. The focus on headline balances obfuscates the emphasis on primary balances. Apart from a commitment to a European fiscal capacity, merely the priority placed on the medium term rather than on annual indicators can be considered innovative and helpful. The notion of a national escape clause also warrants consideration.

6.2 CONCLUSIONS – REFORM OPTIONS

The majority of the proposals advocate substantial changes in European fiscal rules, some involving amendment of the Treaties and some not. Almost all ignore the Fiscal Compact, however, as it is not EU law. Most of the proposals reference European secondary law, i.e. the SGP. Table 3 provides an overview with keywords heading seven assessment categories.

Only the proposal by the Deutsche Bundesbank and Proposal I by the German Council of Economic Experts (Grimm/Wieland) largely stick to the current SGP and want above all to tighten up implementation, for example by eliminating flexibility options. The proposal by the Federal German Government is along similar lines, but seemingly somewhat less hawkish on fiscal tightening. The IMF proposal assigns more fiscal leeway to the low-debt countries, but seeks to tighten austerity and related enforcement of rules for high- and medium-debt Member States. Furthermore, it would undermine the prerogative of democratically elected national authorities by empowering national fiscal councils. The Bruegel Institute's proposal is also close to the status quo, but wants to use all the latitude for "green" reforms and ignore the 1/20 rule because this has also received little attention from the EU Commission so far. Almost all the proposals want to change calculation of cyclical budget balances to expenditure rules. The most important difference is whether special "austerity expenditure paths" with lower increases in expenditure relative to growth in potential output are envisaged for countries with high debt. Expenditure rules can be designed in a hawkish way and also with expansionary colours as well. Many proposals advocate introducing a Golden Rule, allowing credit financing of public net investment with higher structural deficits. The ESM and CAE proposals, on the other hand, want to allow larger structural deficits in combination with higher ceilings for debt that can be used for public investment. Priewe et al. would like to include a minimum ratio for public investment in the budget just like in the Nielsen proposal (2021), with greater overall debt possibilities if the interest burden ratio is chosen as a benchmark or an alarm signal in the order of 3 per cent of GDP.

In order to encourage countries with ample fiscal space – i.e. relatively low debt ratios and low implicit interest rates – to leverage this so that national and EU-wide demand can be bolstered, the 60 per cent limit (or another limit) could also be interpreted as a reference value for these countries. A simple solution would be to allow these countries to run higher structural deficits than the current 0.5 or 1.0 per cent of GDP. This was already proposed by the EFB in 2020 (as well as by Hauptmeier/Kamps 2020 – two ECB officials). Although these countries can hardly be forced to finance a larger share of government spending by borrowing, they could be allowed higher primary or structural deficits by the EU Commission. With nominal growth of three per cent and a debt level of 60 per cent, this would be compatible with structural deficits of 1.8 per cent. This would be a comfortable figure not only for Germany or the Netherlands. In order to make use of this option, however, Germany would have to relax its debt brake (or use extra budgetary funds as planned, see below).

Four proposals advocate a continuation of NGEU after 2026 by permanently increasing the EU budget and providing it with a debt option. The EFB is the clearest in this respect. Nevertheless, the four proposals remain rather vague when it comes to the relationship between the EU budget and the reformed SGP; it takes more time to arrive at a decision here than in the other proposals.

In a comparison of the twelve proposals, the one by Priewe et al. has the advantage of exhibiting a clearer understanding of debt sustainability. The proposal by the CAE is similar, but important details are assigned to expert panels. Both proposals seem best suited to addressing the five challenges mentioned at the beginning. By measuring sovereign debt sustainability with a different yardstick than gross debt and addressing the actual financing burden instead, they can make productive use of the combination of a low inter-

Tabelle 3: **Comparison of the reform proposals**

	Amendment of TFEU	Structural deficits	Cap on debt	Expenditure rule	Measures for Member States with high debt	Connection to NGEU	Special aspects
Bundesbank	No	Eliminate flexibility options	60 per cent	Yes, only short-term	Sanctions	No	Status quo tightened, less complex
EFB	No, only for CFC[7]	Golden Rule	60 per cent	Yes, country-specific	1/50 instead of 1/20 rule	Yes	CFC[7]
IMK	90 per cent debt[1]	1.5 per cent for investments	90 per cent	Yes, country-specific, with limit values	Possibly 1/50 rule[4]	No	Connection to MIP[6]
EESC	No	0.5/1.0 per cent + Golden Rule	60 per cent	Yes, the same for all countries	Check special cases, possibly DSA[5]	No	–
SVR I	No	Delete flex options	60 per cent	Yes, only short-term	None	No	Similar to Bundesbank
SVR II	No	0.5/1.0 per cent + Golden Rule	60 per cent	Yes, country-specific	1/50 instead of 1/20 rule	No	Similar to EFB and IMK
Bruegel	No	Status quo including flex options	60 per cent	–	Ignore 1/20 rule	No	Status quo in Green
ESM	100 per cent debt	Delete 0.5/1.0 per cent	100 per cent	Yes, country-specific	None	No	Strong simplification of the rules
CAE	Yes, reference values, CFC[7]	Increase limits[3], no Golden Rule	Interest burden cap	Yes, without stating details	Possibly spec. DSA[5]	Yes	Strong weight of expert councils, CFC[7]
Priewe et al.	No[2], apart from CFC[7]	Interest burden/GDP < 3 per cent, no Golden Rule, investment ratio	Interest burden ceiling 3 per cent	Yes, the same for all countries	Possibly special measures, DSA[5]	Yes	Key is a new metric for debt sustainability (like CAE), CFC[7]
Federal Government of Germany	No	Unchanged	As in the Treaty	Yes, linked with structural deficit cap	1/20 rule ignored, MTO as substitute	No	More flexibility in investment clause
IMF	No	Replaced by headline balances, no 0.5/1.0 per cent rule	As in the Treaty	Yes, broad medium-term spending rule linked to target headline balances	1/20 rule scrapped, different rules for 3 country groups, DSA[5]	Yes	Build and empower national fiscal councils, national escape clause

[1] Alternatively, 60 per cent with 1/50 rule; [2] Change advantageous, but not compelling; [3] Dependent on interest burden; [4] In variant without Treaty change; [5] Debt Sustainability Analysis; [6] Macroeconomic Imbalances Procedure; [7] Central Fiscal Capacity

Source: author's own compilation.

est rate environment through the ECB and fiscal policy. They may also be more likely candidates for compromise between both groups of countries in the EU, although changing the metric is a big step. A Golden Rule for public investment is not explicitly included, but is made possible by a minimum ratio of public investment to expenditure. Debt financing, however, is not allocated to individual expenditure categories. The IMK, EFB and EESC proposals are similar, but the ESM proposal also overlaps with that of the IMK. The expenditure rule is problematic in some regards, however. Nevertheless, these proposals also take major steps forward. The focus in the IMF proposal on medium terms is sensible, as is allowing an additional national escape clause in the case of severe asymmetric shocks. Many proposals are explicitly or implicitly in favour of the idea of the IMF authors to scrap the TSCG with the 1/20 rule and the 0.5/1.0 per cent caps on structural deficits. Several proposals call for in-depth analyses of public debt in debt-ridden countries with a common methodology to be applied in debt sustainability analyses. The debt ratio alone is not a sufficient metric for risk assessments. Therefore, specific requirements for high-debt countries need to be included in any reform. ←

7
GOVERNMENT DEBT IN GERMANY – AN OVERVIEW

In the following, the development of debt, fiscal balances, interest burdens and public investment with reference to the German general government is first presented and discussed. Then various reform proposals of the German debt brake are explored in more detail in the following chapter.

In Germany, government debt relative to GDP doubled from the mid-1970s to 1990, reaching about 40 per cent before German reunification; thereafter it climbed to a peak of 74 per cent in 2010 (financial statistics which differ from national accounting). Applying the EU Commission's definition, gross debt rose to 82 per cent according to ESA 2010 (cf. Figure 9), which is based on the total public budget including social security funds and extra budgetary resources. Financial transactions – the credit-financed acquisition of financial assets, for example through stakes in companies or purchase of land – are also included. The data for gross debt according to ESA 2010 (national accounts), which represent the so-called Maastricht debt and which the EU Commission uses, are higher than the debt listed in German financial statistics, which are based on cameralistic accounting. The corrected gross debt according to ESA excludes so-called stock-flow adjustments, which are mainly based on financial transactions, and furthermore due to valuation changes and statistical errors. The corrected gross debt calculated from 1999 onwards in Figure 9 results when the budget balance of the respective financial year is added to the debt of the previous year.

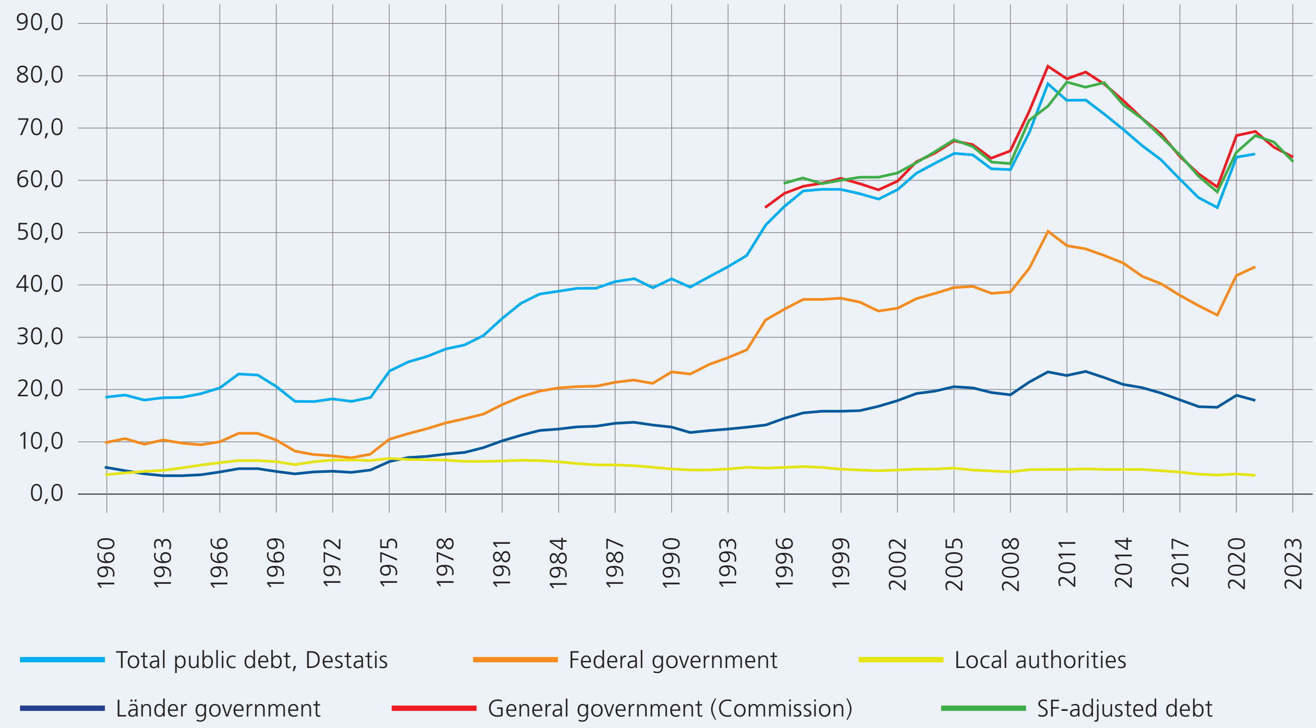
In fact, the debt level, especially since the financial crisis of 2008/2009, is much higher than the level that would result from budgetary fiscal balances. This makes it clear that gross debt is by no means something that can be unambiguously measured. In the fiscal balances on which the SGP is based, but also under the debt brake, annual borrowing excludes financial transactions, as assets and liabilities change in tandem and the level of net assets remains constant. This is, however, not the case for gross debt. For 2020, the three debt ratios were just under 69 per cent (corrected gross debt according to ESA 2010), 64.5 per cent (according to German Financial Statistics/ Destatis) and only 54 per cent (corrected debt according to EU Commission). The focus on gross debt also excludes liquid assets and is not consistent with the calculation of annual budget balances. Economists refer to this as inconsistency between stock and flow figures.

Figure 9 clearly illustrates that the increase in the debt ratio in Germany was predominantly due to the federal government (plus 32 percentage points 1960-2020), less so to the Länder (plus 15 percentage points) and not at all to municipalities. The main phases in the increase in the general government debt ratio have been as follows: (1) a rise in interest rates relative to GDP growth in the inflationary 1970s and early 1980s, followed by a weak recovery with contractionary fiscal policy; (2) a debt boom and high interest rates in the wake of German reunification, followed by a short boom in the late 1990s during the new economy bubble; (3) four years of GDP stagnation in the early 2000s, followed by a very short recovery thanks to favourable global economic conditions leading to high export surpluses; (4) 2008/2009 the financial crisis and the subsequent double-dip recession in the Eurozone as a result of overly contractionary fiscal policy until 2013; surmounting of the "Euro recession" and recovery from 2013 until 2019; (5) renewed economic slump with a high level of new debt as a result of the Covid-19 crisis in 2020/2021, with the increase in debt resulting from bond purchases under the ECB's PEPP programme placed with the ECB and the Deutsche Bundesbank in their capacity as new creditors (De Grauwe 2021). As the latter are legally – despite being independent – part of the government sector, the principle of "we owe it to ourselves" applies. This also goes for bond purchases by the ECB before the pandemic, which cumulatively accounted for about 24.3 per cent of German government debt from 2014 to February 2022 (ECB 2022).

Since the debt brake in the Basic Law does not explicitly mention a debt cap, apart from the reference made to European rules which include the 60 per cent limit for total government, it is the annual budget balance that matters. This is shown in Figure 10 in various delimitations for the period 2007-2022 with its two major crises. During the financial crisis, the unadjusted fiscal balance (headline balance) fell by more than four percentage points to a deficit of more than four per cent; in 2020, the headline balance fell by about eight percentage points within one year. The structural balance, which is supposed to be cyclically adjusted, also fell during the recession and rose again during the upswing. A structural balance of a maximum of -0.35 per cent could not be achieved at all, so in both crises the escape clause became de facto the new "rule".

The decisive factor for debt development is not the structural balance, but the primary balance, i.e. the budget balance excluding interest expenditure (cf. Box 1). This declined by two and six percentage points, respectively, during the two crises, but rose to a surplus of almost three per cent as a result of the upswing that set in after 2010

Figure 9: **Germany: development of public debt since 1960, as percentage of GDP**



Notes: source for "general government" is Finanzstatistik/Destatis; until 1990 West Germany; only local government, social security funds included as of 2010, but < 0.1 percent; as of 2010 general government including extra budgetary funds, excluding other funds, institutions and enterprises (FEU), 2006-2009 selected FEU. "Gross debt (EU Commission)" according to AMECO underlies SGP, data since 1995. Corrected gross debt: Gross debt = debt from 1999 onwards: previous year's debt + budget balance of the respective year according to AMECO (own calculation). Difference between gross debt (EU Commission) and corrected gross debt corresponds to "stock-flow adjustment" (SF-adjusted debt) in AMECO.

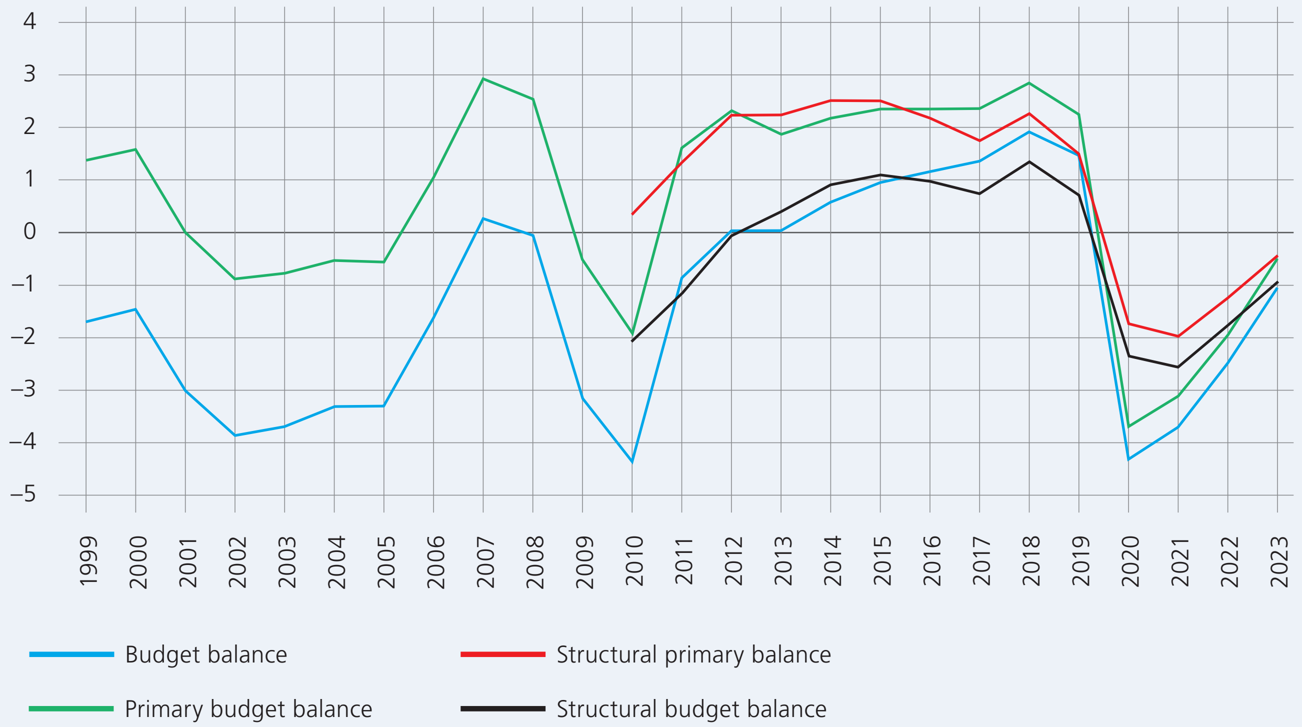
Source: Destatis FS 14 R5, AMECO, series UDGG since 1995 and UDGGS since 1996. Data for 2022 and 2023 estimate from the EU Commission in May 2022.

with soaring tax revenues and a moderately restrictive spending policy that brought with it strong budget surpluses, packaged in various special off-budget funds ("Sondervermögen"). The combination of high primary surpluses and a negative interest rate-growth differential lowered the debt level by no less than 20 percentage points from over 80 per cent to below 60 per cent of GDP in 2019. The fact that tax revenues rose so strongly was mainly due to rising employment in the upswing, caused partly by low labour productivity growth, fuelled by the "cold progression" in income taxes and reinforced by less interest payments on debt. As the interest burden is getting smaller, the difference between the structural balance and the structural primary balance is dwindling.

Gross public investment fell by more than one-third in relation to GDP from the early 1990s until 2015, and rose again slightly thereafter (cf. Figure 11). Net investment – gross investment minus depreciation – is the stepchild of government fiscal policy. The ratio has been hovering around zero since the end of the 1990s, which means that public capital stock is stagnating, despite a large backlog and tremendous new infrastructural needs. Especially in the case of municipalities, inflation-adjusted investments are declining. The growth of the inflation-adjusted net capital stock over the period 1991-2020 is just five per cent, or 0.2 per cent per year. This is not only due to the debt brake, which was only supposed to take effect for the German Länder in 2020, but was deactivated in the years 2020-2022 as a result of the proclaimed state of emergency due to the pandemic. Other priorities, a lack of planning capacities and a shortage of skilled workers in the construction sector are also to blame, as is the austerity policy adopted after the increase in debt as a consequence of German reunification, despite an investment-friendly arrangement in the Basic Law up until 2009 (see below). The data include investments made by special funds and other extra-budgetary accounts.

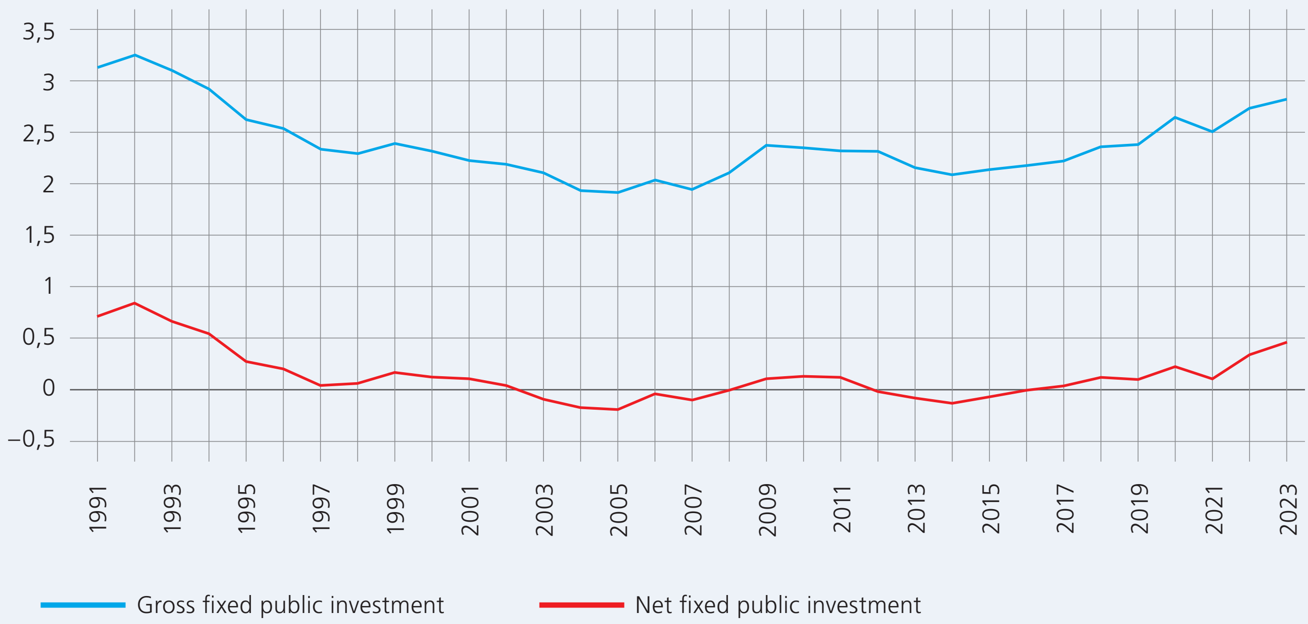
Average interest rates on government debt have been falling since the mid-1980s. In 1996, they still stood at 6.2 per cent, in 2021 at only 0.8 per cent (cf. Figure 12), with

Figure 10: **Germany: different budget balances 1999–2023, as percentage of GDP**



Source: AMECO, UBLG, UBLGI, UBLGAPS, UGLGPS series. Data for 2022 and 2023 estimate from the EU Commission in May 2022.

Figure 11: **Germany: gross and net public investment 1991–2023, as percentage of GDP**



Source: AMECO, UIGGO and UKCG series. Data for 2022 and 2023 estimate from the EU Commission in May 2022.
Note: Delimitation according to ESA 2010.

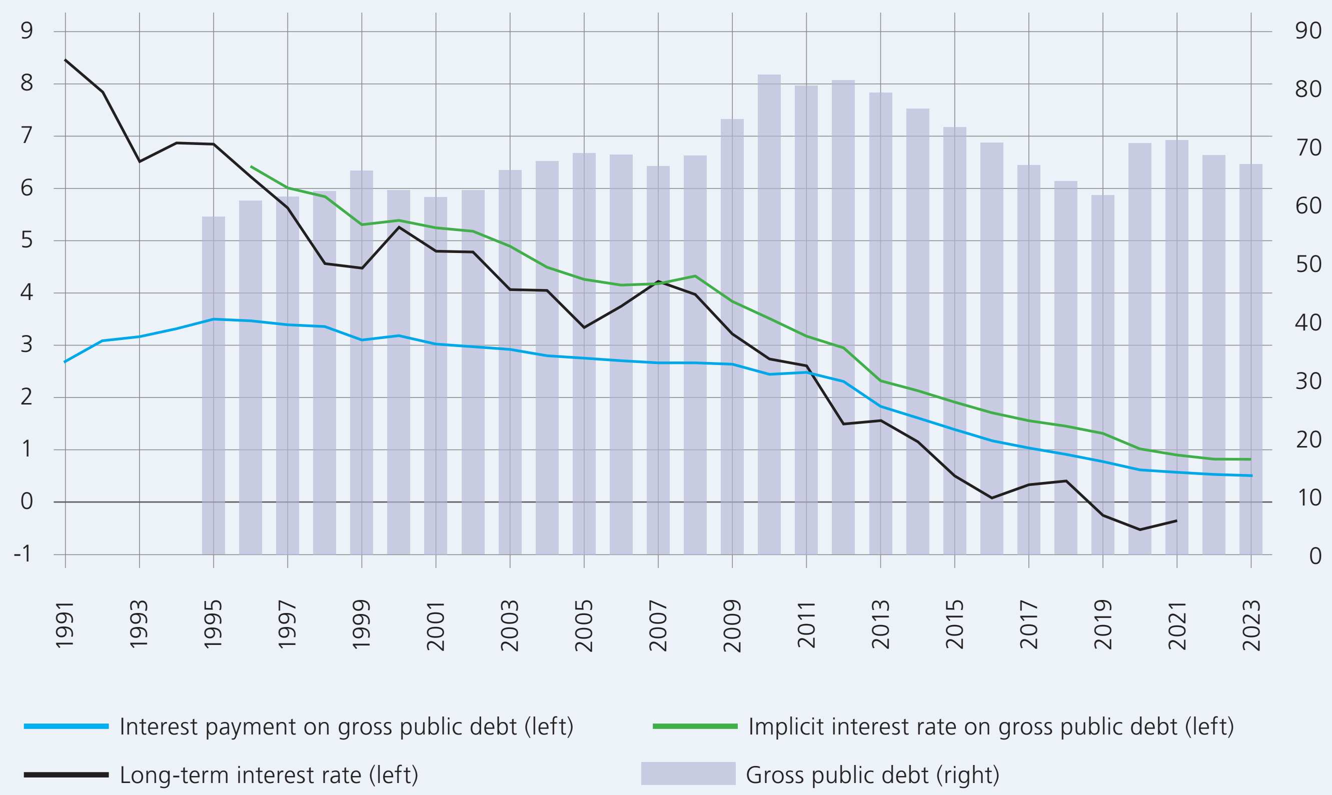
this development being reinforced by the ECB's low interest rate policy and bond purchases from 2012 and 2015, respectively, as a result of which the long-term nominal interest rate has fallen to below zero since 2019. Despite the rising trend in the debt-to-GDP ratio, the government's interest burden, relative to GDP, dropped from 3.5 per cent in 1996 to only 0.5 per cent in 2021. Never before has the sustainability of government debt – the capacity to carry debt – been so strong. The average maturity of government bonds is 7.2 years and rising.

With economic growth of three per cent (nominal) and an interest rate on government bonds of about 0.7 per cent, the debt level in Germany would fall to below 60 per cent in five years at the latest if the primary balance remains slightly positive. But then there would be no additional scope for public investment in the core budgets including extra budgetary entities. Only if there were an unexpected growth spurt or if tax revenues increased significantly due to higher tax rates or better tax enforcement would there be scope for more investment, assuming other expenditure remaining unchanged.

Public debt originates mainly in the core public budgets of the federal government, the governments of the 16 German Länder, local authorities and the social security schemes. The general government in the definition of Eurostat also embraces the extra budgetary accounts outside the core budgets, which are defined employing several criteria determined by the federal statistical office based on the definition of Eurostat. These accounts are under state control, but economically semi-independent. Most of them are small, some are large state-owned enterprises and some are referred to as "Sondervermögen" (special asset funds), a special category based on a specific law adopted by the federal government or the Länder for each entity. The federal government has established 26 of these special asset funds, which are normally entitled to issue a limited amount of debt under the control of the respective government.

A new German off-budgetary asset fund is the "Sondervermögen Bundeswehr", a defence fund endowed with a borrowing capacity of EUR 100 billion (ca. 3 per cent of GDP), founded in mid-2022 in view of Germany's commitment to NATO to spend 2 per cent of GDP on defence (Federal German Government 2022), which has yet to be put in practice. The fund is earmarked for modernisation of the German armed forces ("Bundeswehr"). The

Figure 12: **Germany: gross public debt, implicit interest rate on public debt, interest payment on public debt and long-term interest rate 1991–2023, as percentage of GDP or in per cent**



Source: AMECO, AYIGD, AYIG and ILN series. Data for 2022 and 2023 estimate from the EU Commission in May 2022.
Note: Interest burden ratio: interest payments by the government on gross debt; long-term interest rate: government bonds > 3 years maturity.

decision by the coalition government in 2022 was made with a view to the war in Ukraine. Spending is scheduled for several years. The debt incurred by this entity is not counted as public debt in the definition of the German debt brake, but is rather an off-budget which is intended to circumvent the debt brake. The fund could only be established by changing the German Basic Law, a move supported by the main opposition party, allowing a two-thirds-majority to be achieved. Yet according to the Maastricht criteria this debt counts as part of gross public debt. Whether the structural deficit cap of 0.5 per cent in the SGP is breached depends on the speed of spending by the new fund.

Furthermore, in January 2022 the off-budgetary fund "Energie- und Klimafonds" (Energy and Climate Fund, renamed Climate- and Transformation Fund) was endowed with EUR 60 billion, and in September 2022 the off-budgetary fund "Wirtschaftsstabilisierungsfonds" (Economic Stabilisation Fund), established in 2020 due to the pandemic, was restocked by EUR 200 billion in order to fund gas price stabilisation. Both funds incorporate entitlements for issuing debt in the next few years. The three funds, including the defence fund, increase public off-budget debt in total by EUR 360 billion, more than 10 per cent of GDP. The three off-budgetary funds established in 2022 are not yet included in Figure 12. ←

8
REFORM PROPOSALS FOR THE DEBT BRAKE IN THE BASIC LAW

The so-called debt brake ("Schuldenbremse") was enshrined in Article 109 and Article 115 of the Basic Law in 2009 in the course of the so-called "federalism reform", replacing the old arrangement from 1969. It required a two-thirds majority in the Bundestag and the Bundesrat. In 1969, under the Federal Minister of Economic Affairs Karl Schiller and the ruling Grand Coalition back then, it had been decided that federal borrowing may not exceed expenditure on public investment (without differentiation according to gross or net debt), except in the case of a "disturbance of the macroeconomic equilibrium", i.e. a recession. The Länder followed suit with similar rules they adopted for themselves. Unfortunately, no parallel implementing laws were passed that could have operationally spelled out the key basic concepts (e.g. delimitation of public investment, definition of macroeconomic imbalance). The new arrangement instituted in 2009 followed the mandate assigned by the Federal Constitutional Court in 2007 to the legislature to legally limit government borrowing. A simple law would have sufficed for this. Although it de facto anticipated the 2011 reform of the European SGP, important differences remained, which have already been outlined in Section 3. The investment clause of 1969 in the Basic Law was deleted without replacement in the amendment of the Basic Law. The Fiscal Compact (SCG Treaty) is not addressed in the Basic Law, but it is in Section 51 (2) of the Budget Principles Act, an ordinary law. This law makes reference to the SCG Treaty, although it is not EU law. The law could be amended with a simple majority and the consent of the Bundesrat, if the SGP were reformed accordingly.

As mentioned above, federal borrowing has been limited under the Basic Law to 0.35 per cent of GDP, apart from the cyclical component. The Länder are only allowed to borrow for cyclical reasons, i.e. they must have a balanced structural budget.[8] No debt cap is mentioned. Strictly speaking, the German arrangement laid down in the Basic Law and the implementing law is not in conformity with European law. In some points, comparability is difficult due to the use of different statistical bases (German financial statistics instead of ESA 2010). Especially for the Länder and municipalities, the German rules are stricter and decidedly hostile to investment, although the Länder and municipalities account for more than two-thirds of public investment, with the figure for municipalities themselves reaching 50 per cent.[9] In its constraints delimitating the general government, the debt brake is narrower, which is to say less strict than the SGP. Although changing the debt brake in the Basic Law involves considerable obstacles this issue has been a source of debate for a long time, fuelled by broad discontent.

8.1 NINE PROPOSALS

LARS FELD AND WOLF HEINRICH REUTER

Lars Feld, long-standing former chairman of the German Council of Economic Experts (and presently adviser to the Minister of Finance), and Wolf Heinrich Reuter, Secretary General of the German Council of Economic Experts, argue against a reform of the debt brake, although they recommend changing the calculation method for structural budget balances with an expenditure rule linked to target values indicating structural budget balances (Feld/Reuter 2019). They do not perceive any connection between weak public investment activity and the debt brake, as they note that the trend towards low government investment was already evident in the 1990s. The limited regard shown for future spending for infrastructure is in their view regrettable, but they believe that this would hardly be improved by a greater latitude to incur debt, as practice under the old Basic Law (Articles 109 and 115 GG) in the years 1969-2009 shows. Their overly rough empirical view overlooks the fact that three waves of much stronger public investment took place in the 1970s and as a result of German reunification, but also after 2015.

The permissible structural deficit of 0.35 per cent of GDP is in their view sufficient. They do not discuss the advantages of debt financing of investments or other government expenditures through intergenerational burden-sharing, especially at low interest rates. They see it all as a problem of politicians' tendency to take on debt in or-

8 In the final night session of the Bundesrat debate on the reform of the Basic Law, Federal Finance Minister Peer Steinbrück proposed a structural deficit of 0.5 per cent, to be divided equally between the federal and Länder governments. Bavarian Prime Minister Horst Seehofer, however, countered with a proposal for a "black zero" for the Länder and Steinbrück ended up proposing 0.35 per cent for the federal government. This account is based on statements made by Christian Kastrop, who was responsible for the debt brake in the Federal Ministry of Finance at the time (cf. Freitag No. 4/2021: "Schicksalstage einer Schuldenregel").

9 The municipalities are excluded from the debt brake set out in the Basic Law, but not from EU fiscal rules; they are very dependent on Länder budgets, however.

der to shift financing burdens onto future generations (dubbed a "deficit bias" in public choice theories). The 60 per cent limit should moreover once again be interpreted as a ceiling, not as the normal case, in order to have a discretionary latitude to avert major shocks. They do not undertake any serious examination of infrastructure deficits or financing options. Parliaments are apparently not capable of assuming any responsibility for the future due to their predilection for the present. The logic of their argument is fatal: because politicians have a bias toward deficits and are oblivious to the future, as if it were in the genetic code of their profession, both a future-oriented fiscal policy and also a policy of tax-financed investment would be equally pointless. As they see things, history proves this to be the case.

Their argumentation supporting the debt brake in its current form is thus based on the catch-all argument of a general bias to incur deficits in the DNA of elected politicians and a rejection of fair intertemporal burden-sharing through public debt.

IFO-INSTITUTE

Fuest et al. (2019) from ifo-Institute argue along similar lines. Since 2009, they contend, public investment has not been affected by the debt brake, because the voluminous surpluses that arose a few years after the financial crisis could have been used to this end. On the contrary, budget deficits plummeted after the financial crisis, with the debt level dropping by 20 percentage points below the 60 per cent limit by 2019. The debt brake helps avoid "election gifts" by politicians, as has been demonstrated in studies of political business cycles based on Nordhaus' theory of political business cycles (Nordhaus 1975). Criticism of the debt brake is held to be overblown. A precise analysis of the need for investment is lacking, however.

It is true that the legal admissibility of greater budget deficits to spur public investment does not automatically mean that this possibility will be used. This argument thus precisely runs counter to a strict bias towards deficits on the part of politicians. Preventing "election gifts" by politicians should not be pursued by obstructing investments in the future.

GERMAN INSTITUTE FOR ECONOMIC RESERACH

Fratzscher et al. (2019) from the German Institute for Economic Research (DIW) concede that the debt brake was not sufficiently used for public investment in the years 2009-2019. One major reason for this, they argue, is that municipalities, responsible for half of public investment, are not able to take on debt because they are over-indebted or lack surpluses in their administrative budgets that can be used for debt-servicing. Therefore, they argue, the federal government must support municipalities by increasing its own debt. The authors argue for an expenditure rule within the framework of the debt brake, according to which the federal government increases its nominal spending pegged to nominal potential GDP growth regardless of the economic cycle. Nothing is stated regarding structural deficits and the debt level.

Stronger support for municipalities by the federal government's fiscal policy would require a higher structural deficit at the federal and/or Länder level, while the expenditure rule that is being called for could replace the dubious calculation of the cyclical budget component, but does not necessarily require a change in the debt brake.

GERMAN ECONOMIC INSTITUTE

Michael Hüther (2019), head of the German Economic Institute (IW) funded by the employers' association, sees a considerable backlog and future need for public investment, which he argues should be financed through a large federal wealth budget for the federal government and the Länder by issuing federal bonds. Municipalities can receive earmarked investment allocations. The federal and the 16 Länder governments themselves should not incur any major structural deficits, and should instead apply only automatic cyclical stabilisers. Public investment is viewed – alluding here to an extensive literature – as productive and intertemporally beneficial under low interest rates, which it is presumed will continue to prevail. Hüther advocates a Golden Rule for net investment, citing the 2007 opinion of the German Council of Economic Experts, in which the Council explicitly committed to the Golden Rule, i.e. a financing of deficits in the amount of net investment on top of cyclical budget balances. Investments in education can in his view be included (cf. also Hüther/Südekum 2019).

The debt brake, it is argued, would have to be amended accordingly. However, the capital budget would fall below the radar of the European SGP, remaining limited to 0.5 per cent of GDP (or 1.0 per cent in case of debt significantly below 60 per cent). Since the obstacles to amendment of the Basic Law are formidable and an amendment takes time, Hüther proposes the use of public infrastructure funds for a transitional period, which could be financed with permissible debt for financial transactions – i.e borrowing to acquire financing resources.

Hüther's criticism is very pinpoint. It is asserted that this is in line with Basic Law and the debt brake and also with the SGP. However, a large separate investment budget for the federal government and the Länder could encourage centralist tendencies and hinder targeted needs-based spending. This would only be a second-best option, albeit a more feasible one if it is not possible to obtain majorities for an amendment of the Basic Law. It would appear that the German federal coalition government is following this guideline by using upscaled special asset funds ("Sondervermögen"), a special form of extra budgetary accounts based on special laws and entitlements to issue off-budget debt. The loophole is a broad interpretation of financial transactions.

GERMAN COUNCIL OF ECONOMIC EXPERTS

The German Council of Economic Experts (SVR) stated an opinion on the debt brake in its 2021 annual report with two diverging strands, similar to the opinions regarding reform of the EU fiscal rules. Monika Grimm and Volker Wieland (SVR I) want to keep the debt brake unchanged, but fear transitional problems following deactivation of the escape clause in 2023. Basically, the debt brake is considered to be a budget restriction that forces priorities to be set, to combat distribution conflicts and to prioritise future spending at the expense of consumption spending. The argument is based on the assumption that constraints on the fiscal budget correctly reflect real economic budget constraints, i.e. that production potential is fully utilised and cannot be expanded in the short term. Furthermore, it is argued that future investment needs in Germany could be financed with existing budgets if consumptive spending were restrained.

According to this view, the call for budget constraints in the form of a constitutional debt cap would make sense if structural deficits had an inflationary effect. Then credit margins should indeed not be fully utilised. However, the opposite applies to phases in which inflation is too far below the target inflation level. Furthermore, a budget restriction by means of a debt cap would make sense if private investment would otherwise be crowded out, but not if public goods with positive externalities that stimulate private investment are being provided. Furthermore, Grimm/Wieland would have to explain why the budget restriction should be set at 0.35 per cent and why consumption-related government spending should be cut – this is a matter for parliaments to decide. The problem of intertemporal injustice as a result of the debt brake is not even broached.

However, the two authors rightly see a short-term transition problem if the exception clause pursuant to the debt brake is abruptly lifted. It would not be possible to immediately reduce high deficits to 0.35 per cent for the federal government and zero per cent for the Länder, even though the exceptional situation as a result of the Covid-19 pandemic is coming to an end. The escape clause provided for in the Basic Law lacks a transition-to-normality provision. Various options are being discussed as a result, such as renewed heavy borrowing in 2022 to ensure adequate reserves for the coming years, or to use existing reserves that have been earmarked for other purposes, or extra budgetary accounts are also a possibility. All options run up against significant legal misgivings. A reform of the debt brake is worth considering in this respect, but would give rise to additional demands from critics of the debt brake. The fact that this problem is much more dramatic in other EU countries and that therefore a European solution is actually needed, which would have to take precedence over the arrangement laid down in the Basic Law, is not addressed. Nor does the opinion discuss the fact that the obligation to repay the debt from the "escape years" – prescribed in the Basic Law – exceeds the 0.35 per cent limit and will also force the federal government to adhere to a structural budget balance of zero or surplus in the long term. Normally, government borrowing is repaid through follow-up financing in the form of a roll-over.

The second opinion in the SVR is once again formulated by Monika Schnitzer and Achim Truger (SVR II). They expect investment needs for the public sector in the order of EUR 50 billion annually, which cannot be covered by spending cuts or tax increases. Since the debt brake does not permit credit financing on this scale, public investment corporations are proposed to serve as independent extra budgetary vehicles that are allowed to borrow within the framework of the debt brake and are not subject to stricter EU regulations delimiting general government. According to various legal opinions, if these public investment corporations are assigned clear tasks by federal law and are authorised to borrow, there would be no obstacle to large-scale public investment using this vehicle (cf. also Beckers et al. 2020).[10] The transitional problem described could be dealt with, it is argued, either by extending the escape clause or by exercising it as a precautionary measure in 2022. In principle, the authors once again advocate the Golden Rule in accordance with the analysis of the German Council of Economic Experts from 2007, referring to net investment (SVR 2007, Truger 2015a, 2015b).

Like Hüther, Schnitzer/Truger outline a second-best way to finance public investment if the debt brake cannot be changed. They rightly point out that extra budgetary accounts are to be assigned to the state according to the rules of the SGP and may only be used within the framework of the European rules. In this respect, this proposal by the German Council of Economic Experts must be seen in the context of the proposal by the same authors pursuant to a reform of the SGP.

PETER BOFINGER

Peter Bofinger (2019) advocates a change in the debt brake by raising the structural deficit from 0.35 to 1.8 per cent. This would qualify the 60 per cent debt brake as a target value – instead of a cap – from which a permanent deficit of 1.8 per cent can be derived with a growth trend of nominally three per cent, which can be used for investments. It is amazing to see in all the complex debates how simple true economic logic can be. The key point is here that 60 per cent is seen as a debt target, without any reasoning being provided for the arbitrarily chosen number. As a pragmatic approach, it could solve many problems for Germany.

The proposal is purposeful, but requires an amendment of the SGP and possibly of Protocol 12 to the TFEU if a 3-percentage points margin for cyclical deficits is required, which would lead to 4.8 per cent deficits in recessions. It would also have to be resolved how the increased

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10 Also so-called "other FIE" – state-owned funds, institutions and enterprises classified as market producers – are not subject to credit restrictions under EU law (e.g. Deutsche Bahn, Kreditanstalt für Wiederaufbau [KfW]).

potential budget deficit would be split up between the federal and Länder governments.

ALTERNATIVE ECONOMIC POLICY WORKING GROUP

The Alternative Economic Policy Working Group (AAW) has forwarded detailed proposals for reforming the debt brake (AAW 2020). Provided political majorities are achieved, the permissible general government structural deficit could be increased to between 1.5 and 2.0 per cent, and divided equally between the federal and Länder governments. The higher margin would apply to situations with high current account surpluses, in combination with a reformed EU macroeconomic imbalance procedure (MIP). The debt margin could be reserved for net investment or other clearly defined types of expenditure. 1.5 per cent corresponds to the 2007 proposal by the German Council of Economic Experts, which at the time advocated a Golden Rule and rejected debt bans for Länder (see Schnitzer and Truger above). With structural deficits at the aforementioned level, the debt level would lie in the corridor of between 50 to 67 per cent in the longer term, or converge towards it, with a mean value below, but close to, 60 per cent, assuming realistic growth. The same problem with the 3 per cent deficit cap as mentioned in the commentary on Bofinger applies here, too.

Another proposal by the AAW provides for much more fiscal policy flexibility. According to this proposal, the debt brake would be replaced by a general provision in the Basic Law without any quantitative targets being set, but the legislature would be required to adopt an implementing law. In this scheme, medium-term variable targets could be set that are adjusted to the respective interest rate-growth differential and investment needs. Both proposals should be linked to an inflation proviso to ensure that fiscal policy supports the ECB‘s monetary policy. Without a change in the Basic Law, only the measurement method for estimating cyclical budget balances could be changed, and it would be necessary to resort to borrowing through special off-budget funds.

Both proposals by the AAW make good sense and are future-oriented, but must – similar to Bofinger‘s proposal – be integrated into a new European regulatory system. If this existed, there might not even be a need for a national constitutional rule, as European law takes precedence. A national implementing law would suffice. Those observers and analysts who find these proposals too far-reaching should bear in mind that the 1969 Basic Law arrangement (which applied until 2009) laid down in Articles 109 and 115, adopted by the CDU and SPD at the time, was more far-reaching than the AAW proposals; at the time, it constituted an important component in the evolution of the West German economy, enabling a greater supply of public goods (education, infrastructure, environment) in the late 1960s and early 1970s.

DEZERNAT ZUKUNFT

The German think-tank Dezernat Zukunft, led by Philippa Sigl-Glöckner, proposes a new means of calculating the cyclical component of the budget deficit. The debt brake does not prescribe the calculation method used by the EU Commission, but Article 115 of the Act stipulates that the state of the art in science is to be taken into account. The wide-ranging scholarly discussion has revealed that the EU Commission‘s method exhibits major weaknesses, especially in severe crises (see also the references in Box 2). Schuster et al. (2021) from Dezernat Zukunft develop an alternative that includes underemployment (in its various facets) in the production function, thereby increasing the production potential and at the same time the magnitude of the cyclical component, especially by virtue of a higher female employment rate.

Two objections stand in the way of the Dezernat Zukunft‘s concept. Firstly, the estimation of potential output revolves around a short-term increase of output up to the potential limit, beyond which inflation risks lurk. A desirable use of the “hidden reserve” in the labour market and an increase in labour force participation can definitely not be achieved in the short term, however. Yet, it could be argued that to utilise additional employment reserves in times of a demographic labour shortage can justify higher aggregate demand growth, driven by higher structural deficits. Secondly, Article 115 of the Basic Law prescribes a symmetry between cyclical deficits and surpluses, irrespective of the question of whether there is a risk of inflation in the upswing, even though this is actually what defines a positive output gap. This is similar to the SGP production factor method. Limits are thus set on new measurement methods without changing the Basic Law (cf. among others Heimberger et al. 2020). Therefore, a well-designed expenditure rule is to be preferred, especially since a uniform rule for the renewal of the SGP needs to be found.

8.2 CONCLUSIONS – REFORM OPTIONS

Surprisingly enough, expenditure rules, which are proposed for the EU in almost all the reform options, have only been suggested in the German debt brake by Fratzscher et al. (2019); although there is broad consensus that the cyclical component should be calculated differently throughout the EU or replaced by expenditure rules. If at the EU level the SGP were to be amended accordingly, which many advocate, a change in Berlin either of the Basic Law or the implementation law (“Article 115 law”) could make its way onto the political agenda via Brussels. Interestingly, also the statement issued by the German federal government is in favour of this change in Europe, but has not addressed the issue for a reform in Germany, as mentioned above.

If, in view of an almost unchangeable debt brake, which requires a two-thirds-majority in both parliaments, higher government borrowing for public investment in Germany is not possible, the only way out or workaround is via off-budget infrastructure funds of various kinds. A joint publication put out by the German Economic Institute (IW) and the Macroeconomic Policy Institute (IMK) (Bardt et al. 2019) offers a direction here (see also Krebs 2021). The basic budgetary "principle of unity and completeness" of the budget would be undermined, however, and checks and controls by parliaments could be rendered more difficult. If subsidiary budgetary entities are preferably created at the federal level, the needs of Länder and municipalities might be inadequately taken into account. The expansion of borrowing from special funds or extra budgetary accounts could also conflict with the current version of the SGP since the structural balance cap of 0.5 per cent applies to general government, including these off-budget accounts (unless their expenditure is classified as a financial transaction).

Of the nine proposals regarding the German debt brake discussed here, only Hüther, Fratzscher et al, Bofinger and the Alternative Economic Policy Working Group (AAW) are in principle in favour of changing the debt brake. Schnitzer/Truger would probably agree, but assume that this would not obtain majority support politically. They do believe, however, that there would be a broader consensus below the threshold of a Basic Law amendment reforming the way that the cyclical component is calculated through a spending rule at the EU level. Likewise, there are many voices calling for a transitional rule for the move from the state of emergency to the old normality. Since this problem affects all EU countries, an EU-wide rule ought to be found for it, which would be included in any possible reform of the SGP.

There are not many, but there are some proposals that could improve Articles 109 and 115 of the Basic Law, also including proposals below the level of this obstacle relating to the measurement of the cyclical component. What is most important here is to offer the Länder a debt option and more fiscal leeway. One simple solution could be to limit the general government structural deficit to about two per cent of GDP, depending on the level of interest, and to split it up equally between the federal government and the Länder. It would be even better to allow a cap on the net interest burden of about 1.5 per cent of GDP each for the federal government and the Länder instead of the structural deficit. Just like at the EU level, deficit limits should not be laid down in the Basic Law, but rather in ordinary legislation (in Germany referred to as "Einfachgesetz", which require simple majority approval). Debt rules must also be modifiable in the event of changes in framework conditions. A serious reform is only possible if the SGP is also modified, however. Similar to the limits at the EU level, the German debt brake lacks any serious justification for a deficit limit of 0.35 per cent of GDP for the federal government and for a quasi-debt ban applying to the biggest public investors, the Länder and municipalities: the Länder are obliged to balance the structural budget, while the municipalities are not subject to the debt brake laid down in the Basic Law, but are de facto heavily dependent on the Länder. German reunification would not have been financeable with a debt brake, and it will probably only be able to finance the upcoming ecological and digital transformation in connection with raising defence expenditures with second-rate compromises.

What is the point of having a rule in the Basic Law, in the highest law of the country, which, under realistic assumptions (three per cent nominal trend growth), leads to the debt level converging at an equilibrium value of eleven per cent in the longer term? What sense does it make to impose a ban on Länder borrowing in "normal cyclical situations" in view of a mountain of public investment needs and negative real interest rates? Where is the logic behind stifling or dampening an upswing if there is no threat of inflation and supply-side constraints can be reduced? How useful is it to stipulate a budgetary scope for a minuscule structural deficit, the measurement of which, combined with the method used to measure potential output and the cyclical component, is seriously flawed?

For defenders of the debt brake, the "black zero" – often intended to mean a complete renunciation of new debt, sometimes also meant to designate a structural balance of zero – has become the symbol of fiscal solidity, the epitome of "sound public finances". Symbolic policy instead of a substantial improvement in living conditions? Terms like "solid" and "healthy" do not seem to warrant explanation or justification. In a reform debate, all flood gates and Pandora's box would be opened – which is to say fear, the proverbial German angst. In this juxtaposition, economic reasoning falls by the wayside.

This approach is supported by four factors. First, many budgetary policy practitioners want clear budget ceilings and constraints. As a rule, they are not economists with a well-founded macroeconomic knowledge and understanding of a difficult subject area. Large sections of the population feel the same way. Reliable guidance is what is needed. Secondly, the issue of public debt is psychologically supercharged with fears and anxieties, similar to the spectre of inflation, thereby fuelling simple ideologies. The topic is susceptible to ideologising, hindering sober analysis and use of common sense.

The third reservation is probably the most important. Some staunch defenders of the debt brake believe that Germany plays the role of the "fiscal anchor" for the entire EMU (this is also to be found in the Coalition Agreement 2021: 161) and ultimately for the stability of the euro. From the perspective of the financial markets, this is symbolised by the AAA rating on German government bonds awarded by the three major international rating agencies as well as by the yield of the "Bund" as an international benchmark for risk-free government bonds. Only Germany and four other EU countries (Denmark, Luxembourg, the Netherlands and Sweden) have triple-A ratings along with six other countries outside the EU, according to criteria that are not published in all detail by the rating agencies. It is striking that all five EU countries with this rating have high or very high current account surpluses (and a strong net international creditor position), which go hand in hand with low budget deficits or surpluses – relative to other countries – as do the other six non-EU countries. Low levels of new debt make their bonds scarcer than those of other countries. The rating of government bonds by rating agencies usually serves as a guide for financial investors. However, parliaments, which decide on new debt to be taken on by their governments, have to apply other criteria. Macroeconomic imbalances in surplus countries, which lead to current account deficits in other countries, also play into poor ratings for deficit countries, even though the causes of these deficits are mainly to be found in the surplus countries or on both sides. Striving to be an export champion and low public debt are two sides of the same coin.

The last factor is the uncertainty about the fiscal consequences of demographic change with strong dynamics linked with ageing in the next decades. There is a fear of a fiscal time bomb looming if policy change is delayed or rejected in connection with the financing of social security. It is true that Germany faces a strong increase in the number of pensioners relative to the population in working age. Pensions, health and care costs are expected to rise as a percentage of GDP, outpacing the growth of revenues from social security contributions – under the assumption of "no policy change". Without sizable tax increases, public debt could skyrocket. Some economists believe that for this reason the public debt ratio should be lowered considerably to prepare for the expected rise after 2040; this goes along with the call for a change of the German pay-as-you-go system toward building up a strong additional pillar in the pension system by means of a capital-funding scheme that should be commenced as soon as possible. The contentious future of social security is thus used to fire the menace of losing control of public debt (cf. BMF 2020, Werding 2018). Whatever the solution to this problem may be, it is a genuine problem besetting Germany itself and must not be the yardstick for EU rules. Demography and the demographic problem of a greying society differ greatly among Member States (see the so-called S 2 indicator of the EU Commission for long-term debt sustainability, EU Commission 2021a).

The veiled orientation of fiscal policy towards ratings does not stabilise the euro or EMU. Rather, it tends to destabilise them. It is important that the currency as well as public finances of all the Member States in the EU and the EMU as a whole are stable and that the key goals relating to prosperity, justice and climate are achieved at the same time. International competition aimed at keeping public debt as low as possible is counterproductive for the EMU and for the deficit countries.

On top of all this, views on government debt in the field of economics have changed over the past two decades, and this goes for the economic mainstream, which tends to follow Anglo-Saxon more than German economists. The group of supporters surrounding James Buchanan, who wanted to ban government debt in the U.S. Constitution and (narrowly) failed in the attempt, has become smaller, while the advocates of anti-cyclical fiscal policy along with structural debt in developed OECD countries have grown more numerous. Inflationary risks due to public debt are appraised to be lower than in the past ("great moderation"). The productivity of public investment is now recognised. Empirical evidence counts for more than dogma. The effects of public debt are better understood. The consensus seems to be that discretionary macroeconomic management through monetary and fiscal policy – i.e. the renunciation of rigid rules for any and all situations – is of pivotal importance for the national and international stability of our economic systems. In Germany, however, this consensus is less pronounced.[11]

Finally, the significance of the German debt brake for public investment needs to be put into perspective. For municipalities, responsible for half of the public investments in Germany, a looser debt brake does not help much in a direct way, but it does help indirectly. This is because the municipalities need greater financial resources from the Länder, and the Länder must be granted more fiscal latitude in fiscal federalism, with a balance between federal government and Länder, and not only in terms of borrowing. Strengthening property- and asset-related taxes that the Länder are entitled to raise could improve their fiscal room for manoeuvre, which has been almost entirely lost, and increase their debt sustainability. It is possible that the backlog of public investment and needs for the future may require a new discussion on the topic of fiscal federalism. It must be taken into account that in the case of an investment clause, as called for by proponents of this approach, only net investments should be credit-financed. Depreciation and amortisation must therefore be financed by taxes. ←

11 Cf. Wissenschaftlicher Beirat beim Bundeswirtschaftsministerium von (2008), which is representative of the old mainstream, and the description of the changed consensus in Holtfrerich et al. (2015).

9
CONCLUSIONS FOR THE EU AND GERMANY

In the following, conclusions from the reform proposals for the EU and for Germany are summarised, including their interdependencies, as these constitute twin reforms. In closing, an emphasis is placed on the need for a central fiscal capacity in the EU to complement the rules.

FISCAL RULES

Both in the EU or the Eurozone and in Germany, fiscal rules should be reformed, but in part for different reasons. In the Eurozone as a whole, a return to the SGP poses far more difficulties than in Germany. The budget deficits projected for 2022 in the Eurozone are on average much larger than in Germany, in some large Member States over five per cent, well above the three per cent limit. Debt levels in many Member States, especially in Italy, Spain and France, but also in Greece and Portugal, have also risen much more than in Germany, in some cases by more than 20 percentage points, whereas in Germany the increase is only twelve percentage points (2019-2022).[12] The interest burden from government debt is very low, however, averaging 1.4 per cent of GDP in the Eurozone (2021). Italy tops the list at 3.4 per cent, with Germany coming in at 0.5 per cent (excluding seigniorage transfers from the ECB to national governments). Implicit interest rates on government debt are also low (1.3 per cent on average in the Eurozone, for Germany 0.8 per cent (forecast for 2022). The maximum spread compared to the Eurozone average is 70 base points expected for 2022 (Italy: 200 base points). All Eurozone countries can currently bear their debt and interest burden without any problems. The average remaining maturity for bonds is about seven years, so no significant abrupt changes as a result of rising key interest rates are to be expected here in the medium term. By comparison, when the euro was launched in 1999, implicit nominal interest rates were 4.5 percentage points higher on average in the Eurozone, although target inflation was not exceeded at the time. The debt ratio in Italy and Portugal is critical, but when a new normal mode of growth settles in, debt levels there should also decline.

All countries have considerable backlogs in infrastructure and tremendous future needs for public investment in view of the challenges associated with the ecological and digital transformation. Austerity is the last thing the Member States need in the wake of the Corona pandemic. But this is precisely what the SGP demands - from all countries in the short term and from many, especially the three large ones, except Germany, in the medium to long term as well. This problem would be alleviated until 2026 if transfers from NGEU could be counted as ordinary revenues. All the Member States, even those with low debt levels below or slightly above 60 per cent, have a major problem with the structural deficit cap of 0.5 per cent (or 1.0 per cent if the debt level is significantly below 60 per cent). Nor is this enough in Germany to finance necessary investments in infrastructure and defence by borrowing. Partial financing using tax revenue is already being planned, but credit financing offers major advantages.

As far as the 60 per cent debt cap is concerned, three alternatives are under discussion among those who are in favour of substantial reforms: (1) extending the consolidation period from 20 to 50 years without any Treaty change, (2) increasing the debt cap laid down in Protocol 12 of the TFEU, or (3) moving to a new yardstick for the interest burden instead of gross debt as a target, possibly without any Treaty change and laid down for a medium-term period in secondary legislation, i.e. in the SGP. New caps for structural primary deficits could be derived from country-specific, medium-term fiscal plans with debt levels or interest burdens that are deemed sustainable (especially highlighted in CAE 2021). If all Member States running a debt above 60 per cent had their previous structural deficit limits increased by 0.5 per cent with an additional X for investment (say 1.5 per cent in the IMK proposal), an implicit interest rate of r = 1.3 per cent and nominal growth of three per cent (r-g = -1.7) would result in an opportunity for a primary balance of -1.7 per cent with a stable debt level of (assumed) 100 per cent. With an interest burden of 1.4 per cent, the structural deficit would then be 3.1 per cent (1.7 + 1.4). Any primary balance > -1.7 per cent would cause the debt level to fall. For example, if a Member State whose debt level is 100 per cent aims for a reduction to 80 per cent, the target would be reached at a permanent structural deficit of 2.4 per cent; this corresponds to a primary balance of -1.0 per cent if the interest burden is 1.4 per cent. These figures are in line with average levels in the Eurozone for 2021 and 2022, respectively. Highly indebted countries such as Italy and Portugal could also reduce their debt ratios if

12 These data are from spring 2022 with an estimate for 2022; they do not include the three off-budget accounts established or augmented in 2022, mentioned in section 7 which sum up to more than 10 per cent of GDP.

they manage to return to moderate growth with primary balances close to zero through smart structural reforms as well as with aid from the NGEU programme. The said figures may rise a bit with rising nominal interest rates due to tightened monetary policy, but at the same time nominal growth of GDP increases due to inflation. The r-g differential is unlikely to deteriorate as a result of a temporary surge in inflation. That interest rates hike after ECB's asset purchase programme during the pandemic was foreseeable and long awaited. Yet, it is quite unlikely that the "new normal" for the sovereign bonds rate will return to 4-5 per cent like in the early 2000s.

If a country like Germany would desire a structural deficit of 2.1 per cent to finance public investment in infrastructure instead of only 0.35 per cent, this would mean a stabilisation of the debt level at 70 per cent (with 66 per cent being expected for 2022; cf. AMECO: 17 August 2022) with a growth trend of three per cent. At an implicit interest rate of 0.8 per cent, the interest burden would remain at a level of 0.5 per cent, which corresponds to the level in the old Federal Republic in 1960, when the debt ratio was 18 per cent (Priewe 2020c: 414). The primary balance would be -1.6 per cent, a very comfortable situation for Germany and a positive influence on the stabilisation of demand in the Eurozone as a whole. In addition, primary deficits used for investment and/or innovation boost GDP growth and improve the interest-growth differential (r-g), so that debt sustainability can be expected to increase (vice-versa if there are expected moderate increases in the implicit interest rate). Germany's debt-to-GDP ratio would no longer trend towards eleven per cent, however, as is currently the case with an assumed growth trend of three per cent in nominal terms.

Derived from the debt ratio target and in conjunction with the country-specific interest burden, structural primary budget balances could be set as medium-term targets (new MTOs). A move toward expected country-specific interest burden ratios as "debt anchors" instead of gross debt ratios would create much more flexibility. This would allow sustainable debt and deficit corridors to be identified. These should be agreed upon bilaterally between the Member States and the EU Commission – with the EU Council having the final say – and the expenditure corridors should be set in a binding manner in the European Semester. Sanctions should be imposed on deviations in the form of reduced allocations from the EU budget to the Member States. It would be a good idea to have centralised bond issues carried out by a European finance agency, with all credit risks remaining in the hands of the debtor, i.e. the respective Member State.

For the cyclical component of fiscal balances, a spending rule should be opted for that is based on country-specific expected potential growth and not on past trends. This is the analogue to the forward-looking view of the ECB's monetary policy, of course in relation to the Eurozone as a whole. However, the non-cyclical, i.e. structural deficit (or surplus) determined on the basis of the expenditure path is not an operational variable because the interest burden contained therein cannot be influenced by fiscal policy in the short and medium term.

For Germany and other countries with debt levels below 60 per cent or slightly above, an option for larger structural deficits could arise through a reformed SGP. In Germany, however, the debt brake stands in the way of this. However, Germany could take the route of off-budgets to comply with the Basic Law and the debt brake. However, this would mean no change for Länder budgets as a result of new EU rules. Hence, new EU rules that allow more fiscal leeway would put Germany under pressure to obtain a majority to reform its debt brake. If the EU were to prescribe an expenditure rule instead of measuring the cyclical component, the German "Article 115 Law" on the debt brake would have to be amended by a simple majority in the Bundestag. The Länder would also have to amend their respective state legislation, which would not pose a problem.

The various reform proposals presented in this study differ, among other things, regarding an explicit Golden Rule for public investment. If, as is suggested here and also proposed by the CAE, the interest burden ratio is used as a guide, there would also be indirect scope for more public investment without having to re-define what investment should be. The proposal by Nielsen (2021) to set a minimum investment ratio in the conventional definition (as a share of government expenditure) in the SGP, and possibly also a minimum ratio for education and research, can also be helpful.

In order to prevent a patchwork of different national arrangements in the EU or the Eurozone, all Member States with divergent national regulations should adapt sooner or later the new common set of rules and not take the circuitous route via extra budgetary accounts, the route which the "traffic light coalition" in Germany is opting for. The European Fiscal Compact should be transposed into European law, i.e. into the new SGP. This is exactly what the Fiscal Compact provides for, but this has not been done so far.

It is important that employment of the new fiscal rules, which would give countries much more latitude to carry their old debts and to finance public investments in infrastructure, be made subject to the caveat of price stability. National fiscal policy must neither fuel inflation nor encourage deflation. The ECB can only fight inflation in the Eurozone as an entirety and needs the support of the Member States. This is also in line with the logic of the expenditure rule. In a way, the proposed rules imply a decentralisation of fiscal policy of the Member States; however in a common framework. The controls of the EU Commission in the case of deviations from the rules need to be significantly tightened, however. Rights and obligations have to be in balance.

The new fiscal rules and the new SGP should in principle only apply to the Eurozone Member States and should therefore only be adopted by these countries. This can only be done if Treaty change is not necessary. Yet, in all proposals discussed, this point is not clarified. The eight EU countries that are not part of the Eurozone could use the same rules or opt for different ones. This can make decisions on a reform easier than uniting all EU members. If Treaty amendment is the path adopted, all the EU members would have to decide.

Another possibility would be to retain the present SGP, including the Fiscal Compact, and only allow a few minor reforms, perhaps following the route proposed by the German Federal Government. Dropping the 1/20-rule is window dressing if tight increases in primary structural balances to achieve sizable surpluses are prescribed as in the present rulebook. The can would then be kicked down the road, just like in the past. Perhaps revenues from the NGEU, especially for the countries having suffered more than others from the pandemic, could mitigate the transition from the escape clause years to business as usual. Europe would again miss a big opportunity, and Germany would be true to its role as a naysayer when it comes to substantial European reforms.

Finally, the issue of changing fiscal rules is strongly linked to a problem of a political economy nature. Germany is a case in point here, but similarities can be seen in other Member States. Conservatives who reject active fiscal policy and prefer balanced budgets and low debt levels have only three alternative options: raising taxes to finance urgent new needs, cutting public expenditure, mainly social transfers, possibly trimming or amputating the welfare state, or cutting taxes and deregulating markets in order to revamp high GDP growth. The first two options risk losing voters. The last option was applied in the 1980s and the 1990s and by and large failed in economic terms (supply-side-economics, neoliberalism in different shades). It is based on poor macroeconomics. Centre-left parties are caught up in similar dilemmas but have a stronger need to guarantee more investment, more social security and some redistribution with an eye to their main clientele. Without well-understood Keynesian strategic advice, they are stuck in gloomy blind alleys. For both major political camps, more fiscal leeway would offer a strong tailwind that eases their respective strategies. New insights from modern macroeconomics (see once again the majority of the proposals) would offer on big, although largely untapped support to date.

Four of the five challenges mentioned at the outset of this report can be better met with six of the proposed reforms than under the status quo, but in varying degrees: (1) high debt levels become more sustainable and austerity is avoided or limited; (2) the opportunities offered by a low interest rate environment – assuming it remains lower than what was normal in the 1990s and early 2000s, prior to the great financial crisis; (3) with larger structural deficits, the tasks ahead can be better addressed; (4) with expenditure rules, pro-cyclical fiscal policy as a result of a problematic operational target variable (structural budget balance) can be avoided when setting the MTO. The addition of a central fiscal capacity to the rules, the fifth challenge, is briefly addressed in the following.

EUROPEAN FISCAL CAPACITY

If all Eurozone Member States behave according to the agreed rules (whether old or new) with their nationally planned expenditure and debt corridors, it is possible that sub-optimal results will emerge for the Eurozone as a whole due to asymmetric or symmetric shocks or as a result of unforeseen interactions between Member States. The whole can be sometimes more, sometimes less, than the sum of all parts. Asymmetric shocks can occur, for example, through (a) structurally weak individual Member States falling behind in the ecological and digital transformation, with negative repercussions for other Member States (e.g. weaker growth, less success in the fight against climate change and unemployment, higher budget and current account deficits, mounting banking stress, etc.) or, conversely, through (b) structurally weak (e.g. southern European) Member States catching up economically thanks to appropriate structural reforms and relaxed fiscal policies, which could have an inflationary effect. Asymmetric shocks (c) can also originate in one of the strong economies, for instance Germany or the Netherlands: if such a country strives for a high current account surplus by wage restraints and inflation below target inflation, it forces neighbouring countries into wage repression and hence causes domestic demand to flag. One example of a symmetric shock can be (d) a strong impetus coming from commodity prices, driving up inflation in the Eurozone as a whole. Russia's aggression against Ukraine and its economic consequences is another example of a symmetric shock, similar to the COVID-19 pandemic. Symmetric shocks normally have asymmetric consequences, since not all Member States are affected equally.

In case (a), it may make sense for individual member countries to be supported by the others, with positive consequences for all, for example in the area of climate policy. In case (b), inflation should be contained within the group of countries that are the cause, especially since the ECB is only responsible for the Eurozone as a whole. In case (c), economic action by a central policymaker is necessary to prevent negative spill-over effects from mercantilist trade and wage policies. Regarding case (d), the ECB does not have suitable instruments, since the causes of inflation lie outside the Eurozone. In this case, centralised fiscal policy could alleviate the consequences and dampen subsequent price-wage spirals. In all four cases, a central economic and fiscal policy could be helpful, especially since coordination of economic and fiscal policies of autonomous Member States can result in high transaction costs and free-rider behaviour. What is needed here is therefore a central economic and financial policy that is oriented towards the Member States as a whole.

This would require a central fiscal capacity, as was wisely created for the joint pandemic response (NGEU). This is composed of a mixture of a general government stabilisation, allocation and distribution function. A common financial policy for the provision of genuinely European public goods (e.g. securing external borders, migration policy, supranational research policy, transnational transport networks, climate change policy and possibly also defence policy) is necessary. It is particularly important to combat the risk of deflation, because this is where monetary policy reaches its limits, but also to support the ECB in fighting inflation. In part, these common tasks have been dealt with by the ECB, including banking supervision, the European Commission or the European Council und the Euro Council. European governance without a democratic government, including majority voting, quickly arrives at the brink of failure. A key and indispensable pillar for a new type of governance would be a common treasury.

Solidarity can be highly efficient, economically speaking: If I help you, you will help me next time, and together we are both stronger. With strong economic interdependencies within the Eurozone, but also in the EU as a whole, a bit of federalism is very efficient and at the same time shows solidarity. Risks from free riders and moral hazards (seeking advantages at the expense of others) cannot be excluded, but they can be minimised. That is why the Eurozone needs a common central fiscal capacity, as called for in particular by the EFB (2020) and Arnold et al (2022) from the IMF. The German Coalition Agreement concluded by the "traffic light coalition" also mentions a "federal European state". For some, this immediately conjures up notions of a "United States of Europe", but the comparison with the U.S. is misleading and would be tantamount to the abolition of nation-states.

As far as fiscal policy is concerned, its stabilising function is its most important element. The NGEU programme is just one example of a bold leap forward to cope with a disaster in the guise of the Corona pandemic. Europe has additional major challenges lying ahead, however, which even the largest Member States cannot tackle alone. Therefore, NGEU should be the prelude, the dress rehearsal, so to speak, for a small central budget allocated to the EU (or even just the Eurozone), which should nevertheless be much larger than the current EU budget of about one per cent of EU GDP. The best reform of EU fiscal rules cannot solve special challenges, be it for all Member States, be it for single Member States. Special rules and special fiscal capacities are needed here. Decision-making in these cases takes more time than deciding on reforming the fiscal rules. Moreover, the creation of a permanent European fiscal capacity will probably require amendment of the European Treaties, which cannot be done in the simplified procedure stipulated in Article 48 TEU. Finally, a central fiscal capacity can only be created if the central parliament, i.e. the EU Parliament, is also assigned more rights. More statehood in the EU requires more European democracy.

The political, economic and social situation in the EU in autumn 2022 and the prospects for 2023 are more critical than ever - in the face of the war in Ukraine, the energy crisis, high inflation and an imminent recession. A functional fiscal policy framework and a central fiscal capacity would be extremely helpful to better cope with our common challenges. ←

LIST OF ACRONYMS

CAB	Current Account Balance
CAE	Council d'Analyse Economique
COM	European Commission
DSA	Debt Sustainability Analysis
ECB	European Central Bank
EFB	European Fiscal Board
EESC	European Economic and Social Committee
EMU	European Monetary Union
ESA	European System of Accounts
ESM	European Stability Mechanism
EU	European Union
FIE	Funds, institutions and enterprises (as parts of extra-budgetary funds allocated to the general government sector in national accounting)
GDP	Gross Domestic Product
IMF	International Monetary Fund
IMK	Macroeconomic Research Institute (Institut für Makroökonomie und Konjunkturforschung)
MIP	Macroeconomic Imbalances Procedure
MMT	Modern Monetary Theory
MTO	Medium Term Objective
NGEU	Next Generation EU
OECD	Organisation for Economic Cooperation and Development
PEPP	Pandemic Emergency Purchase Programme
PP	Production Potential
PSPP	Public Sector Purchase Programme
SGP	Stability and Growth Pact
SVR	German Council of Economic Experts (Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung)
SNA	System of National Accounts
TEU	Treaty on European Union
TFEU	Treaty on the Functioning of the European Union
TSCG	Treaty on Stability, Coordination and Governance in the Economic and Monetary Union ("Fiscal Compact")

LIST OF FIGURES AND TABLES

GLOSSARY

Austerity
Reducing expenditure or increasing taxes and levies in order to reduce a budget deficit and the debt ratio

Base year
The starting year for time series and index figures

Budget semi-elasticity
The change in the budget balance, relative to GDP, due to a cyclical increase in GDP; this is estimated at 0.5 in the EU as a whole

Corrective arm of the Stability and Growth Pact
The part of the Stability and Growth Pact involving the correction of excessive deficits or debts

Current account
Sub-balance of the balance of payments for an economy, in which foreign trade (exports and imports), cross-border income from wages and assets as well as transfers are accounted for

Cyclical adjustment
Adjusting a time series for cyclical fluctuations, either by filtering methods or by econometric estimation of potential output

Cyclical budget balance
Temporary deviation of the budget balance (revenue minus expenditure) from the value that would result in a normal cyclical situation; the latter exists if the output gap is zero

Cyclical component
Cyclical share of the overall (headline) budget balance

Cyclical expenditure component
Change in government expenditure due to cyclical fluctuations

Debt brake
A rule in the German Basic Law that restricts the structural budget balance for the federal government to 0.35 per cent of GDP and to zero for the 16 German Länder governments

Deflation
A persistent decline in the price level

European fiscal capacity
A central budget of the EU with a debt option, possibly with its own fiscal sovereignty with the aim of a common fiscal policy

European Semester
An institutional framework for planning and coordinating the budgetary and economic policies of EU Member States with the European Commission based on a fixed timetable each year

Expenditure rule
A rule that nominal government spending, excluding interest on government debt and spending on unemployment benefits, should increase at a rate equal to the growth of potential output with a constant tax rate, irrespective of the business cycle; the rule is proposed in several variants

Fiscal Compact
The "Treaty on Stability, Coordination and Governance in the Economic and Monetary Union" (SCG Treaty) was signed in 2012 by 25 EU Member States (excluding the UK and the Czech Republic); it is an international treaty between the signatory countries outside EU law; it limits the structural deficit of Member States to a maximum of 0.5 per cent, or 1.0 per cent if the debt level is significantly lower than 60 per cent of GDP

Golden Rule of fiscal policy
A rule that allows credit financing of government expenditure, provided it is in the form of investment; often coupled with a balanced budget in the case of current expenditure in normal situations

Gross debt
General government debt without deduction of receivables and other assets

Gross investment
Investments including replacement investments

Implicit interest
Interest paid annually by the government on its gross debt, as a percentage of gross debt (average interest rate)

Inflation
Persistent price increases in consumer prices or in the gross domestic product (GDP deflator)

Lender of Last Resort
Task of a central bank to lend money to distressed but solvent banks without restriction at a slightly higher interest rate if there is a temporary lack of liquidity

Lisbon Treaty
Treaty of 2009 amending the Treaty on European Union (EU Treaty) and the Treaty establishing the European Community; the latter became the TFEU

Macroeconomic imbalance
A national economy whose internal and/or external balance is persistently impaired (under- or overemployment, inflation or deflation, persistent current account surpluses or deficits)

Medium-term (structural) budgetary objective
The medium-term target (MTO) for the structural budget balance set by the EU Commission

Net debt
Gross government debt less financial and tangible assets; sometimes also calculated less liquid financial assets

Net investments
Gross investments without replacement investments in the amount of depreciation and amortisation

Next Generation EU
A temporary EU recovery plan (2021-2026) endowed with more than EUR 800 billion to support Europe's recovery from the Coronavirus pandemic while helping to build a greener, more digital and more resilient Europe

Nominal appreciation or depreciation
Appreciation or depreciation of one currency against another, irrespective of different inflation rates between countries

Nominal interest rate
Interest rate not adjusted for inflation

Output gap
Difference between real output and potential output of an economy; a positive output gap means real output is greater than potential output, in the case of a negative output gap, it is smaller

Pandemic Emergency Purchase Programme (PEPP)
European Central Bank programme to buy government bonds

Primary balance
Revenue minus expenditure excluding interest payments on the public debt

Primary market
The market for bonds at the time the bonds were issued

Primary surplus or deficit
See primary balance

Production potential
The quantity of output, measured as real GDP, that can be produced with full utilisation of all factors of production, in particular labour, physical capital and given technology, without creating inflationary or deflationary pressures

Public Sector Purchase Programme (PSPP)
European Central Bank programme to buy government bonds

Real appreciation or depreciation
Nominal appreciation/depreciation adjusted for the inflation differential between countries

Real interest rate
Inflation-adjusted interest rate

Recovery and resilience facility
The core of the Next Generation EU programme, endowed with loans and grants for EU Member States

Scoreboard
A set of fixed macroeconomic indicators in the Macroeconomic Imbalance Procedure (MIP)

Secondary market
The market for bonds after issuance of the bonds

Sectoral net lending/borrowing
The net lending/borrowing for a sector, usually related to households, private enterprises, general government or the rest of the world

Simplified procedure
According to Art. 48 (6) of the EU Treaty, the Treaty on the Functioning of the European Union can be amended by unanimous decision of the EU Council under certain conditions, as opposed to the ordinary procedure of a treaty amendment

Six-Pack
Five EU regulations and one EU Directive from 2011 that related to a reform of the 2005 Stability and Growth Pact

Stability and Growth Pact (SGP)
Adopted in 1997 to harden the fiscal criteria laid down in the 1992 Maastricht Treaty; it was reformed in 2005 and 2011

Structural budget balance
Budget balance less the cyclical component and less one-offs and financial transactions

Structural component
The part of the budget balance that is not due to the cyclical component when excluding the effects of one-offs and financial transactions

Structural primary balance
Cyclically adjusted primary balance

Unit labour costs
The nominal wage and salary costs of an economy as a percentage of real gross domestic product

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Reactivation of the fiscal rules of the European Stability and Growth Pact and, in Germany, the debt brake laid down in the Basic Law is scheduled for 2024 and 2023 respectively. In the EU and especially in the Eurozone, this would lead to fiscal austerity on a massive scale following very loose budgetary policies during the Corona pandemic. The current fiscal policy framework has been heavily criticised by many actors for years. It is far too complex, in many respects based on arbitrary assumptions, it is pro-cyclical and exerts a drag on public investment. This study examines twelve proposals for reforms of the Stability and Growth Pact, including six that could bring about substantial improvements (including one proposal by the author of the study). Parallel to this, proposals for reforming the German debt brake are examined. Germany plays a key role in the reform of the European fiscal rules. The German government has recently presented its position in this regard. Fiscal policy plays a central role for the future of the EU and the Eurozone, especially in view of the multiple challenges posed by the climate policy transformation, digitalisation and the reorientation taking place in the area of defence policy.

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