

The debt brake in Germany – key aspects and implementation

In 2009, the German parliament passed a fundamental reform of government borrowing rules. For central and state government, strict borrowing limits and the requirement for a structurally close-to-balance or balanced budget were constitutionally enshrined in the German Basic Law (*Grundgesetz*). Exemptions were defined much more narrowly and tied to repayment rules. The reform is also designed to ensure compliance with the medium-term objective for the general government deficit that is established in the European Stability and Growth Pact. Before the limits become binding, there will be a transitional period extending to 2020 for the states and to 2016 for central government.

This reform is a very welcome development and a clear improvement on the *status quo ante*. The current sovereign debt crisis has driven home the key importance of safeguarding sound public finances, and strict national rules play a major part in achieving this objective. Rigorous implementation of and adherence to the new provisions are crucial for the reform's success; transparency regarding both the rules and their application is especially important. In particular, this will allow the general public to monitor the implementation of the rules.

At present, developments in Germany's public finances are better than expected, and the country's previously very high deficits are falling sharply. To date, the new rules have probably noticeably supported the initiated path of consolidation. Nonetheless, central government has set very high deficit ceilings for the transitional period, and several states appear to be postponing ultimately unavoidable consolidation measures. It is important to swiftly achieve balanced budgets at all levels of government. Furthermore, all government entities would be well advised to incorporate a safety margin below the constitutional ceiling, thus avoiding the need for short-term adjustments that could have a procyclical impact, particularly given unexpected adverse developments. To avoid incurring excessive structural debt in line with the new budgetary rules, it is also necessary to appropriately define the financial transactions that are to be factored out of the borrowing limit, ensure that positive and negative cyclical effects are truly taken into account in a symmetric fashion, and prohibit government borrowing via entities outside of the core budgets.

Main elements of the new debt brake

Previous constitutional limits did not sufficiently restrict rise in debt

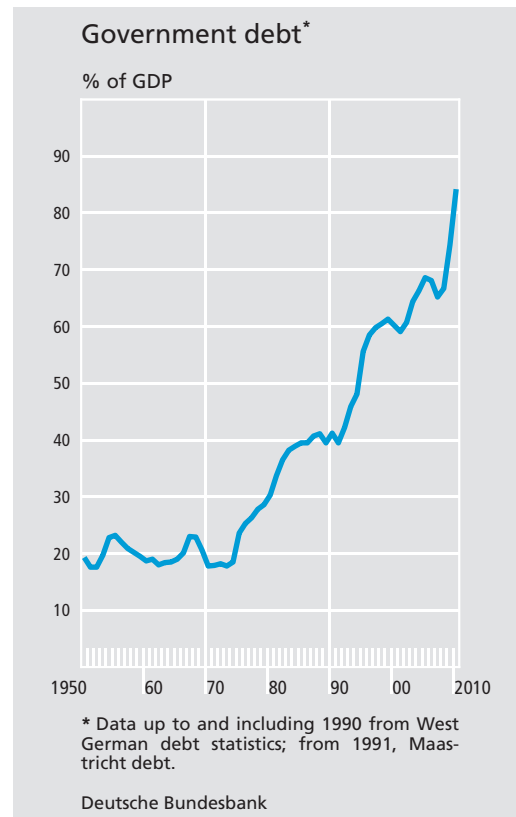
Central government borrowing has been restricted by the Basic Law and state government borrowing by the state constitutions ever since the Federal Republic of Germany was founded. The provisions in place before the recent reform – some of which can still be applied during the transitional phase – stipulated that borrowing must not, as a general rule, exceed total projected investment expenditure. Nonetheless, the debt ratio rose sharply over time (see chart on this page) and was not offset by a corresponding increase in general government assets.¹

New borrowing rule adopted in 2009

In addition to the fact that investment expenditure was defined too loosely, the main weaknesses identified in the previous rules were the overly vague definition of the exemption clause for averting a disruption of the macroeconomic equilibrium, which did not impose any repayment obligations, the general possibility for exempting off-budget special funds from the rules and the inadequate monitoring of compliance at budget outturn. To rectify these deficiencies, a comprehensive reform of the constitutional rules was debated in the latter part of the previous decade at central and state government level. This reform was adopted in early summer 2009 after achieving a broad consensus in both houses of parliament (Bundestag and Bundesrat).

Structurally balanced budget to ensure compliance with European rules

Common principles are established for central and state government in Article 109 of the Basic Law; Article 109 II of the Basic Law stipulates adherence to the euro-area budget-



ary rules. The statement of legislative intent accompanying the draft act makes it clear that this applies, in particular, to the requirement in the Stability and Growth Pact for a structural general government budget position that is at least close-to-balance.²

The debt brake enshrined in Article 109 III of the Basic Law explicitly requires that, as a general rule, central and state government must achieve balanced budgets without incurring new debt, and it therefore differs substantially from the previous investment-related borrowing limit. The debt brake does

Operationally defined debt brake for central and state government

¹ See Deutsche Bundesbank, Government debt and interest payment burden in Germany, Monthly Report, April 2010, pp 15-33. For more details on the weaknesses in the previous constitutional rules, see also Deutsche Bundesbank, Reform of German budgetary rules, Monthly Report, October 2007, pp 47-68.

² See Bundestagsdrucksache 16/12410, p 10.

not merely set a target; it imposes a ceiling that must not be overshoot. Suitable safety margins are therefore needed to allow governments fiscal leeway under the new rules. Given the clarity of the rules, any planned contravention of the borrowing limit could at least be halted by the constitutional courts if someone were to file a suit. Unfortunately, however, the new rules contain no automatic triggers in the event of the limit being contravened. While there is no comparable explicit deficit limit for local government and the social security funds, the latter are permitted to borrow on the capital market only in exceptional cases anyway, and state law generally imposes narrow limits on borrowing by municipalities. Rigorous implementation of these provisions should therefore ensure that European obligations are met.

Cyclically induced deficits must be offset by surpluses in good times

Exemptions to the ban on borrowing by central and state government budgets are permitted in order to offset cyclically induced burdens vis-à-vis a normal setting. However, this hinges on the condition that comparable surpluses be built up in good economic times in order to prevent a sustained rise in government debt caused by the long-term accumulation of burdens that were deemed to be cyclically induced.³ The borrowing limit on the central government budget is considered to have been observed if, after adjustment, in particular, for cyclical effects, net borrowing does not exceed a threshold of 0.35% of gross domestic product (GDP). For state budgets, however, no structural leeway for incurring debt is permitted.

Moderate structural deficits permitted for central government only

Further exceptions can be made in the event of specific emergencies that are beyond the government's control and place a great strain on its budgets. Compared with the previous, very loosely defined exemption clause for averting a disruption of the macroeconomic equilibrium, much stricter requirements now have to be fulfilled. The statement of legislative intent cites various examples of permissible exemptions, such as the severe economic downturn following the escalation of the financial crisis in autumn 2008 or the reunification of Germany. The question of how to treat the ensuing debt in such situations is at least as important as establishing a narrow definition of the exemptions themselves. While the previous rules even allowed unused portions of loan authorisations after invoking the exemption clause to be drawn down for further borrowing in later years, the new debt brake stipulates that additional debt must be tied to explicit repayment rules. This condition is designed to curb the incentive to make excessive use of the exemption clause and prevent a systematic rise in debt, even though neither specific repayment periods nor resolutions on consolidation measures are prescribed.

Exemption for emergencies defined relatively narrowly ...

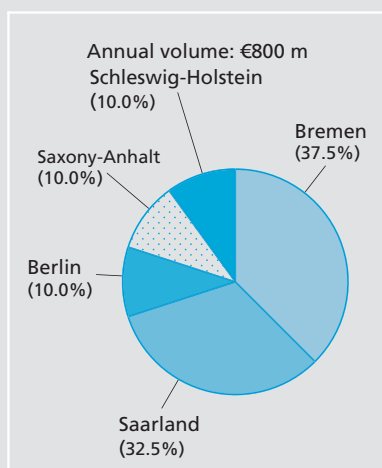
... and tied to repayment condition

In principle, the new rules apply from the 2011 budget year onwards. However, as large budgetary strains as result of the economic and financial crisis were anticipated to persist for a number of years when the reform was adopted, extended transitional periods were specified in Article 143d of the Basic Law. The ceiling of 0.35% of GDP for central govern-

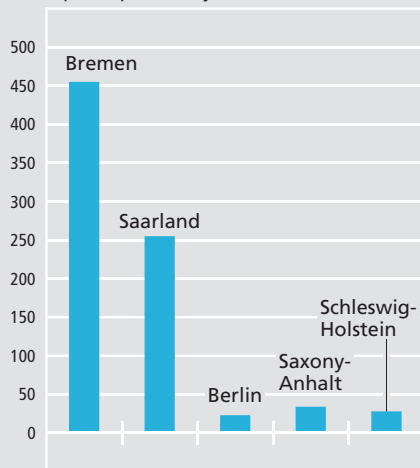
Different transitional regulations for central and state government

³ See also the statement of legislative intent accompanying the draft act: Bundestagsdrucksache 16/12410, p 11.

Consolidation assistance for the budget years from 2011 to 2019



€ per capita and year



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ment structural borrowing will come into force in 2016, and central government is to start reducing its deficit in 2011. The states were granted a transitional period up to the end of 2019,⁴ during which time the state-specific borrowing limits can still apply, not least owing to some states' very high starting values for their deficits. If the state constitutions have not been amended accordingly by then, the constitutional ban on borrowing

will enter into force immediately and without exception. Transitional assistance totalling €800 million per year is planned for the particularly highly indebted states of Berlin, Bremen, Saarland, Saxony-Anhalt and Schleswig-Holstein, which is to be financed in equal part by central government and the states (see chart on this page). In return, these five states must steadily reduce their 2010 starting structural deficit. The other states must merely aim to comply with the new provisions from 2020 onwards.

The new borrowing limits are accompanied by the creation of a Stability Council (Article 109a of the Basic Law), which is designed to prevent future budgetary emergencies. The Council monitors developments in central and state government budgets. It must identify looming budgetary emergencies and then agree restructuring programmes. It seems that the reason for obliging the Stability Council to publish its decisions and consultancy documents was to ensure that the general public would have the easiest possible access to information, particularly on individual states' financial situation. Nonetheless, the Stability Council runs the risk – like its predecessor, the Financial Planning Council – of having very limited influence, not least given the remaining gaps in transparency and its almost complete inability to intervene or impose sanctions (see box on pages 20 to 23).

Stability Council to monitor budgetary developments and publicise information

⁴ For more details on the need for longer transitional periods for Bremen, Saarland and Schleswig-Holstein even before the economic crisis see *Kommissionsdrucksache 102 der Kommission von Bundestag und Bundesrat zur Modernisierung der Bund-Länder-Finanzbeziehungen*, April 2008.

Specifics of the debt rule for central government

Basic Law

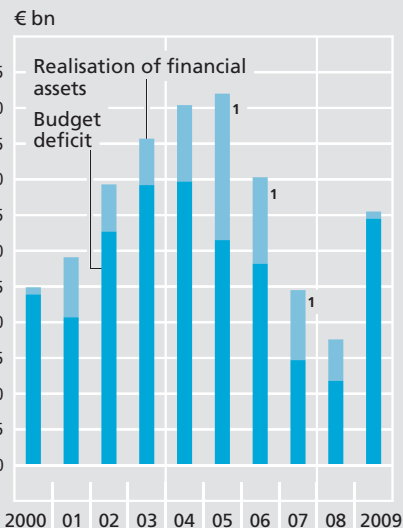
Article 115 of the Basic Law factors out financial transactions in line with the EU rules, ...

Some of the principles applicable to the central government budget were defined more precisely in Article 115 II of the Basic Law, which also grants the authorisation to flesh out the rules in an implementation act. Prior to the reform, substantial realisations of participating interests and loan assets were often used in order to plug budgetary gaps, which ultimately eroded the expenditure-related borrowing limit. The new rules specify that acquisitions and realisations of financial assets (eg loans granted or privatisation proceeds) are not relevant to the borrowing limit and must be factored out of the deficits on which the rule is based (see chart on this page for realisation volumes over the past decade). As financial transactions are excluded under the European budgetary rules (which are based on the national accounts), this is also an important precondition for the new fiscal framework's effectiveness in ensuring that European obligations pursuant to Article 109 II of the Basic Law are met.

... stipulates ex post monitoring of compliance with rules ...

In addition, it is to be ensured in future that any borrowing which exceeds the ceiling at budget outturn does not cause structural debt to rise. Central government is therefore obliged to keep a control account that records any divergence between actual borrowing and the constitutional limit each year. The ceiling could, for example, be overshoot if a borrowing authorisation from the Budget Act that entirely exhausts the constitutional

Realisation of financial assets* and deficits in central government budget



* Realisations of participating interests and inflows from loan repayments minus loans granted. — 1 Including relief provided by a securitisation in the post office pension fund.

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limit is used in full at budget outturn (eg owing to planned expenditure being overshoot) even though the strain placed on the budget by the business cycle or financial transactions was lower than projected. If the cumulated debt on the control account exceeds 1.5% of GDP, the corresponding amounts are to be "scaled back in a cyclically appropriate fashion" by keeping borrowing below the structural limit of 0.35% of GDP. These provisions show that the debt brake regulations – unlike the previous arrangements – are to be binding not only during *ex ante* budget preparation but also *ex post*.

The role of the Stability Council

The reformed budgetary rules assign an important role to a new Stability Council, namely to monitor and render transparent the budgetary development and budget plans of both central government and the state governments. In particular, the aim is to avert a budgetary emergency of a government entity in future before it materialises. The Council therefore has the power to declare that a budgetary emergency is imminent and to stipulate restructuring programmes as and when necessary. However, compliance with the existing or new debt rules is merely to be commented on in the context of the stability reports that each government entity must submit annually.

The Stability Council comprises the federal ministers of finance and economics plus the state finance ministers; it drew up its rules of procedure in April 2010. It meets at least semi-annually and passes resolutions with a majority of at least 11 of the 16 states and the approval of central government, with individual entities abstaining on votes regarding their own entity.

In the course of regular budgetary surveillance, central government and the state governments submit annual reports on their current and planned medium-term budgetary situation. The reports chiefly focus on four budgetary key figures and thresholds defined by the Stability Council. Any overrun of these values is interpreted as a warning signal of a looming budget emergency (see also the box inset opposite). In addition, the government entities must draw up standardised medium-term budget projections. A differentiated evaluation is only instigated once a state government or central government overshoots three thresholds twice during the recent period (the last two years and the current year) or twice during the planning period (generally the four following years) or the projection shows figures deemed to be critical. Based on this evaluation, the Stability Council may, if necessary, declare a looming budgetary emergency and then agree a restructuring programme with the entity concerned to avert it. This programme requires the net borrowing volume to be reduced over a standard period of five years. To this end, the respective entity has to specify measures of its own to safeguard

the necessary consolidation. As the state governments have limited revenue autonomy, their measures must necessarily focus on curbing expenditure. The entity in question must submit a semi-annual progress report to the Stability Council detailing its implementation of the measures. If the set targets are missed, however, the Council can merely make further requests. No sanctions are envisaged, with the result that the pressure to rigorously implement the consolidation programme may not be intense enough.

The establishment of a Stability Council and the strengthening of preventative budget surveillance using simple procedures based on a standardised framework, and the aspired transparency in reporting,¹ are definitely to be welcomed. They could help to counter the propensity to incur debt observed in the past.

Seen from the present perspective, however, there is a risk that the current approach may fall short of the mark. The assessment criteria might not detect problematic developments in time. Moreover, the comparability of the data and their usefulness for assessing the current situation are significantly restricted by the fact that not all of the published state government budget plans are up to date on the reporting date. Although the necessary step of systematically including off-budget funds is envisaged, it has apparently not been implemented to date. Another desideratum would be not just to list the values for the agreed key figures in the stability reports but also to show the associated detailed standardised calculations and, in addition, to produce cross-state comparisons that extend beyond the agreed ratios. At the moment there is a partial respective information gap, which makes it much harder to comprehensively evaluate the current situation and the future development.

Current key figures and thresholds only of limited use

The agreed key figures for warning of a budgetary emergency at state government level² seem only partly suited to meeting the Stability Council's objectives. No cyclical adjustment procedure is used (yet) for

seems to be advisable. — ³ Concerning the definition of the reduction paths for the structural deficits of states receiving consolidation aid, see Deutsche Bundesbank, German states receiving consolidation

¹ The consultancy documents are available at www.stabilitaetsrat.de. —
² It is especially difficult to derive suitable key figures for the Federal government. A focus on compliance with the new borrowing rules

Key figures and rules for budgetary surveillance

Key figures regarding the current budgetary situation and financial plan*

Annual thresholds

Position	Central government		Non-city states		City-states	
	Current budgetary situation ⁵	Financial plan ⁶	Current budgetary situation ⁵	Financial plan ⁶	Current budgetary situation ⁵	Financial plan ⁶
Structural fiscal balance ¹ € per inhabitant	Up to 2010: level of investment spending	Reduction path during transitional period -€50	State average -€200	Threshold of current budget year -€100 ⁷	State average -€200	Threshold of current budget year -€100 ⁷
Debt-financing ratio ² in %	Moving average of the last 5 years +8 pp	Threshold of current budget year	State average +3 pp	Threshold of current budget year +4 pp ⁷	State average +3 pp	Threshold of current budget year +4 pp ⁷
Interest-to-tax ratio ³ in %	Moving average of the last 5 years +8 pp	Threshold of current budget year	140% of the state average	Threshold of current budget year +1 pp	150% of the state average	Threshold of current budget year +1 pp
Debt level ⁴ central government: % of GDP, states: € per inhabitant	Moving average of the last 5 years +8 pp	Threshold of current budget year	130% of the state average	Threshold of current budget year +€200 pa	220% of the state average	Threshold of current budget year +€200 pa

* The data are to be provided on the basis of the Federal Statistical Office's multi-tier concept, ie the reporting group covers the core and off-budget entities, as well as other outsourced public entities. So long as this remains unimplemented, a case-by-case check is made on whether the threshold overshoot is due to the omission of off-budget entities. — 1 Structural fiscal balance: fiscal balance (on an accruals basis of the state tax revenue-sharing scheme), adjusted for the balance of financial transactions and cyclical effects (states: currently not cyclically adjusted; until cyclical adjustment procedure has been agreed, the state average is used as a comparison). Balances of asset funds (separated from the core budget) and civil servant pension funds are included. — 2 Debt-financing ratio: net borrowing as % of total expenditure (adjusted for payments within the same state level). — 3 Interest-to-tax ratio: interest payments as

% of tax revenue. Taxes after state tax revenue-sharing, including general supplementary Federal grants, mining royalties and motor vehicle tax offset. — 4 Debt level: credit market debt on 31 December. Target debt level of the year in question and of the financial plan period is calculated as the debt level of the previous year plus net borrowing in the year in question. — 5 Current budgetary situation: observation values = actual values of the two preceding years and the target value of the current budget year (t-2 to t). — 6 Financial plan: observation values = values according to draft budget for the following year and medium-term financial plan (t+1 to t+4). — 7 Financial plan: the add-on vis-à-vis the threshold value for the current budgetary situation (ie easing) can be waived if the tax estimate for the current year produces markedly better results than the previous estimate.

Standard forecast of the medium-term budgetary development

In addition to the key figures given above, a projection of the medium-term budgetary situation, based on standardised assumptions regarding growth and revenue, is presented under the budget surveillance procedure. The benchmark that is computed is the expenditure growth rate at which the debt level threshold value is marginally not exceeded at the end of a seven-year projection period (based on the outturn of the year prior to the reporting year and also on the target value of the current

year). In a first step, an assessment is made as to whether the expenditure growth rate of a state is more than 3 pp below the average of all states and whether central government's expenditure growth rate is more than 2 pp lower than the expenditure growth rate calculated for the reporting year. In a second step, the result is subjected to a quality check, if necessary also taking into consideration additional in-house projections of the entity in question.

Evaluating a looming budget emergency

An evaluation of a looming budget emergency is initiated if in one of the two periods the threshold values of a majority of the key figures are exceeded or the projec-

tion indicates a problematic development. Data for a key figure are considered problematic if the reference value is exceeded at least twice in one of the two periods.

aid – initial deficit reduction requirements not very ambitious, Monthly Report, May 2011, pp 70-71. — 4 As the scale of a state's possible own consolidation measures may be controversial, the minimum

requirement would be to have a list of measures needed for a gradual convergence with the average deficit per inhabitant of non-hardship

The role of the Stability Council (cont'd)

the first key figure, the structural fiscal balance per inhabitant, owing to the states' inability to agree on a common procedure, and for that reason there are currently no structural balances adjusted for cyclical influences. The second key figure, the debt-financing ratio, includes discretionary allocations to reserves – financed, for example, out of higher-than-estimated revenue – and their equally arbitrary use. If not adjusted for the respective fluctuations, the development of this variable permits only a partial insight into the budgetary situation. Longer-term developments are reflected in the debt-per-inhabitant figure. It has the major drawback that it excludes cash advances. It might also make sense to additionally include risky guarantees as well as unfunded civil servant pension entitlements, the volume of which varies greatly from state to state, so as to capture present and future budget liabilities more fully. The last key figure – the interest-to-tax ratio – would detect a problematic development, such as in the debt level, only after several years, so that the warning, which is not triggered until a majority of the thresholds has been exceeded, would be activated only after a considerable time-lag.

The key figures selected for state government are directly related neither to the new debt rule nor to the investment-pegged borrowing limit, which still applies in some states and was exceeded in many budget plans in 2011. Although the stability reports of the individual government entities contain some general remarks about their current status of compliance with their respective constitutional borrowing limits, they do not elaborate on any overrun of the limits or on stop-gap measures taken to prevent such an overrun. Furthermore, there is no possibility in the reports to validate the robustness of the budget plans in this regard. Another shortcoming is that the thresholds, especially for the medium-term planning period which frequently contains high global expenditure cuts and favourable growth scenarios, are calibrated generously, meaning that a precarious budgetary situation can go unnoticed by the Stability Council's monitoring process for a long period. Notwithstanding the constitutional requirement of a structurally balanced budget for state governments from 2020 that has been added to Germany's Basic Law (*Grundgesetz*),

threatened states. When the individual consolidation measures for non-hardship threatened states are identifiable, the scale of these

the states are being granted sizeable additional scope for annual debt growth without this needing to be offset by increases in financial asset acquisition. Lastly, taking the average of the state governments as a benchmark for comparisons is fraught with problems since the information value of compliance with the thresholds diminishes as more state budgets slide into significant deficits.

In addition, the validation processes are very drawn out (a whole year elapses between identifying a problem concerning thresholds for the key figures and agreeing on a restructuring programme), and the possibility of financial sanctions is envisaged solely for states receiving consolidation aid during the transitional period (withdrawal of financial assistance). Therefore it does not appear certain overall that timely and sufficient pressure to thoroughly consolidate (during the transitional period or when claiming exemption) and to interpret the budgetary rules systematically and properly can normally be exerted, as the Stability Council originally intended. Given the far stricter and also much clearer new debt rules, this task is thus likely to be assumed not by the Stability Council, which is in principle suitable for this purpose, but instead by the constitutional courts, which will only get involved upon request.

Restructuring programmes need underpinning with suitable concrete measures

To date, the states that have been certified as facing looming budget emergencies based on data from autumn 2010 are those receiving consolidation aid: Berlin and Schleswig-Holstein, as well as Bremen and Saarland, which are in much worse financial shape. Berlin and Schleswig-Holstein presented (differing) reasons why, in their opinion, they are not facing a looming budget emergency, whereas Bremen and Saarland, which for this reason had both previously filed a suit with the Federal Constitutional Court (*Bundesverfassungsgericht*) requesting central government aid, had actually described their budget emergencies as "extreme". The affected states plan to agree a restructuring programme with the Stability Council – as is stipulated – in November 2011. Follow-

measures would then be requested by the hardship-threatened states – staggered over time, if necessary. — 5 Data on the share of units

ing Bremen's and Saarland's poor restructuring track record since the 1990s and given in part grossly excessive starting point values for the structural borrowing reduction paths, it would be important to ensure that not compliance with the excessive borrowing limits³ stated in the administrative agreements, but rather the reduction steps associated with these limits are backed up, as far as possible, by the states' own permanent, effective measures.⁴ The *ex ante* specification of such measures several years in advance should be considered. It would also make sense to include concrete improvement obligations in the respective programmes to rectify any deviations from the set targets.

Meaningful key figures and transparent comparisons

An extended and more detailed reporting obligation would seem to be desirable in respect of the data provided by the Stability Council. Both central government and some states already give somewhat more detailed derivations of the key figures in their reports. Besides actual figures (for the individual states, as well as separately for the state government including and excluding its local government entities if possible), target figures for the current year and for the multi-year financial planning period would be especially informative. Respective data regarding the size of the fiscal balances, the revenue and expenditure totals (adjusted for transactions concerning reserves), payments on and revenues from financial transactions, tax receipts, interest expenses and payments made to the state tax revenue-sharing scheme would be important.

Besides these data, which are necessary anyway to determine the four agreed key figures at the state government level, the disclosure of civil servant pension costs (in the case of central government inclusive of allocations to the Federal Railways Fund, post office pension fund and the statutory pension insurance scheme), transfers to local governments, the estimated global expenditure savings and the estimated global additional receipts would be of particular importance to enable independent observers to assess developments. Figures about the debt level – as set

(weighted by their share in expenditure) with unbalanced budgets in the year in question with a short explanation of state law peculiarities

out above – at least including cash advances, would also be relevant.

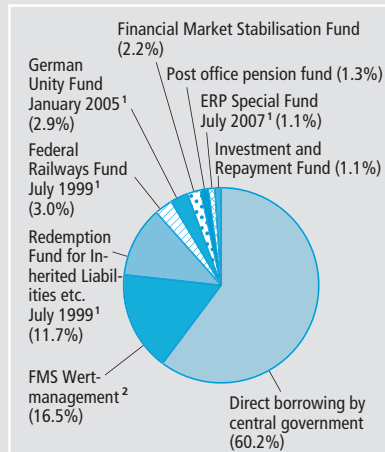
Transparency could also be improved significantly by showing the margin in the target/outturn to the constitutional borrowing limits.⁵ Further details about the data adjustments derived from tax estimates after drafting the budget, for example, and about safety margins or corrections undertaken for expected changes to tax law compared with the official tax estimate would also be important, and should be presented regularly, both in order to make meaningful comparisons and to draw up a picture of the current situation. These extra data, which should be given both as absolute amounts and as amounts per inhabitant, would enable much more informative comparisons of the state government finances to be made – using comparative overviews, for example – and, by agreeing on lower alarm thresholds, would allow problematic developments to be detected far more reliably and quickly, so that valuable response time is not lost unnecessarily.

The data that would be required to provide the more detailed information outlined above should be generally available and, in some cases, are already recorded in other regular statistical reports, whereas outside observers can compile them, if at all, only with a great deal of effort. With an appropriately expanded data base and meaningful comparisons, the Stability Council could provide a significant contribution to comprehensively informing the public about the financial situation and outlook in the individual states and at the level of central government. Rigorous and transparent monitoring would perceptibly increase public pressure in the event of looming budgetary problems and would provide the public, not least in the respective states, with a timely signal of imbalances and problematic developments requiring correction. Transparency with regard to medium-term planning could, in addition, place the discussion about fiscal projects and their counterfinancing on a more rational basis.

regarding provisions for the municipal budgets would be preferable for local governments.

Contribution from debt of off-budget entities to total central government debt in 2010*

Total: €1,312 bn



* Accumulated debt at time of assumption or end-2010. — 1 Time when central government (co-) assumed debt. — 2 Liquidation agency for problematic Hypo Real Estate assets.

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... and does not envisage any exemptions for off-budget entities

To ensure that the borrowing limit is not circumvented using off-budget entities,⁵ paragraph 2 of the former Article 115 of the Basic Law, which exempted special funds from the borrowing limit, was rescinded (see the chart on this page for more details on the importance of off-budget entities to total central government debt). The newly introduced Article 143d I sentence 1 of the Basic Law also specifies that only those special funds' residual borrowing authorisations already in existence at the end of 2010 are allowed to be fully utilised. To ensure adherence to the European rules pursuant to Article 109 II of the Basic Law, it is particularly important that the borrowing limit should include not only special funds but also all other entities that are ascribed to the central government sub-sector under the European budgetary rules.⁶

Implementation act

In direct connection with the reform of the Basic Law, an act implementing Article 115 of the Basic Law (Act 115) was passed, specifying further details regarding the central government debt brake. It stipulates that (budgetary) expenditure and revenue titles for acquiring or realising credit claims and participating interests in enterprises as well as loans granted from and repaid to government budgets are deemed to be financial transactions and are factored out of the debt brake. The statement of legislative intent accompanying the act emphasises that this ensures that the borrowing limit specified under the debt brake rules is closer to Maastricht net lending/borrowing,⁷ citing practicality as the reason for tying the definition of financial transactions to selected budgetary items. It would be appropriate to apply the definitions specified in the European budgetary surveillance procedure to more important cases.

Implementation act defines financial transactions, ...

Furthermore, Act 115 stipulates that the cyclical component must be calculated as the product of the output gap and budget sensitivity. Act 115 grants the power to issue a regulation for more detailed provisions. In addition to requiring a symmetric approach to accounting for cyclical upswings and downswings, Act 115 states that the method of cyclical adjustment must essentially correspond to that applied under the European budgetary surveillance framework and must

... stipulates harmonisation with EU procedure for cyclical adjustment, ...

⁵ See Bundestagsdrucksache 16/12410, p 13.

⁶ See statement from the Deutsche Bundesbank in the public hearing of the Budget Committee on 21 March 2011, p 4 at www.bundestag.de.

⁷ See Bundestagsdrucksache 16/12400, p 19.

be regularly monitored and, where necessary, revised.

... expands borrowing scope where supplementary budgets used, ...

In future, borrowing needs will still, on occasion, be higher than expected because revenue is lower than estimated or legally prescribed benefits cost more than projected and the respective budgetary burden is not offset elsewhere. If no residual borrowing authorisations from previous years are available, a supplementary budget with additional borrowing authorisations is generally required in such cases. The additional borrowing requirement can also be considerably higher than the amount calculated as being cyclically induced given weaker-than-expected growth. In past tax estimates, for example, the revenue outlook – adjusted for legislative changes made in the intervening period – has sometimes been reduced much further than could be explained by the correction of macroeconomic assumptions.⁸ The new rules stipulate that borrowing in supplementary budgets may exceed the regular constitutional limit by 3% of estimated tax revenue (currently €7 billion) if the supplementary budget does not entail new measures that place a strain on the budget. To prevent such additional borrowing from affecting the debt level in the long term, the overshooting of the regular structural borrowing limit must be booked in full on the control account, which has a limited balance.⁹

... provides a framework for the control account, ...

Under the new rules, after the closing date of the budget the difference between the structural borrowing budget outcome and its regular ceiling will be booked on the control account first on 1 March and finally revised on

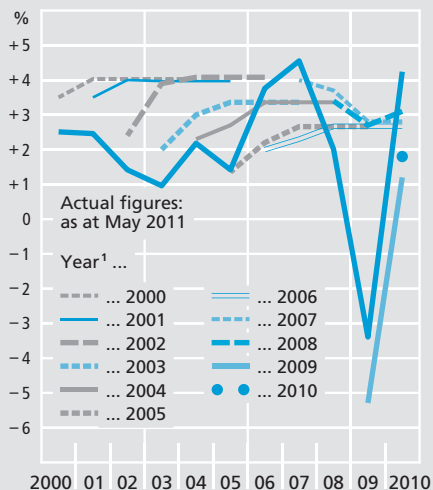
1 September of the following year. Net borrowing is to be adjusted for the actual net acquisition of financial assets and the actual cyclical component and deducted from the ceiling. The cyclical component is not fully recalculated. Instead, the divergence between the GDP growth expected when the budget was adopted and actual GDP growth is classified as entirely cyclically induced.¹⁰ Any additional deficits derived by multiplication of the budget sensitivity and the GDP growth rate divergence for the preceding budget year are therefore categorised as cyclically induced and factored out. Nonetheless, it should be borne in mind that supplementary data often lead to a re-evaluation of the medium-term growth outlook, and this fact has to be taken into account when the next budget is prepared. The macroeconomic projections on which the medium-term financial plans were based have mostly been revised downwards in the past (see the chart on page 26 for developments over the past decade). To ensure that cyclical adjustment is symmetric, potential GDP must also then be reduced, meaning that a larger share of the observed deficits – both retrospectively and prospectively – are classified as structural. It is

⁸ See Deutsche Bundesbank, Development of tax revenue in Germany and current tax policy issues, Monthly Report, October 2008, pp 45-46.

⁹ However, the Basic Law does not provide for this exemption – for which there are indeed good reasons – for higher-than-expected borrowing during budget implementation. It should therefore be applied solely within the narrow constraints established along with the constitutional reform. See H Kube, Kommentierung des Art. 115 GG, Rn. 205, in T Maunz, H Dürig (eds), *Grundgesetz*, Kommentar (56. Ergänzungslieferung, 2009) for a critical view.

¹⁰ Pursuant to the Regulation on the procedure for calculating the cyclical component (Verordnung über das Verfahren zur Bestimmung der Konjunkturkomponente) of 9 July 2010.

Growth rates for nominal GDP in the central government financial plan and actual figures



1 Stated year: time at which budget for following year was compiled (year 2000 for 2001 central government budget and for financial plan up to 2004).

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often overlooked that, as for the aforementioned extensive and unexpected tax shortfalls (if they are not classified as being cyclically induced), structural gaps open up also in subsequent years that are not permitted to be absorbed via the control account and must be closed in full when the next budget is prepared. Furthermore, it is stipulated that accumulated debt on the control account must generally be reduced. Where the debt level booked on the control account exceeds 1% of GDP, the permissible borrowing limit is lowered by the amount by which the control account threshold is exceeded, or a maximum of 0.35% of GDP, if GDP growth is expected to be above potential GDP growth in that budget year. This constitutes a tightening of the rules compared with the ceiling of 1.5% of GDP envisaged in Article 115 of the

Basic Law, designed to better ensure actual compliance with this constitutional limit (see overview on page 27 for more on the application of the debt brake).

The new rules will enter into full force in 2016. Until then, a transitional provision for the borrowing limit (section 9 of Act 115) governing the minimum “reduction of the existing deficit” will apply, which fleshes out Article 143d of the Basic Law by defining the starting point as “the structural deficit for the 2010 budget year” and specifying that the limit is to be “reduced in equal steps from 2011 onwards”.

... and defines borrowing limit in the transitional period

Specific aspects of central government’s implementation of the debt brake

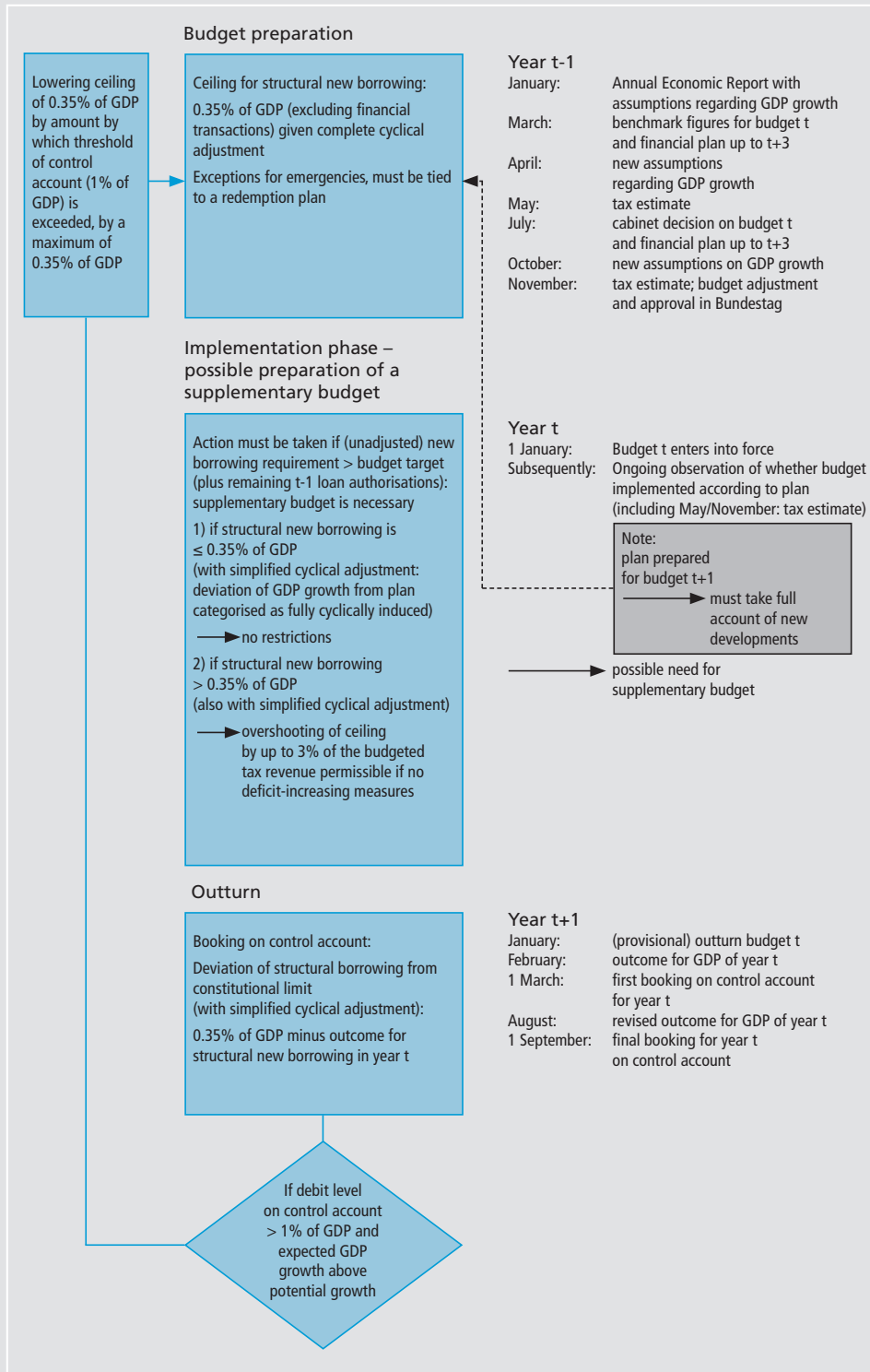
In principle, the German debt brake is a very suitable instrument for effectively restricting government debt. However, stringent implementation and avoidance of exploiting loopholes for circumventing the rules will ultimately be key to its success.

Stringent application key to reform’s success

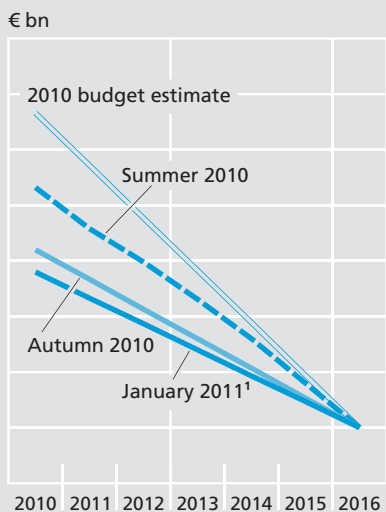
The size of the borrowing limit in the transitional phase up to 2016, which will be reduced in fixed stages, essentially hinges on the starting value for the structural deficit in 2010. After the budget plan for 2010 had been adopted in March 2010, the economic setting and outlook steadily improved. In early summer last year, expected structural borrowing for 2010 was revised to €53 billion from a structural target of €66½ billion in the

2010 structural deficit – as starting value for borrowing limit – revised in summer 2010 ...

The debt brake in central government's budget cycle



Structural central government deficit in 2010 and reduction path up to 2016*



* Excluding GDP extrapolation (exception: summer 2010 pursuant to central government figures from the current financial plan). — 1 Under the new EU cyclical adjustment procedure, the 2010 value would be up to another €5 billion lower.

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2010 budget.¹¹ Although a much more favourable outcome was already foreseeable when the 2011 budget was adopted in November 2010, the ceiling for the transitional period was not adjusted any further, and nor was the additionally improved budget outcome, with a structural deficit of less than €40 billion, taken into account (see chart on this page). However, Article 143d of the Basic Law ultimately requires the starting value and thus also the adjustment path to be lowered accordingly.¹² This would not jeopardise budgetary continuity, since the revision to the structural deficit not only affects 2010 but is also carried forward into subsequent years as a baseline effect.¹³ By contrast, the fact that the starting value was not adjusted could weaken the consolidation path agreed in

... but no further adjustments subsequently made

June 2010 and cause the necessary consolidation to be largely deferred to the future.¹⁴

However, keeping the higher ceiling in place creates greater scope for borrowing even if it is supposed to be undershot. Pursuant to Act 115, the items to be credited to the control account amount to more than €40 billion in the years from 2012 to 2015 alone under the current medium-term financial plan (see chart on page 29). While these credit items cannot be used to project higher deficits in future budgets, they do allow negative deviations to be offset during budget implementation. If, for example, the effects of benefit increases or tax cuts are underestimated in the budget, deficits can be offset using credit balances booked on the control account, in-

Dubious credit items on the control account open up scope for borrowing

¹¹ The adjustments vis-à-vis the 2010 target were initially rejected by the government, see, for example, Bundestagsdrucksache 17/494, p 14f.

¹² See the statements made by the Bundesbank and the Federal Court of Auditors on the hearing of the Budget Committee of the German Bundestag on 21 March 2011 at www.bundestag.de. The statement of legislative intent accompanying the draft act to reform the Basic Law (Drucksache 16/12410) likewise clearly states that the starting value must be up-to-date. Reference is made to forecast uncertainty, and the Basic Law even permits a later starting point for deficit reduction in the event of less favourable general economic developments.

¹³ For example, not only was additional tax revenue posted in 2010, but expectations for subsequent years were actually adjusted upwards even more strongly. The same is true of the positive developments on the labour market and interest expenditure.

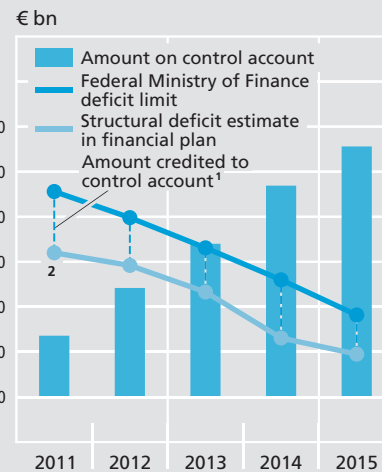
¹⁴ Another advantage of adjusting the ceiling on the basis of the 2010 budget outcome is that the reduction path would barely be influenced by any one-off measures in the base year. The 2010 deficit was initially considerably increased in structural terms (€12 billion in the target) by one-off transfers to the statutory health insurance scheme and the Federal Employment Agency; at outturn, however, labour market developments, which were far better than predicted and thus substantially reduced the Federal Employment Agency's grant requirements, and proceeds from the auction of mobile telephone licences meant that there was almost no one-off effect on balance. By contrast, the summer 2010 starting value used by the government is probably overstated by €5 billion as a result of one-off measures.

cluding those from the transitional period. It is worth considering applying the stricter provisions made in the Basic Law, which explicitly state that credit items may be booked to the control account only when the regular structural borrowing limit of 0.35% of GDP is undershot, in order to prevent any erosion of the rule.

Change of cyclical adjustment procedure increases borrowing scope

Another aspect of the rule's implementation that warrants criticism is the change to the cyclical adjustment procedure during the transitional phase.¹⁵ Under the new procedure, the burdens classified as being cyclically induced are shown to be significantly larger at the current end, meaning that the structural components of given unadjusted deficits will be lower than before. To ensure that the new procedure is faithful to the regulatory intent behind the debt brake, the structural situation in the starting year of 2010 needs to be re-evaluated. The fact that this correction has not yet been made means that the structural starting value is overstated by up to €5 billion and the resulting structural scope for borrowing in the transitional period increases further. As this is not the only shortcoming of the new procedure in the context of the debt rule, it would be better to return to the approach used for 2010.¹⁶ The new procedure is highly complex. In general, the need for extensive settings and databases jeopardises the transparency of the estimates. In addition, the estimation results are elastic to minor modelling choices that are extremely difficult to justify objectively, meaning that the procedure is comparatively vulnerable to manipulation. Furthermore, ongoing methodological changes undermine the real sym-

Bookings on the control account* if financial plan up to 2015 is implemented



* Tool for accumulating divergences between actual borrowing and its constitutional limit. — 1 Already shown in the corresponding budget year. — 2 Federal Ministry of Finance's summer 2011 estimate for new borrowing in 2011 (around €30 billion), adjusted for Bundesbank estimate of financial transactions and cyclical effect.

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metry of the cyclical components estimated in real time. If the changes mean that greater cyclical burdens are shown for the current end, as has recently been the case, this poses the danger of a lasting rise in debt. Given the fundamental and inevitable methodological difficulties that cyclical adjustment involves, it would be advisable also to book the cyclical components on a separate control account to allow easy monitoring of their broad match over time and, where necessary, to counteract a structural rise in debt. Irrespective of the

¹⁵ This entails central government adopting the change to the cyclical adjustment procedure initiated by the European Commission in 2010.

¹⁶ For more details on the fundamental problems associated with the new procedure, see Deutsche Bundesbank, Requirements regarding the cyclical adjustment procedure under the new debt rule, Monthly Report, January 2011, pp 55-60. Clear progress has meanwhile been made in the publication of data underlying the calculations by the relevant federal ministries.

method chosen, this would avoid a gradual additional build-up of debt mislabelled as being cyclically induced.

Principle of defining financial transactions on the basis of strict EU rules ...

Furthermore, a sufficiently strict definition of financial transactions is important to ensuring the effectiveness of the debt brake. Otherwise, there is a danger that, given marked budgetary tensions, payments will be categorised as loans granted or acquisitions of participating interests so that their volume is not curtailed by the deficit limit. In extreme cases, loans might be used to carry out regular spending. This, combined with low interest rates or even full debt waivers, could lead to substantial transfers being made outside of the debt brake. Since the statement of legislative intent accompanying the act specifies that financial transactions are to be factored out of the debt brake in order to harmonise German provisions with the European budgetary surveillance rules governing deficits, and since compliance with the European rules is now enshrined in the Basic Law, the European rules should ultimately also apply to the debt brake. This means that transactions with important transfer components – regardless of their budgetary classification – and, in particular, debt waivers, which reduce financial assets without affecting on-budget payment flows, should be counted towards the borrowing limits. In accordance with the legislative intent of the act, only acquisitions of financial assets with genuine recoverable value should be factored out.

... increasingly being implemented ...

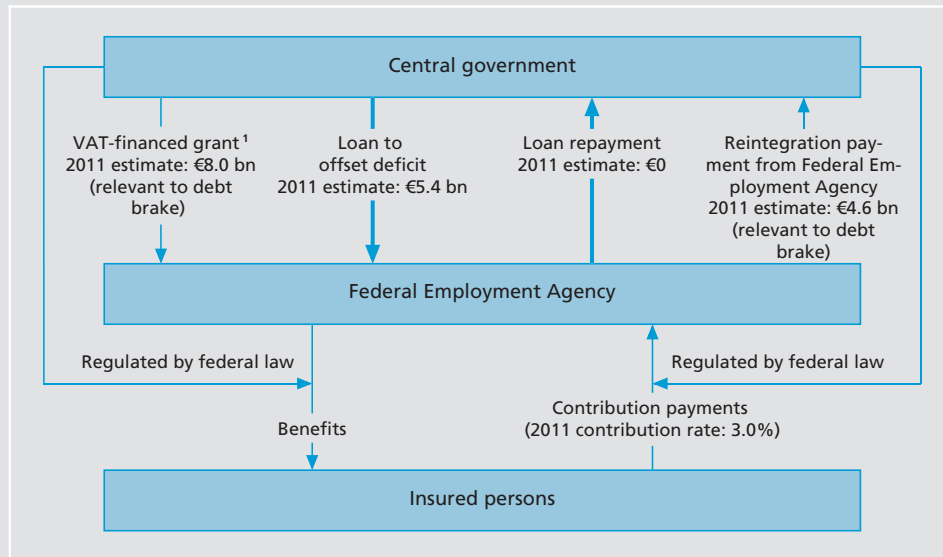
This principle is increasingly being taken into account. Capital injections for development banks, which in recent years have been

booked as acquisitions of participating interests even though they yielded no dividends, are categorised as capital transfers in the 2012 draft budget. Furthermore, calls on guarantees are no longer deemed to be financial transactions in this draft, whereas this is still envisaged for foreign calls and repayments in 2011.

However, the payment to offset the Federal Employment Agency's deficit is still being booked as a financial transaction. The payments of €5½ billion estimated in the 2011 budget are envisaged as interest-free loans without a fixed maturity. Repayments are to be made as soon as the Federal Employment Agency posts a surplus. This warrants a critical assessment if the contribution rate to the Federal Employment Agency is not high enough across one business cycle to ensure that revenue covers expenditure. Legislators at central government level can strongly influence the Federal Employment Agency's financial situation themselves (see the chart on page 31). In order to counterfinance the reform of social welfare basic allowances adopted at the beginning of 2011, central government's VAT-funded payments to the Federal Employment Agency are to be reduced by a similar amount (around €4 billion in 2014). This constitutes a cut in spending on the Federal Employment Agency that counts towards the debt brake. This expenditure is to be replaced where necessary by a central government loan to offset the agency's deficit, which is categorised as a financial transaction. Under the debt brake rules, there is a strong incentive for such reforms. As a consequence, the Federal Employment

... but classification of interest-free loans to Federal Employment Agency as financial transaction dubious

Impact of central government on the financial situation of the Federal Employment Agency



¹ Another payment from the central government budget that is relevant to the provisions of the debt brake: administration cost reimbursements as part of the basic allowance for jobseekers. 2011 estimate= €4.3 bn (mainly to Federal Employment Agency).

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Agency may not be able to repay incurred debts. It is worth noting that the current contribution rate to the Federal Employment Agency is already insufficient to cover its costs without major benefit cuts.¹⁷ Categorising the granting of interest-free loans to the Federal Employment Agency to offset its deficit as an acquisition of financial assets with recoverable value thus appears problematic. There is a danger of a cumulating volume of debt outside the debt brake's reach.

To be effective, the debt brake also needs to encompass debt-like burdens outside of the core budget. One initial idea was to establish a debt-financed special fund to offset the deficits of the social security funds before the brake came into force, but it was scrapped following strong public criticism. Article 143d

of the Basic Law closed this loophole with effect from 2011. In view of the rules' intent, this ban should be applied consistently to all other central government entities ascribed to the government sector under the European budgetary rules. Enterprises that do not charge prices that sufficiently cover their costs or have insufficient autonomy in their core business would thus have to be included in the debt brake. For example, the plan specified in the central government coalition agreement to grant the financing corporation for transport infrastructure¹⁸ a limited borrowing entitlement should be reassessed. Public-private partnerships (PPPs) should like-

¹⁷ See Deutsche Bundesbank, Sustainable contribution rate for the Federal Employment Agency, Monthly Report, August 2011, p 76-77.

¹⁸ See coalition agreement between the CDU, the CSU and the FDP, 17th legislative period, p 35.

Off-budget entities and hidden deficits must be consistently included in debt brake

wise be analysed critically. As in the European rules for calculating the Maastricht deficit, their investment volume should be recorded as having an impact on the deficit if the government bears the relevant project risks. Moreover, including such projects in the debt brake could help to ensure that decisions to initiate PPP projects are indeed based on cost-efficiency gains.

Strict borrowing limit makes safety margin highly advisable

By their very nature, strict borrowing limits limit budgetary flexibility in respect of debt-financing. Nonetheless, to be able to comply with borrowing limits even in difficult circumstances without the need for erratic adjustments, it is generally highly advisable to factor in a safety margin below the ceiling. This problem is underscored, in particular, by the substantial estimation uncertainty regarding tax revenue developments. Even excluding effects resulting from legislative changes, which often entail estimation uncertainty, fluctuations in revenue are only partly classified as cyclically induced under the usual cyclical adjustment procedures.¹⁹ If there is no safety margin below the constitutional borrowing limit, unexpectedly poor structural tax revenue developments rapidly trigger a substantial need for consolidation.²⁰ During the implementation of a budget, substantial additional burdens can occasionally be absorbed through residual borrowing authorisations or, where necessary, through a supplementary budget with an expanded credit line. But this does not apply to the preparation of the next regular budget, which must comply with the strict debt brake rules. The short-term measures then needed to keep borrowing below the ceiling may have a pro-

cyclical impact, however. Taking a more ambitious strategic focus – which is necessary to ensure a sufficient safety margin – can prevent such acute pressure for action from arising. A worse-than-expected structural development can then be absorbed by the safety cushion, keeping borrowing below the ceiling. Yet even aside from the problem of negative shocks, introducing a safety margin that would normally be adhered to would also usefully serve to speed up the reduction of the high debt ratio.²¹

State debt brakes

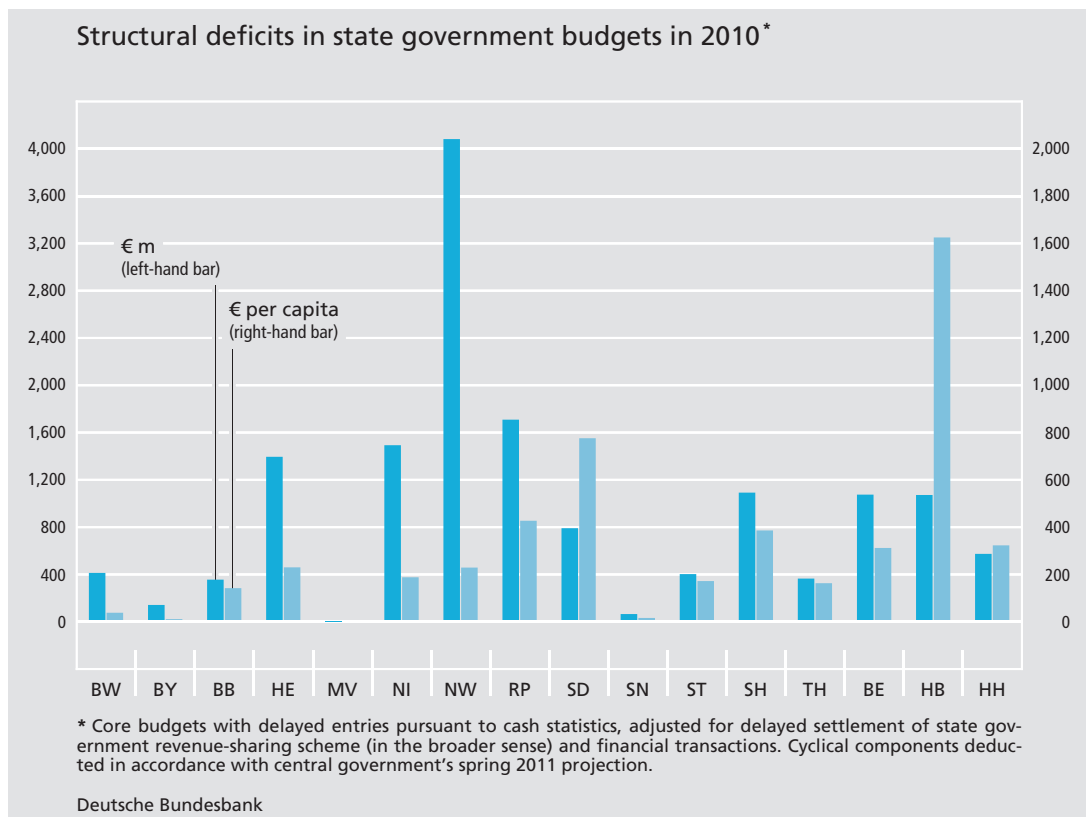
In view of the long transitional period up to 2020, the states have made far less progress than central government in implementing the new constitutional rules (for more details, see box on pages 34 to 37). Nonetheless, some states have already amended their constitutions, or are discussing changes. The reforms adopted to date make full use of the adjustment period. It would, of course, be more in keeping with the debt brake's strict objective if states with

States still hesitant to introduce debt brakes in their constitutions

¹⁹ See also p 25 [footnote 8].

²⁰ For each of the budget years from 2003 to 2006, this would have reached a considerable volume of up to €10 billion in the central government budget. See J Kremer and D Stegarescu, *Neue Schuldenregeln: Sicherheitsabstand für eine stetige Finanzpolitik*, in *Wirtschaftsdienst*, 9/2009, p 632.

²¹ The obligation to factor in a safety margin could be enshrined in law. To maintain government budgets' desired buffer function, target values could be set significantly below the ceiling; if developments are unexpectedly poor, the burdens could be passed through to net lending/borrowing positions and a delayed return towards the stricter target values would be stipulated. For a detailed account see Deutsche Bundesbank, *Reform of German budgetary rules*, Monthly Report, October 2007, pp 47-68 and J Kremer and D Stegarescu, footnote 20, p 633f.



relatively low starting values for their deficits were to stop incurring new structural debt at a much earlier stage (for more information on the starting situation in 2010, see chart on this page). Where numerical borrowing limits for the transitional phase are planned, these too should be specified in keeping with the aim of rigorously curbing deficits.

States receiving consolidation assistance subject to provisions in administrative agreements

In spring 2011, the five states receiving consolidation assistance signed administrative agreements with central government containing rules to mark out the deficit reduction path during the transitional period. These affect, in particular, the definition of the scope of application – which, in line with the European provisions, goes well beyond the core budget – as well as the cyclical adjustment

procedure to be used and the treatment of financial transactions.

Some states with relatively good starting positions have incorporated debt brakes into their state budgetary regulation laws and, in some cases, even implemented them ahead of the reform of Germany's Basic Law. However, these limits, which were given only a non-constitutional status, have sometimes been circumvented or set aside by a *lex posterior*. It would therefore seem helpful to anchor the debt brake in the state constitutions already during the transitional period.

Limited effectiveness of legal provisions suggests constitutional underpinning appropriate

Fixing starting values for the deficit reduction path in a way that is compatible with the reform's objective is key to ensuring that a balanced budget is achieved in 2020. It is vital to

Avoidance of "ski jump" approach important for states, too

Implementing the debt rules in the German states

Whereas the debt brake for central government has been applicable since the budget year 2011, state governments can keep their existing differing state-specific rules – ie investment-related borrowing limits – or enact new rules in line with the adopted debt brake up to the end of 2019. In the event that state law is not adjusted, however, new borrowing will be strictly prohibited without exception from 2020 onwards. Against this backdrop, four German states have already changed their constitutions by incorporating the ban on new borrowing as of 2020 with some exemption clauses reflecting the provisions set out in Germany's Basic Law (*Grundgesetz*).

After proposals for reform had failed to gain the necessary parliamentary majorities in North Rhine-Westphalia and Thuringia among others, Schleswig-Holstein was the first state to act in May 2010.¹ Besides an exception for cyclically induced deficits, an emergency clause was introduced which, to prevent it from being invoked too frequently, requires a two-thirds voting majority in the state parliament. As Schleswig-Holstein is receiving consolidation aid, it additionally resolved to incorporate a deficit reduction path in its constitution according to which the borrowing limit – based on the structural fiscal balance of 2010 – declines annually by one-tenth of the starting value as of 2011. However, the reduction path was initially alleviated, not least by artificially raising the starting value in De-

Debt brakes in state constitutions

State	General rule	Exceptions	Redemption plan for exceptions
Hesse	<ul style="list-style-type: none"> – Article 141: ban on new borrowing as of 2020 – Article 161: deficit reduction as of 2011 (no concrete reduction path specified) 	<ul style="list-style-type: none"> – Cyclical effects taken into account symmetrically – Natural disasters or similar 	To be redeemed within an appropriate time frame
Mecklenburg-West Pomerania	<ul style="list-style-type: none"> – Article 65: ban on new borrowing as of 2020 – Article 79a: deficit reduction as of 2012 (no concrete reduction path specified) 	<ul style="list-style-type: none"> – Cyclical effects taken into account symmetrically – Natural disasters or similar 	To be redeemed within a defined time frame
Rhineland-Palatinate	<ul style="list-style-type: none"> – Article 117: ban on new borrowing as of 2020 – Amending Act, Article 2: deficit reduction as of 2011 with "steady reduction in structural deficit" 	<ul style="list-style-type: none"> – Cyclical effects taken into account symmetrically – Natural disasters or similar – For "adjusting over a maximum of four years to a structural change in the revenue or expenditure situation due to legislation adopted outside the state" 	Cyclically appropriate redemption
Schleswig-Holstein ³	<ul style="list-style-type: none"> – Article 53: ban on new borrowing as of 2020 – Article 59a: deficit reduction as of 2011: ceiling reduced annually by one-tenth, starting value 2010 	<ul style="list-style-type: none"> – Cyclical effects taken into account symmetrically – Natural disasters or similar (two-thirds majority required) 	To be redeemed within an appropriate time frame
Lower Saxony	<ul style="list-style-type: none"> – Article 71 (draft law by coalition, June 2011, being debated): ban on new borrowing as of 2017. – Article 71a: deficit reduction as of 2011. Starting value 2011 borrowing target, linear annual decrease of ceiling 	<ul style="list-style-type: none"> – Cyclical effects taken into account symmetrically – Natural disasters or similar (two-thirds majority required) 	To be redeemed within an appropriate time frame

¹ The state parliament felt that the amendment of the German Basic Law violated its own legislative prerogative. However, an appeal be-

fore the Federal Constitutional Court (2 BvG 1/10) in February 2010 was rejected on the grounds that the plaintiff lacked the right of ac-

ember 2010 through a one-off transfer of free funds in the amount of €60 million – available due to lower-than-planned interest expenditure – in order to promote the expansion of childcare, which inflated the deficit reduction path's starting value by the aforementioned sum to a total of €1.3 billion. Although the statutory implementation provisions still need to be specified, article 53V of the state constitution implies that, besides an adjustment for financial transactions, a control account is also scheduled to be introduced. However, the publicly available information does not spell out how the cyclical component of net borrowing indicated in the budget plan for 2011 and 2012 was determined. Hence it cannot be cross-checked to what extent the constitutional requirement to reduce the structural deficit is actually fulfilled in the budget.²

Rhineland-Palatinate, too, changed its constitution in December 2010. The rule closely follows the provisions in the Basic Law and additionally stipulates a steady reduction in the structural deficit until 2019, although annual reduction targets are not specified. However, besides the exceptions listed in article 109 of the Basic Law, an exemption from the ban on new borrowing, coupled with redemption provisions and limited to a maximum of four years, may be applied in the event that a legislative change not attributable to the state parliament leads to strains on revenue or expenditure. This includes measures introduced by the Bundesrat (Germany's upper house of parliament composed of government representatives of all the states) as Rhineland-Palatinate considers that it has "no direct influence" on such legislation.⁴ It is questionable, however, whether this rule will be compatible with the provisions of the Basic Law as of 2020. Against the backdrop of the provisions aimed at complying with European rules stated in article 109II of the Basic Law, the provision in article 117III of the state constitution logically states that the

debt brake also applies to some entities beyond the core budget. Whether the selected criteria are sufficiently in line with the definitions outlined in the Basic Law remains to be seen when implemented.

In a referendum held in March 2011 on a draft amendment approved by the state parliament, the inhabitants of Hesse voted for the introduction of a debt brake in their state constitution. The principal provisions are closely modelled on those in the Basic Law. In addition, a broad majority of the state parliament has already agreed on a number of key points for the implementation act which is yet to be finalised.⁵ An adjustment of revenue and expenditure figures for financial transactions and a transparent cyclical adjustment procedure – the details of which remain to be specified – as well as a kind of control account in line with the arrangements at central government level are being envisaged. Options for new borrowing by off-budget entities are coupled to a legal exception – yet to be enacted for this purpose – which could be regarded as a starting point for substantially limiting the effectiveness of the debt brake.

At the end of June 2011, Mecklenburg-West Pomerania also adopted a constitutional reform which assumes the provisions of the Basic Law. In this case, too, the corresponding implementation acts are still to be completed. Given Mecklenburg-West Pomerania's good starting position in terms of its fiscal balance, the state government budget essentially only needs adjusting for the running down of the comprehensive special supplementary Federal grants to the east German states, which is to be completed by 2020.

A constitutional amendment is also under consideration in other states such as Lower Saxony. The draft amendment in Lower Saxony foresees 2017 as the starting date for the general ban on new borrowing. A linear reduction path is envisaged for

tion. — 2 For critical comments on the creation of an artificially high starting point ("ski jump") and the lack of transparency regarding cyc-

lical effects, see also: Landesrechnungshof Schleswig-Holstein, *Bemerkungen 2011*, p 41 ff, at www.landesrechnungshof-sh.de. — 3 Re-

Implementing the debt rules in the German states (cont'd)

the transitional period, although the choice of the high 2011 budget target figure as the starting point for net borrowing is likely to reduce the adjustment pressure in the first few years. If first applied in 2012, the new rules would actually create greater scope for borrowing than the old constitutional limit.

Those states currently receiving consolidation aid appear to see no urgent need for further legislative initiatives over and above the administrative agreements concluded in spring 2011 given that those agreements already specify the deficit reduction path (based on prescribed calculation methods), compliance with which is a prerequisite for the disbursement of consolidation aid pursuant to article 143 (d) of the Basic Law.⁶ Besides the cyclical adjustment procedure, the provisions regulate the step-by-step minimum reduction of the initial budget deficit adjusted for financial transactions. Here, too, the starting point values are inflated, particularly through their referencing to the low tax estimate figures of May 2010, which considerably alleviates consolidation pressure at the current end ("ski jump"). This is problematic as experience has shown that commitments regarding future deficit reduction are often ignored. Despite compliance with the provisions stipulated in the administrative agreement, an overshooting of the still unchanged constitutional borrowing limit, which is pegged to the level of new investment, occurred in the case of Bremen in 2011. For an interim period, this was explicitly approved by the state constitutional court in order to overcome an extreme budgetary situation.⁷ In the context of such an interpretation of the constitutional rules, great importance is attributed to strict adherence to the – initially rather unambitious – deficit ceilings throughout the transitional period.

Instead of a constitutional reform, six states (Baden-Württemberg, Bavaria, Hamburg, Saxony, Saxony-

Anhalt and Thuringia) have adopted a general legal ban on new borrowing in their state budgetary regulation laws, some of which have already been implemented. The derogations are often more generous compared with the reformed state constitutions mentioned above, given that they also include revenue shortfalls that exceed a certain threshold (Baden Württemberg, Saxony, Thuringia). Hence, full compliance with the provisions stipulated by the Basic Law as of 2020 appears not to be assured beyond all doubt. Moreover, the ban on new borrowing in the state budgetary regulation law – as opposed to the state constitution – can be suspended by an additional law during the transitional period and thus provides far less protection from soaring state budget indebtedness.

Examples of a ban on new borrowing contained in the state budgetary regulation laws already being evaded in practice can be found in Bavaria and Baden-Württemberg. A supplementary budget adopted by Bavaria in 2008 contained a borrowing authorisation of €10 billion to recapitalise Bayern Landesbank, which was stricken by the financial crisis. However, instead of invoking the state budgetary regulation law's clause on exceptional circumstances to justify this action, the state lawmakers merely cited extraordinary need in line with article 82 of the state constitution, thereby overriding the legal rules. Although the government of Baden-Württemberg that was newly elected in spring 2011 promised to achieve considerable consolidation progress during the current legislative period and to illustrate the actual magnitude of the state's indebtedness by a comparison with asset accounts in future, it appears to have no plans at the moment to enshrine the debt brake in the state constitution. Moreover, the fourth supplementary budget of 2011 indicates virtually no consolidation efforts: the budget volume is on the rise and, despite the existing ban on new borrowing, the budget continues to be balanced through loans, although the

ipient of consolidation aid. — 4 See the memorandum of the draft act: Landtag Rheinland-Pfalz, printed matter 15/4966, p 7. — 5 See

Hessischer Landtag, printed matter 18/3492. — 6 Meanwhile, the upper limits agreed for structural net borrowing have been included

Debt brakes in state budgetary regulation laws

State	General rule (date of announcement)	Exceptions	Redemption plan
Baden-Württemberg	Section 18 (12 February 2007): ban on new borrowing as of 2008	<ul style="list-style-type: none"> – Up to debt level of end-2007: to safeguard macroeconomic equilibrium – Year-on-year decrease in state's tax revenue of at least 1% – Natural disasters or similar 	General redemption deadline: seven years
Bavaria	Section 18 (22 December 2000): ban on new borrowing as of 2006	<ul style="list-style-type: none"> – To safeguard macroeconomic equilibrium 	Not stipulated
Bremen ³	Section 18a (17 May 2011): consolidation requirements from 2011 to 2019, ceilings from administrative agreement		
Hamburg	Section 18 (12 June 2007): ban on new borrowing as of 2013	<ul style="list-style-type: none"> – To safeguard macroeconomic equilibrium 	Yes, but no deadline
Saxony	Section 18 (12 December 2008): ban on new borrowing as of 2009	<ul style="list-style-type: none"> – Up to debt level of end-2008: to safeguard macroeconomic equilibrium – Decrease in tax revenue of more than 3% – Natural disasters or similar 	General redemption deadline: five years
Saxony-Anhalt ³	Section 18 (17 December 2010): ban on new borrowing as of 2012	<ul style="list-style-type: none"> – Cyclical revenue shortfalls – Natural disasters or similar 	Start four years after borrowing at latest
Thuringia	Section 18 (8 July 2009): ban on new borrowing as of 2011	<ul style="list-style-type: none"> – Tax revenue below average of three years prior to drawing up of budget – Natural disasters or similar 	Five years after first balanced budget year

prerequisites for an exception prescribed by the state budgetary regulation law manifestly no longer apply.⁸ Prior to this, however, the borrowing cap rule – which was established without excluding financial transactions – had already been circumvented by setting up special-purpose entities outside the budget as vehicles for borrowing. Baden-Württemberg used this loophole for the first time in 2009 when Landesbank Baden-Württemberg was supported by a capital increase which, in the amount of €2 billion, was debt-financed by an entity backed by a state guarantee and assignable to the government sector according to the Maastricht Treaty definition. In addition to this, Baden-Württemberg granted guarantees in connection with the establishment of a risk shield totalling €12½ billion which impacted on the Maastricht debt level. At the end of 2010, Baden-Württemberg

also decided to purchase a sizeable shareholding in the regional energy utility through a state enterprise for which guarantees of up to €6 billion were made available. This, too, may be expected to have a major impact on the government debt level as defined in the Maastricht Treaty. In general it must be said that debt arising from financial transactions to acquire shares in financially sound enterprises could legitimately have been deducted from the borrowing limit under the terms of the debt brake incorporated into the Basic Law. Yet quite apart from the concrete classification applicable to the transactions mentioned above, the state budgetary regulation law does not provide for this. It also remains to be seen to what extent the state will actually comply with the statutory requirement to pay down debt incurred by invoking the exemption clause in the case of tax revenue shortfalls.

in Bremen's state budgetary regulation law. — 7 See Deutsche Bundesbank, Public finances, Monthly Report, August 2011, p 75. — 8 Neither

a natural disaster or similar contingency nor a year-on-year decline in tax revenue by at least 1% is apparent.

avoid creating a “ski jump effect” by applying an overly high starting value, thus deferring consolidation to the future – as has often happened in the past. The states should likewise use the current favourable conditions to achieve the aim of a structurally balanced budget as soon as possible instead of delaying consolidation until the last few years before the transitional period expires. Given the strict constitutional provisions, it would be highly advisable for the states, too, to factor in ample safety margins.

Outlook and conclusions

Debt brake can eliminate the key weaknesses in the old constitutional rules ...

The new debt brake for central and state government should eliminate the most important weaknesses in the former borrowing limit. The investment-related rule, which was susceptible to limitations in its effectiveness, has been replaced by the obligation to at least achieve a structurally close-to-balance or fully balanced budget. Unlike before, the provisions are also targeted unequivocally at the phase of budget implementation. In addition, there are now far fewer possibilities for exploiting exemptions which were used to circumvent the old rules; the obligation to adopt a repayment schedule for the debts exempted from the rule is particularly important in this respect. Finally, the possibility of circumventing the borrowing limit via central government special funds has also been eliminated.

... and reverse the worrying trend in the debt ratio

The rules are essentially a very suitable instrument for halting and reversing the previous strong and almost continuous rise in the gen-

eral government debt ratio. Central and state government deficits have developed very favourably this year, particularly as a result of the unexpectedly positive macroeconomic setting. However, we should be under no illusions: relatively large-scale consolidation is still needed, the debt ratio is very high and, in particular, demographic developments are set to create budgetary burdens in the future. The new borrowing rule, too, is likely to have had a positive impact on current fiscal developments. Nonetheless, adherence to such rules under unexpectedly favourable circumstances is hardly the acid test. Indeed, it is important to use good times as an opportunity for rapid consolidation and to ensure that the rules are consistently obeyed even under difficult circumstances.

Some recent experiences sound a note of caution and suggest that regular political practice may tend towards less-than-stringent interpretations of the rule. In particular, the fact that the starting value for the central government structural borrowing limit set for the transitional phase from 2011 to 2015 is overly high is evidence of a rather unambitious approach. To effectively ensure that the regulatory intent is put into effect, it is also important to properly define the financial transactions that are factored out of the debt brake. While clear improvements have recently been made in this area, the classification of the payment to offset the Federal Employment Agency's deficit, for example, should be reappraised. It is also crucial to use a transparent cyclical adjustment procedure and avoid a gradual rise in debt that is classified as cyclically induced. Documenting the

Initial experiences not yet entirely satisfactory; some questions remain

cumulated cyclical burdens could help in exposing undesirable developments and, where appropriate, taking corrective measures. Borrowing outside of the core budgets and the debt brake – via both off-budget entities and PPPs that are ascribed to the government sector – should likewise be avoided.

Danger of states delaying adjustment

Some states have already enshrined a debt brake in their constitutions, or at least in their budgetary regulation laws. However, it remains to be seen, not least given the lack of regulations governing implementation, how the debt brake stipulated in the Basic Laws is ultimately put into practice. In addition, some states appear to be delaying adjustment. This puts the achievement of a balanced budget in 2020 at risk if, as so often in the past, the resulting greater annual need for consolidation towards the end of the adjustment period is deemed impossible because, for example, it coincides with an unfavourable macroeconomic setting. The manner in which the budgetary problems of states with especially high budget deficits have been addressed to date has certainly been less than encouraging. The creation of the Stability Council, which is tasked with preventing budgetary emergencies, is therefore essentially a welcome development and may make a key contribution towards safeguarding sound public finances. However, there is a danger that the

ratios and reference values it uses will not flag up looming budgetary emergencies at an early stage. In addition, there are only limited possibilities for imposing sanctions on states whose deficit reduction is found to be insufficient. More detailed, directly comparable information could be provided in order to ensure transparency regarding the budgetary situation and budget plans for the individual governments. This could perceptibly enhance the monitoring and safeguarding of budgetary discipline agreed under the debt brake.

Not least given the importance of the German debt brake as a benchmark within the euro area, it is crucial that it is implemented rigorously and in a manner that is true to its intention. A certain fiscal policy reserve buffer deemed necessary for dealing with unexpected developments can be created by factoring in safety margins below the constitutional borrowing limit. It would be advisable to apply this precaution to the transitional period, too. The reduced interest burden resulting from rigorous consolidation will give fiscal policymakers greater room to manoeuvre in the future. The current sovereign debt crisis alone highlights the fundamental importance of sound public finances and credible fiscal rules, not least for robust macroeconomic developments.

Crucial importance of sound public finances requires rigorous implementation in line with rule's intent