European Stability and Growth Pact: individual reform options

Sound public finances are of crucial importance for a stability-oriented monetary union. This should therefore be what the European budget rules aim to achieve. The rules have been amended on numerous occasions, and changes are currently once again under discussion.

Any reform should uphold the fundamental objectives of the budget rules. If the medium-term objectives (or MTOs) are achieved rapidly and maintained, the debt ratios will drop quickly from a high level. In order to render the quantitative targets more binding again, however, the rules have to be designed more transparently and implemented predictably. Therefore, large numbers of exceptions and scope for discretion should be dispensed with. Strict fiscal surveillance is also important. To this end, it would make sense to transfer the European Commission's tasks to an independent, less political institution with its focus on monitoring compliance with the rules.

Various other adjustments are currently also being discussed. These include a stronger focus on expenditure ceilings. This could streamline the rules in various places. However, expenditure rules are also difficult in practice, and they open up new loopholes. This would have to be taken into account when designing the rules. In any event, expenditure ceilings should take the existing structural fiscal objectives as their frame of reference. In addition, they should be specified only for the next financial year, and not for a number of years.

A frequent complaint is that strict quantitative requirements are too narrow. In order to have a buffer even where limits are strict, national rainy day funds could be created and utilised. It should be possible to fund them in advance to the amount by which the MTO is overachieved. This would help prevent undesirable additional borrowing. It would be advisable to use such buffers only in a rule-based manner to cover unexpected burdens. Proposals for a relatively complicated rainy day fund at the European level do not make a convincing case, however. It is difficult to reconcile its joint financing with continued national responsibility for fiscal policy. Key objectives being pursued with European funds could also be achieved through national funds.

Frequent calls are made, moreover, for a "golden rule" to protect public investment. The problems associated with such an approach became evident, for instance, with the previous German budget rule, which was replaced with good reason. If a golden rule were nevertheless considered for the European rules, the associated risks, at least, should be minimised. Thus, investment should not justify unlimited additional deficits. No compromises should be made regarding the objective of rapidly declining high debt ratios, meaning that the MTO should be relaxed, if at all, only if the debt ratio is significantly below 60%. Also, the definition of investment should be narrow and harmonised. Moreover, only the build-up of additional assets should be encompassed, while capital depletion (negative net investment) would call for more ambitious fiscal positions.

Credible and binding fiscal rules help to limit the risks to stability and build confidence. However, their success will ultimately be determined by the Member States, which are responsible for fiscal policy. It is therefore vital that they raise their own funding on the capital market and are compelled to present a convincing fiscal policy stance there.

Debate on the Stability and Growth Pact

Sound public finances safeguard monetary policy

Sound public finances are important for the stability of the monetary union. They ensure that the Member States are capable of fiscal policy action and safeguard a stability-oriented monetary policy. Monetary policy could come under pressure to assist fiscal policy if confidence in sound public finances is lost.

Member States responsible for their fiscal policy

Within the monetary union, Member States decide their own fiscal policy. The currently very low interest rates make it easier for them to shoulder their debt.[1] However, high debt levels remain a risk to the stability of the monetary union.[2] It would be risky to view the currently very low interest rates as permanent and therefore to pursue a strategy of high government debt levels. Rising interest rates might then quickly erode confidence in the soundness of public finances, with adverse effects on the Member State and the monetary union.

Individually liable financing important

Jointly agreed fiscal rules should set binding limits and create confidence in the sustainability of public finances. However, the fiscal rules can fulfil their purpose only if countries adhere to them. The European level cannot determine Member States' fiscal policy in order to enforce compliance with the rules. It is therefore vital that Member States raise their own funding on the capital market and are compelled to present a convincing fiscal policy stance there. Potential risk premia are a strong incentive for fiscal discipline.

Reform discussion should be guided by existing quantitative budget ceilings

Over time, the fiscal rules have been repeatedly modified, and reforms are currently being debated again. The aim should be to design the rules such that high debt ratios are brought down swiftly and a sound underlying position is achieved. And, indeed, the existing agreements do reflect this intention: the key objective is for the general government budget to be at least (close to) balanced in structural terms – in other words, after adjustment for cyclical and one-off effects. This is known as the medium-term objective or MTO. Where debt ratios are higher, the MTO should not exceed -0.5% of gross domestic product (GDP). If this MTO is met, debt ratios will usually also decline rapidly. Only if the debt ratio is significantly below 60% may a less ambitious MTO be set. If Member States fail to meet their MTO, the rule is that they should generally lower their structural deficit ratio by 0.5 percentage point per year. By doing so, they would in most cases deviate from their budgetary objective for no more than a limited transitional period.[3]

Fiscal rules are currently poorly designed and implemented

At present, however, the common rules often allow deviations from these basic quantitative requirements. The aim should be to strengthen the rules again. Although a certain degree of flexibility in the budget rules is appropriate and some measure of complexity is therefore unavoidable, the rules and their implementation still have to be transparent and predictable. This is becoming less and less the case with the European rules. Their application is the result of a process of political negotiation, and instead of binding quantitative rules, there are moving targets. Wide areas of scope for discretion mean that it is possible to excuse even persistent gross failure to achieve the targets. It is, for instance, evidently possible to delay the reduction of even very high debt ratios again and again, while still remaining within the rules. In the meantime, neither the general public, nor politicians, nor academics can determine where the boundaries of a rule-consistent budgetary policy lie. Changes are necessary to reinforce the rules.[4]

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1 See Deutsche Bundesbank (2017a); Blanchard (2019).
2 See ECB (2016), p. 59; Fuest and Gros (2019a).
3 In addition to the MTO, there is the reference value of 3% of GDP for the (unadjusted) deficit and a figure of 60% for the debt ratio. These define the limit for what is known as the corrective arm of the Stability and Growth Pact (SGP), which will not be discussed in greater detail here. For information on the rules, see European Commission (2017a, 2019); Regulation (EU) 1175/2011; Council Regulation (EU) 1177/2011; Regulation (EU) 473/2013; OJ 2010 C83/99; OJ 2010 C83/279; Treaty (2012).
4 For more information on the tasks and a criticism of the European fiscal rules, see also Deutsche Bundesbank (2017b).

Discussion on more budgetary leeway

Yet strict rules are also criticised for being too restrictive. The argument is that they allow too little room for macroeconomic stabilisation and government investment. However, the rules do allow some leeway in this context. For instance, the rules are designed to ensure that automatic stabilisers can operate. In addition, exceptions are made for severe downturns. Leeway is also available where safety margins vis-à-vis the normal limits were established. Nor do the rules prevent the provision of an efficient public infrastructure. Shortcomings there are, in fact, more often the result of political priorities being set differently.

Taking on board criticisms without compromising the objective of sound finances

The underlying quantitative objectives of the European budget rules are reasonable and appropriate. They safeguard sound government finances and allow sufficient room for manoeuvre. In that respect, they do not require an overhaul. Nonetheless, adjustments in individual areas could be examined without compromising the objective of sound public finances. The following areas will be looked at more closely: transferring fiscal surveillance to an independent institution, making the rules more transparent and more binding, introducing an expenditure rule, using control accounts and rainy day funds and, finally, the question of the extent to which a special role could be given to government investment.

Selected reform areas

Transferring fiscal surveillance to an independent institution

Independent fiscal surveillance advisable

Limits are only effective if compliance is monitored and any breaches are reported and penalised. Independent bodies are better suited to monitoring than institutions which are themselves part of the political process. Policy decisions consistently give rise to strong incentives for excessive borrowing. The fiscal rules form a counterweight to such incentives, meaning that fiscal surveillance by bodies with close connections to the political sphere is disadvantageous.[5] Consequently, the Member States agreed, with the Fiscal Compact, to establish independent national fiscal councils for the national level.

Rules at the European level must also …

At the European level, by contrast, the European Commission is the key player in fiscal surveillance. However, the Commission sees itself as a political institution and has other tasks besides fiscal surveillance. It therefore weighs different policy objectives in the negotiation process with the Member States. The very high degree of flexibility and the wide scope for discretion, in particular, mean that there is a risk of the objectives of the fiscal rules receding into the background.

… be monitored in a focused and independent way

To offset this, it would make sense to transfer fiscal surveillance to an independent institution. The competent authority should have a clear and narrow mandate and should not, in particular, pursue conflicting objectives. It should monitor public finances and assess fiscal plans. Its tasks would be to flag up actual and imminent breaches of the rules, identify consolidation needs and recommend procedural steps and sanctions. Its leeway for discretion should be strictly limited. On the basis of this preparation, the Council would, as is currently the case, take the decisions (e.g. determining the existence of an excessive deficit). However, the preparatory work and submissions would be less political. One could, for example, consider transferring the task of surveillance to the European Stability Mechanism and enhancing its independence in this area.[6] By contrast, the recently established European Fiscal Board focuses on the fiscal stance of the euro area and has very close ties to the European Commission.[7]

5 See, for example, Beetsma and Debrun (2016); Feld (2018).
6 See Deutsche Bundesbank (2019).
7 See OJ 2015 L 282/37.

Making the rules more transparent and more binding

Effective fiscal surveillance through clear and binding rules

Fiscal rules should set concrete and transparent standards. This is the only way to ensure that fiscal developments are assessed and treated in a comparable manner over time and between Member States. The European rules do not meet these requirements.[8] Therefore, clear restrictions should be placed on possible ways of deviating from the basic quantitative objectives. This relates to exemptions to the rules, as these are often neither clearly defined nor coherently justified. It is also problematic that assessments are, in many instances, not rule-based and breaches are excused. The European Commission has very wide discretion and may give its approval even if quantitative requirements for all indicators are breached. The exceptions should be delimited strictly and clearly, and the relevant audit processes and components should be defined in advance.

Any expenditure rules should be valid for one year at most and be tied to structural objectives

Expenditure rules are under discussion

A frequent proposal is that expenditure ceilings should feature more prominently in the rules.[9] This could, in fact, simplify the rules in some cases. However, expenditure rules are not easy in practice, and they also open up new loopholes. This would have to be taken into consideration when designing the rules. It is key that the expenditure ceilings should be based on the underlying requirement in terms of the structural balance and should not undermine it. This is another reason why it is not advisable to determine expenditure targets for multiple years.

Objectives should continue to be defined as structural balances, …

Under the European rules, the MTO is defined as a structural balance. In addition, the amount by which the structural balance must be improved is specified if a country is on the adjustment path towards the MTO or must correct an excessive deficit. Structural balances (like all target variables for budget rules) have specific inherent problems. They are nonetheless sensible anchor points for budget rules and should therefore be retained. Structural goals, for instance, allow the automatic stabilisers to "breathe". At the same time, the fiscal stance can be identified from the structural balances.

… but they are subject to revisions …

However, it is not always possible to unerringly achieve concrete structural balances. They may reflect unexpected developments, for instance. This applies, in particular, to revenues, or it might relate to a revised estimate of aggregate economic output, on which cyclical adjustment is based. If no safety margins were incorporated, such forecast errors could cause structural balance objectives to be missed, even though the budget plans have otherwise been implemented as planned. Where structural balance targets are to be met despite unexpected developments, implementation of the budget would have to be adjusted on an ad hoc basis. This could trigger a rather erratic fiscal path. In order to avoid this and take due account of such unintentional failures to achieve targets, complex corrections and special assessments are carried out at present. As a result, even experts can often find it nearly impossible to identify why a requirement is considered as having been met or missed.

… and should therefore be put into operation using an expenditure rule

An expenditure rule could simplify this assessment process. For instance, corresponding maximum expenditure growth could be calculated for the structural balance to be achieved in the coming financial year.[10] This ceiling

8 A detailed and concrete description of the current rules' high degree of complexity and of starting points for simplification may be found in Deutsche Bundesbank (2017b).
9 Proposals for an expenditure rule may be found, for example, in European Commission (2017b); European Fiscal Board (2018), pp. 70-88; Bénassy-Quéré et al. (2018), pp. 10-12; Christofzik et al. (2018), pp. 13-21; Andrle et al. (2015), pp. 11-18; Darvas et al. (2018); Fuest and Gros (2019b).
10 A lot of proposals meanwhile envisage an expenditure rule that is not tied to a structural budgetary objective for the balance. The evaluation of such proposals will depend largely on what the setting of the expenditure ceiling is targeted at. In this, how quickly high debt ratios come down should be of particular importance. In many proposals, however, this remains indeterminate.

would then be the benchmark for assessing compliance with the rules in the year in question. Deviations in other categories or revisions of the cyclical adjustment would not be relevant but would be excused.

Expenditure rule not trivial

Nevertheless, an expenditure rule is not as simple as it seems at first sight. It is, for instance, likely to be difficult to implement and monitor such a rule in the individual government entities of a strongly decentralised or federal Member State. Moreover, the expenditure ceiling would have to be adjusted immediately if there were any measures on the revenue side: it would, for example, have to be reduced if taxes were subsequently lowered or subsectors of government with revenues and expenditure were to be spun off.[11] By contrast, subsequent tax increases could be used to fund additional expenditure.

Expenditure rule requires prudent forecasting

For the expenditure rule to be effective, it is essential that its limits be based on realistic forecasts. This is particularly true of profit-related taxes, which are especially hard to estimate, changes in tax legislation, and tax enforcement. If revenue forecasts were too high, the permissible expenditure growth would be set too high. The objectives for the structural balance would then be exceeded. In order to address false incentives, independent surveillance authorities should validate all forecasts and plans.

Expenditure ceiling should be laid down only for the coming year

Moreover, it would be important for the maximum expenditure growth to be determined annually, i.e. only for the coming financial year. For the following financial year, it would then have to be newly derived from the current, rule-compliant structural balance or from the required improvement in the structural balance. By contrast, there are also some proposals to set expenditure targets spanning a number of years, such as for one legislative period. This would be problematic, as it would potentially allow deficits to rise over this period without any countermeasures being taken. Economic activity being significantly weaker, in structural terms, than forecast might cause considerable problems over a period of several years, because the response to the new development would be much too late.[12]

Control accounts an important addition

Control account for missed targets …

Budget objectives may be missed for a variety of reasons. Revenue forecasts may have been too high or too low, for example, or spending may have been higher or lower than the authorised levels. This becomes critical when, as a result, debt increases over time more rapidly than the upper limits were designed to permit. It would therefore make sense to establish a control account for failures to achieve targets. This would record the amounts by which budget objectives have been exceeded or undershot.[13] At the same time, a threshold for negative deviations from the target should be established to indicate when the cumulative rise in debt needs to be corrected. If the amounts recorded more or less cancel each other out over time, there would be no need for action. However, if the threshold were to be exceeded, the accumulated shortfall would have to be offset, in a rules-based manner, in the next few years.[14] To this end, the requirements for the annual budget objective would

11 This would also be the case, for instance, if usage fees were to be reduced (or collected less consistently) or if there were a cut in specific transfers linked to expenditure, say from the EU.
12 However, it is sensible to continue to embed the annual budget in a medium-term plan, since corrective action is taken on an annual basis.
13 In principle, the amounts of both positive and negative deviations from the MTO could be recorded in the control account. Alternatively, before the MTO is reached, only deviations from the adjustment path could be recorded.
14 The main objective of the control account would be to prevent an unintentional build-up of debt. In principle, however, if entries are positive on balance and above a threshold, budgetary objectives could be made less ambitious for a while. That said, if this is at all possible, it should be on the basis of positive entries due to the MTO having previously been overachieved. By contrast, positive deviations from the adjustment path alone – i.e. if the MTO has not yet been met – should not be used to justify higher levels of new borrowing. Generally speaking, surplus funds from overachieving the MTO could also be used as a rainy day fund. This will be discussed in the following section.

have to be more ambitious for a certain period of time.[15]

… and cyclical components

There may be other reasons, too, for levels of debt being higher over time than is intended under the rules. This is especially true if the cyclical adjustment method is not symmetrical and shows negative output gaps on balance. This cannot be ruled out for the method which the European Commission applies to the European rules. As a control measure, the identified cyclical components could also be added up over time and any accumulated debt could be repaid.

Incorporating national rainy day funds into fiscal rules

Increase room for manoeuvre …

The quantitative requirements of the European fiscal rules are sometimes criticised for being too narrow. Critics argue, for instance, that Member States should avoid having to carry out procyclical consolidation in the event of an unexpected structural downturn. There are also calls for greater scope to be given to an active stabilisation policy, for example.

… without jeopardising debt reduction: creation of rainy day funds where MTO is exceeded

So as not to undermine the necessarily strict limits by making numerous exceptions, on the one hand, and to allow flexibility on the other, national rainy day funds could be utilised within the framework of the rules. The basic idea behind this type of fund is to build up a financial buffer in good times in order to prepare for "rainy days" ahead.[16] This concept could be added to the Stability and Growth Pact (SGP) without permitting additional debt. In other words, the targeted debt path under the MTO should, as a minimum, still be adhered to. Therefore, it should be possible to credit the fund only in the amount by which the MTO is overachieved.[17] This reserve could then allow room for manoeuvre. The limit of the regular MTO could be exceeded at a later date by drawing on these funds.[18] As a result, the regular MTO would not be met in every single year but on average from the time the rainy day fund is established.[19]

Rule-based utilisation of funds advisable

Such funds could, in principle, be used for different purposes. However, it would be highly advisable to stipulate provisions for the rule-based use of such funds in national legislation.[20] Otherwise, funds could create new problems. For instance, they might be used to generate "political business cycles". Moreover, large reserves might tempt policymakers to decide on permanent additional spending or tax cuts that are financed (only) temporarily from the fund. Structural difficulties would initially be masked and any need for consolidation would be shifted to future governments. In order to avoid this, it would be advisable to set out specific requirements for the use of the reserve in the medium-term fiscal plans. Therefore, the budget should be financed soundly and in full after the reserves have been used up. This would be ensured if the reserves were used to finance one-off expenses. This would also be the case if use of the buffers were tapered and had to be linked over time to specific matching fiscal consolidation measures. Provisions could also specify that the funds would, in general, be exclusively reserved for cushioning unexpected budgetary burdens. The aim of this would be to spread out any un-

15 As in Christofzik et al. (2018), pp. 18-19. For details on the debt brake, see Deutsche Bundesbank (2011, 2012); Federal Ministry of Finance (2015).
16 Almost all the US federal states have rainy day funds. See NASBO (2018).
17 The buffers in the rainy day fund do not necessarily involve a build-up of assets. It is more of a notional account that adds up the amount by which the MTO has been overachieved.
18 The control accounts described above could be introduced in parallel. At all events, only financial resources arising from overachieving the MTO should be added to the rainy day fund.
19 Government funds or reserves are unable to fulfil a similar purpose at present, since the MTO is fixed and the rules are linked to the public sector's national accounts balance. This balance is not altered by additions to or withdrawals from a government fund. Internal transactions such as these have a neutral effect on the balance. This means that higher expenditure or tax cuts have a detrimental effect on the balance even if they are financed from a government fund. Unlike in the EU rules, Germany's debt brake for central government is based on net borrowing (not on the fiscal balance). Therefore, with a view to net borrowing, the refugee reserve allows central government to apply a similar principle to that of a rainy day fund. It does not change the deficit as per the national accounts, however.
20 For detailed information, see Deutsche Bundesbank (2018), p. 32.

expected need for fiscal adjustment further using resources from the funds. Although the current rules already make allowances should the structural budgetary position take an unexpected turn for the worse during the fiscal year in progress, the structural deterioration would need to be addressed over the next few years. Drawing on the funds would then allow the adjustments to be spread over a longer period of time.

Rainy day funds: national rather than European

Calls are sometimes made for the introduction of a European rainy day fund, which would be jointly financed. Its proponents often stress that additional borrowing opportunities and transfers between Member States are to be ruled out.[21] However, the stated objectives of such a European fund could be achieved more effectively using national rainy day funds. For example, these do not require complicated "claw-back" mechanisms to avoid permanent transfers between Member States. In the current regulatory framework of the monetary union, national solutions generally appear more appropriate given that the Member States are responsible for their own fiscal policy.

Special protection for investment in budget rules?

Golden rule under debate

Debt-financed investment

In the debate about the budget rules, there are often also calls for borrowing to be allowed to finance government investment expenditure (known as the "golden rule").[22] The European fiscal rules make no provision for this.

Arguments in favour of a golden rule

On the one hand, supporters of a golden rule put forward the following arguments.

– Investment creates public assets. If additional assets are financed through borrowing, the debt level rises but the volume of net government assets remains unchanged. Seen in that light, the sustainability of public finances is not impaired, either.[23]

– Capital stock formed through government investment is a major prerequisite for macroeconomic growth. Investment funds itself insofar as future government revenue is higher.

– A golden rule would enable the investment costs to be distributed more appropriately between generations. It would improve the balance between the costs and benefits of the additional capital stock – financing it solely from current revenue would place the burden on today's taxpayers. Debt financing would allow the burden to be spread over a longer period corresponding to the assets' useful life.

– If borrowing is not permitted, there is a risk that investment and the government capital stock will be too low. For instance, investment tends to be supported by stakeholders who are less assertive than those calling for different expenditure or tax cuts. Politically speaking, investment is therefore fairly dispensable. If no final contractual agreement is in place, it is also relatively easy to curtail investment in practice (e.g. by postponing it). Should the need for consolidation arise, it is often the first thing to be reversed.

Arguments against a golden rule

Others, meanwhile, point out the problems associated with a golden rule.

– Replacement investment is likely to make up the vast majority of government investment

21 See Lenarčič and Korhonen (2018); Arnold et al. (2018).
22 See, for example, Blanchard and Giavazzi (2004); Truger (2015); Melyn et al. (2016); Hüther (2019). For the pros and cons of taking investment into account, see Deutsche Bundesbank (1999, 2005); Expert Commission (2016); European Commission (2016); International Monetary Fund (2018a, 2018b).
23 The European budgetary rules are based on the national accounts balance. Investment in financial assets does not affect the balance. It is considered to be purely a shifting of financial assets, and debt financing is therefore permitted. Such financial transactions include, say, loans issued or privatisation proceeds. However, there exists a limit for financial transactions through the provisions for the debt ratio (60%): if financial assets are acquired through additional borrowing, gross debt goes up. This is the main factor for the Maastricht debt level.

in advanced economies; this means that there is no increase, on balance, in the capital stock. Loan financing would be justifiable, if at all, only if the capital stock were to rise, however. This would mean having to take write-downs and other disposals into account.

- Problems can occur even if high levels of borrowing are balanced by a statistically high government capital stock. If there are doubts as to the sustainability of government debt, it is often very difficult to mobilise parts of the government capital stock in order to service the debt.[24]

- Whether or not government investment encourages growth depends on the specific investment projects. For example, net investment in what is already a very good infrastructure is likely to boost growth to only a very limited extent. Under these conditions, if there is any need for consolidation, it may well make sense to cut investment expenditure first. Ultimately, investment clauses in the budget rules are just as unsuitable as generalised targets for government investment ratios as a means of ensuring appropriate and efficient government investment.

- Credit financing as an easy option for policymakers could increase the risk of overinvestment and bad investments. Private investment might be crowded out, especially if aggregate capacity utilisation is high. There is also a danger that not enough effort would be made to check whether it would be better to obtain the corresponding service from private investors.

- Without further analysis, it is not possible to tell whether the costs and benefits of public investment are shared fairly between the generations. Preferences for individual investments can change, too, while the debt incurred in order to finance them has to be serviced under any circumstances. In addition, all other things being equal, a reduction or stagnation of the capital stock would seem reasonable given a decreasing population. A comprehensive review would ultimately be needed to evaluate the intergenerational distribution. For example, the pay-as-you-go statutory pension insurance scheme also has significant distributional effects in the context of demographic change. The golden rule does not take aspects such as these into account.

- There is a danger that, as a result of the golden rule, expenditure will be booked as investment where this was previously not the case. More generally, scope for bending and manipulating the rules would increase. The rules would also become more complex.

No golden rules at present

German debt brake a success thus far …

In Germany, central and state governments were subject to investment-related budgetary rules for many years. However, these proved ineffective[25] and were replaced by the debt brake.[26] Thus far, the debt brake has been successful in terms of reversing the decades-long trend of rising debt ratios. Although government budgets have benefited from very favourable underlying conditions, the new, strict budget limits are likely to have played a key role in ensuring that relief from sources such as

24 This applies, not least, to government investment in intellectual property.

25 In Germany, rule-consistent borrowing was limited to the level of investment expenditure. Investment grants received had to be deducted. This upper limit could be exceeded only in order to avert a disruption to overall economic equilibrium. Among the points of criticism here were that investment was defined very broadly, no account was taken of write-downs and asset sales, the requirement had to be met only at the planning stage but not when implementing the budget, burdens in special funds were not taken into account, and the exception was not defined in detail. On balance, these rules did not halt the depletion of government assets. The general government debt ratio rose to well over 60% without being accompanied by a matching increase in assets. See Deutsche Bundesbank (2005).

26 The debt brake under German Basic Law *(Grundgesetz)* will not apply fully to the state governments until 2020. Local governments can continue to finance investment through borrowing, but will have to furnish proof of their financial capacity.

interest expenditure or positive labour market developments was also used to reduce deficits.

… and not the cause of inadequate infrastructure

At the same time, Germany's infrastructure is still rated as above average in comparative international surveys.[27] Although it has shortcomings in various places, this can hardly be blamed on the new debt brake. Not least, there has been plenty of budgetary leeway even within these limits for some time now. Although other priorities have largely been set for using such scope, such as appreciably higher social benefits, investment budgets have nonetheless been topped up as well. The fact that infrastructural weaknesses are being remedied fairly slowly is probably also due to planning and capacity constraints, complex legal requirements, and lengthy approval procedures.

Complying with the debt brake and ensuring good infrastructure

All in all, introducing the debt brake was an important step for Germany. It again places sound public finances on a more reliable footing. The debt ratio will probably not reach the limit of 60% this year. However, the significant increase in demographic strains on the horizon means there are still major fiscal challenges ahead. This is one of the reasons why it is still advisable to apply the rules and, at the same time, ensure a very good public infrastructure within this framework.

Keeping an eye on the downsides of a golden rule in the European reform debate

The problems associated with a golden rule have meant that the European fiscal rules have largely shied away from introducing it, too. When the monetary union was established, placing a limit on government debt was seen as a priority. As part of the reform debate there are now occasional calls for investment to be considered more specifically in the form of a golden rule.

Requirements to limit risks of a potential golden rule and examples of design options

Important guidelines for potential special rules for investment

There are substantial concerns about a golden rule. If, however, the outcome of the current European debate is that the potential benefits outweigh such concerns, the important thing would be to narrow down the risks to a minimum. This would mean bearing in mind four principles.

Rapid reduction of high debt ratios

First, it should be ensured that high debt ratios do not decline more slowly if the rules are complied with. In other words, the budgetary objective should not be less ambitious than the current MTO. An upper limit should therefore also be agreed for the additional deficits and debt resulting from investment (a "capped" golden rule). This cap would also limit the risks arising from undesirable interpretations and over-investment.[28]

Only investment according to the national accounts to be included

Second, the investment to be recognised would have to be clearly and narrowly defined. One possibility would be government investment according to the national accounts. The national accounts provide an internationally harmonised definition of investment based on the build-up of a government capital stock. This could at least limit the scope for defining the concept of investment.

Additional debt only for positive net investment

Third, countries should be able to run up additional debt only to the same extent that they accumulate additional assets. When calculating the deficit limit, the write-downs according to the national accounts would have to be deducted from gross investment – in other words, only net investment would be separated out.

Taking a symmetrical approach in the event of negative net investment

Fourth, a symmetrical approach should be taken. If higher deficits were allowed in the case of positive net investment, then in the case of negative net investment – i.e. the consumption of government capital stocks – more ambitious budgetary objectives would have to be set.

In order to fulfil these requirements, a potential golden rule could be based on the existing

27 See Jaramillo et al. (2018); World Economic Forum (2018).
28 One of the things to be examined is whether only self-financed net investment is counted towards this limit. This would prevent, say, investment projects co-financed by the EU permitting a higher level of national debt.

Taking current MTO as starting point and continuing …

limits for the MTO. The existing rules allow a structural deficit of up to 0.5% of GDP provided that the debt ratio is not "significantly below 60%".[29] What counts as "significant" has not yet been quantified. Nonetheless, a debt ratio of below 50% could, as a rule, be considered to be an appropriate, quite sound basis for moderately easing the MTO.

… to ensure budgetary objective is …

Therefore, for debt ratios above 50% (i.e. not significantly below 60%), the structural deficit could be as high as net investment in the national accounts – but no greater than 0.5% of GDP. The MTO ceiling would thus continue to apply, but only if net investment amounted to at least 0.5% of GDP. If net investment were between 0% and 0.5% of GDP, deficits of the same amounts could be permitted. If net investment were negative, the government would need to run surpluses.

… differentiated by level of debt ratio

For debt ratios significantly below 60%, under the current rules, a structural deficit ratio that is higher by 0.5 percentage point can be set as the MTO, thus reaching up to 1%. In line with the above-described approach, for debt ratios below 50% deficits of at most 1% of GDP would be permissible only if net investment amounts to at least 0.5% of GDP. Given relatively sound positions such as these, consideration might, under certain circumstances, be given to adding the amount of net investment to the 1% limit – again up to a maximum of 0.5% of GDP. In other words, a structural deficit ratio of up to 1.5% would be allowed as long as net investment is at least 0.5% of GDP. If net investment is lower than that, more ambitious fiscal targets would have to be met. The debt ratio would potentially drop less significantly below 50%. However, very low debt ratios thanks to persistently balanced budgets would still be possible, because the MTO is not a target figure but an upper limit.

Investment protection on the adjustment path towards MTO, too

Investment could also be factored into the adjustment path towards the MTO. For example, provision could be made for falling investment expenditure being regarded as a contribution to consolidation only if net investment still comes to at least 0.5% of GDP. If net investment is lower than this, consolidation would have to be accomplished entirely through other expenditure categories or through revenue.[30]

Target/actual comparison

If investment expenditure is taken into account by the rules, fiscal surveillance would also have to track the actual level of investment. Investment expenditure being lower ex post (without lower deficits) would constitute a breach.

High debt ratios would continue to drop swiftly

This sample design of a strict capped golden rule would ensure that very high and high debt ratios decline swiftly given adherence to the rules. Due account would be taken of the risk that high debt ratios pose to monetary union. Only if debt ratios were significantly below the 60% threshold could thought be given to a somewhat greater easing of the MTO based on positive net investment.

Counteracting incentives to reduce investment

At the same time, this would counteract incentives to make excessive cuts to investment in order to comply with the European fiscal rules. The deficit targets would become more ambitious, the further net investment falls below 0.5% of GDP. This would mean that countries would be unable to comply with the fiscal rules by reducing investment expenditure to below 0.5% of GDP. Even where there is a need for structural adjustment, government investment would, at most, face limited consolidation pressure. This pressure would then arise in other areas. If the amount of net investment that can be counted were capped at 0.5% of GDP, any misguided incentives would be limited, thus mitigating the risks of inefficient over-investment or improper structures. This would not make higher government net investment impossible – it would just not be permissible for it to be financed by additional borrowing.

29 See Treaty (2012), Article 3(1) letter (d).
30 If net investment was previously lower than 0.5% of GDP, investment expenditure could in fact rise to this level without increasing consolidation pressure in other categories. Overall, this would slow down debt reduction, but only by a little. Alternatively, instead of net investment of 0.5% of GDP, a figure of 0% could also be set.

Conclusion

There is a need for reform

The way in which the European fiscal rules have evolved is unsatisfactory, and the way in which they are being applied has become somewhat incomprehensible. Even during the favourable times of the past few years, very high debt ratios, in particular, barely declined in many cases. Fiscal surveillance evidently failed to induce further steps towards consolidation, and even instances of structural loosening went unpunished. There is a need for reform. The medium-term objective of the structurally (close to) balanced budget should be more binding on fiscal policymakers. This would ensure that high debt ratios fall swiftly. Numerous exceptions and discretionary scope should therefore be dispensed with.

Implement rules strictly

Limits must be implemented strictly. National parliaments retain responsibility for setting fiscal policy, but the pressure to adopt a sound stance could be increased. Progress in this direction could be expected if fiscal surveillance were to be transferred to a clearly focused independent institution. If an expenditure rule were to be introduced, the structural fiscal balance should remain the key reference point and guidepost. It could be converted into an expenditure ceiling which would have to be complied with in the budget planning and execution phases. The expenditure ceiling would be set only for the year ahead, not for multiple years. For each subsequent fiscal year, it would be newly derived from the current, rule-compliant structural balance or the required improvement in the structural balance.

Flexibility thanks to rainy day funds

National rainy day funds could create flexibility for fiscal policymakers within the framework of the rules, even if quantitative objectives were more stringent. For this to work, such funds would have to be better integrated into the fiscal rules. The funds would be stocked in advance from overachieving the medium-term objective (MTO) and should not create additional scope for borrowing. It would be advisable to stipulate solely rule-based utilisation of the funds, as a way of cushioning the impact of unexpected budget burdens, in particular. This would not require complex European mechanisms.

Reforms with debt reduction as their prime objective

Swiftly reducing high debt ratios should be a key objective of the fiscal rules. This should also be at the heart of deliberations on any reforms. This also holds true if the rules were geared, say, to greater protection for government investment. Such golden rules have considerable inherent problems and risks, and have often proved unsuccessful in the past. If the European rulebook moves in this direction nonetheless, it has to be ensured that the rules do not make compromises on the objective of rapidly declining high debt ratios. They should refer to narrowly defined net investment. In the event of capital depletion (i.e. negative net investment), a more ambitious fiscal position than at present would be called for. For debt ratios significantly below 60%, positive net investment could permit limited additional deficits.

Autonomous Member States – autonomous financing

Each Member State in the monetary union is responsible for its own fiscal policy and hence must also answer for its repercussions. Quite apart from the specific fiscal rules, each Member State decides whether or not to comply with the joint agreements and uphold them. The European level cannot intervene in fiscal policy to ensure that limits are complied with or debts serviced. This means that the rejection of joint liability along with individually liable financing on the capital market have to remain key elements of the fiscal framework in monetary union. Thus, it remains necessary for each Member State to make sure that no doubts arise on the financial markets as to the servicing of government debt. Potentially increasing risk premia still constitute a material incentive to run a sound fiscal policy. Targeted fiscal rules that are perceived to be binding can play a crucial role in creating and maintaining trust. But to do so, they have to be implemented in an appropriate manner, and compliance must be monitored transparently and sanctioned if and when required.

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