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Germany's Debt Brake and Europe's Fiscal Stance after COVID-19

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Germany's plan to return to its debt brake creates a serious risk of premature fiscal tightening. Given that the fiscal divide between Europe and the US will widen sharply in 2021, a hasty return to European and German fiscal rules would stifle recovery and undermine efforts to rebuild transatlantic ties in trade and macroeconomic cooperation. This paper proposes several practical options to attenuate the fiscal drag associated with a return to the debt brake and calls for a broad debate on its reform.

- Germany's commitment to a rapid return to "normalcy" creates considerable macroeconomic risk in Europe. Its plan to consolidate 2 percent of GDP in 2022 would translate into a negative fiscal impulse for the euro area of 0.6 percent of GDP.
- This could be avoided without amending Germany's constitution through technical steps such as changing the formula used to calculate the countercyclical buffer, frontloading the disbursements of special fund reserves, extending the debt repayment period for exceptional borrowing in 2020–21, or delaying the reintroduction of the rules.
- More ambitious reforms are needed to redress the medium-term consequences of the fiscal framework in Germany and the euro area.
- This debate is not only vital for Germany's and Europe's economic performance, but also key to redressing Europe's external imbalances and establishing a cooperative role in global economic policy coordination.

After suspending the debt brake (*Schuldenbremse*) to respond to the pandemic, Germany's federal government is currently planning to go back to its fiscal rule book next year. Following through with this plan would imply a large reduction in the structural deficit of around 2 percent of GDP in 2022.[1] The risk to European recovery of prematurely adopting such a consolidation course is clear – both directly, because Germany accounts for almost 30 percent of the euro area economy, and indirectly, because Germany's fiscal choices will set the tone for the euro area as a whole.

Given that the United States is currently in the process of implementing a very ambitious short-term fiscal plan,[2] an unnecessarily tight fiscal stance by Europe would create a sharp divergence with US fiscal policy that would weigh on global recovery and likely stifle efforts to rebuild transatlantic ties. While the new administration of US President Joe Biden is expected to depart from excessive reliance on tariff threats, it will count on Europe to not freeride on US demand but rather implement its own supportive fiscal policy to help sustain global recovery.[3] Because tight German and European fiscal policy helped drive external imbalances[4] and slow recovery after the Great Financial Crisis (Figure 1[5]), international macroeconomic cooperation will focus on Europe's contribution to global fiscal policy or the lack thereof.

The German fiscal rulebook is, in fact, more flexible than commonly believed. Reintroducing the federal and state debt rules in their original forms as early as 2022 is a political choice that is starting to be challenged[6] and alternative fiscal paths can and should emerge. The question is when these alternative policy options will first be discussed – in March when the federal government prepares its annual budget (*Finanzplan*), in April when Germany submits its stability program, before the general elections in September, or before the submission of the draft budgetary plan in October 2021? In any case, a whole menu of policy options is available.

Beyond the option of applying the escape clause of the debt brake for as long as necessary, a transition period for the permissible level of net new borrowing could be considered to address the specific fiscal challenges posed by the coronavirus pandemic. While these changes may require constitutional amendments, other changes would only require a change in ordinary law or a change in the regulations agreed upon by Germany's Federal Ministry of Finance (BMF) and Federal Ministry for Economic Affairs and Energy (BMWi). In particular, the formula used to calculate the cyclical component of the debt brake – flexibility margin authorized on the basis of economic activity – could be revised to provide for a more fiscal space in the current period. The repayment plans that have been agreed to reimburse the borrowing in excess of the debt brake limit in 2020 and 2021 could start later than is currently provided for, could be made countercyclical, and stretched from 20 years to 50 years by a simple law as has been done, for example, in some of Germany's federal states (*Länder*). More generous transfers, for example in the form of concessional loans to the *Länder* and municipalities could also relieve important bottlenecks at lower levels of government. Finally, recent history highlights that constitutional amendments affecting the letter and spirit of the debt brake are, in fact, possible.[7]

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1 Figure 1 illustrates the large range of existing estimates for the structural government balance. Beyond differences in assessments for the speed of the recovery, the level of potential output, and movements in revenue elasticities, these differences reflect heterogenous accounting conventions for recording emergency measures. Irrespective of their exact values, all of these estimates point to a large improvement in the structural balance between 2021 and 2022. It is unclear whether this improvement simply reflects the withdrawl of income-support and medical emergency measures adopted to respond to the COVID-19 crisis or new measures needed to compensate for structurally higher expenditures and structurally lower revenues in 2020 and 2021. But, as argued by Cohen-Setton and Vallee in the paper cited here, at least some emergency measures go beyond simply substituting for already existing automatic stabilizers and thus reflect the introduction and withdrawal of discretionary stimulus. See: Jérémie Cohen-Setton and Shahin Vallée, "Measuring the European Fiscal Stance After Covid-19 from National and European Budget Plans," *CESifo Forum*, vol. 22(01) (2021), pp. 26–36: <https://www.cesifo.org/en/publikationen/2021/article-journal/measuring-european-fiscal-stance-afer-covid-19-national-and> (accessed February 12, 2021).

2 The pandemic rescue plan submitted by President Biden to the US Congress and currently under discussion amounts to $1.9 trillion. A 10-member Republican group countered with a narrower $618 billion proposal. At the time of this writing, the size of the rescue plan that will eventually be adopted is not known. As it will come on the heels of a $900 billion act enacted in December 2020, the discretionary fiscal impulse for 2021 should thus be between 7 and 13 percent of GDP.

3 In October 2020 (that is, before the adoption of the most recent US recovery packages), the IMF forecasted that the current account of the euro area and Germany will increase by 0.6 percent and 1.3 percent of GDP between 2020 and 2022, respectively. See: IMF World Economic Outlook Database, October 2020: <https://www.imf.org/en/Publications/WEO/weo-database/2020/October> (accessed February 12, 2021).

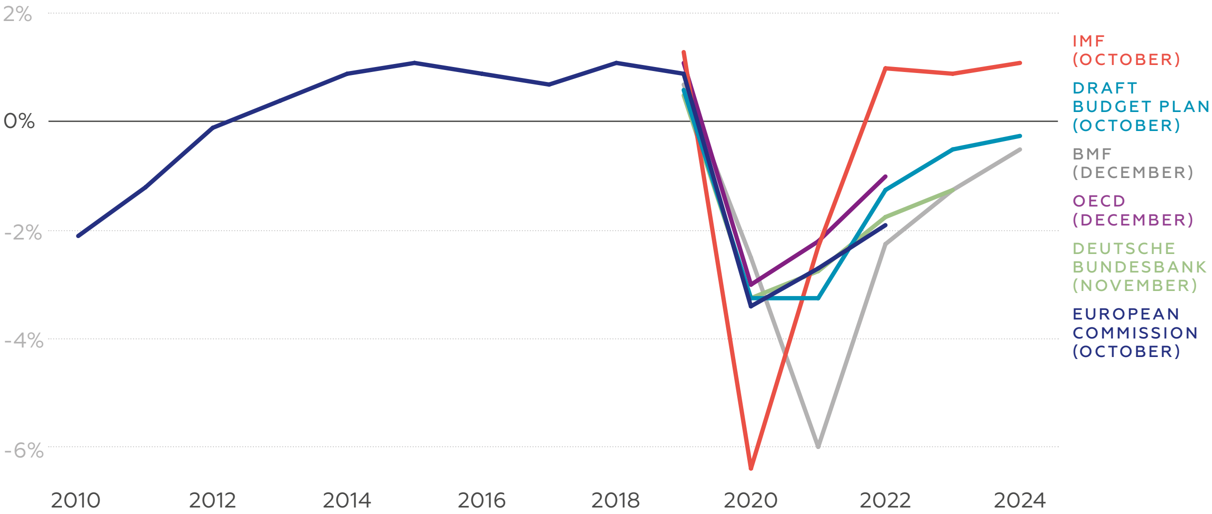
4 The current account balance can be expressed as the sum of the household, corporate, and government financial balances.

5 See also: Jan Behringer, Till van Treeck, and Achim Truger, "How to reduce Germany's current account surplus?", Working Paper, Forum for a New Economy, January 2021: <https://newforum.org/en/globalization/new-economy-working-paper-wie-der-deutsche-leistungsbilanzueberschuss-abgebaut-werden-kann/> (accessed February 12, 2021).

6 On January 26, Helge Braun, head of the chancellery and, like Angela Merkel, a member of the Christian Democratic Union (CDU) party, published a guest article in the *Handelsblatt* in which he argued for a change of the constitution to suspend the debt break for a longer period beyond 2021: Helge Braun, "Das ist der Plan für Deutschland nach Corona" [This is the plan for Germany after Corona], *Handelsblatt*, January 26, 2021: <https://www.handelsblatt.com/meinung/gastbeitraege/gastkommentar-das-ist-der-plan-fuer-deutschland-nach-corona/26850508.html> (accessed February 12, 2021).

7 See also: Shahin Vallée, "Living a Lie," *Berlin Policy Journal*, October 31, 2019: <https://berlinpolicyjournal.com/living-a-lie/> (accessed February 12, 2021).

1 – ESTIMATES OF THE GENERAL GOVERNMENT STRUCTURAL BUDGET BALANCE IN PERCENT OF POTENTIAL GDP



Source: German Stability Council (*Stabilitätsrat*), "15th statement on compliance with the upper limit to the structural general government budget deficit pursuant to Section 51 (2) of the German Budgetary Principles Act (HGrG)," December 14, 2020: https://www.stabilitaetsrat.de/SharedDocs/Downloads/EN/Beirat/2020/20201218_Independent%20Advisory%20Board%20of%20Stability%20Council.pdf?__blob=publicationFile (accessed February 12, 2021). Note: European Commission estimates from before 2019.

CONSEQUENCES OF THE DEBT BRAKE FOR THE COVID-19 CRISIS RESPONSE

Here, we review the repercussions of the debt brake on the three levels of German government: federal (*Bund*), state (*Länder*), and municipal (*Kommunen*).

Bund

The debt brake sets a maximum permissible net borrowing. This maximum has several components:

- **A structural component** that corresponds to the maximum permissible deficit, which is 0.35 percent of GDP[8];
- **A cyclical component**, which increases or decreases the leeway for additional borrowing over and above the structural component depending on the current economic situation; and
- **A balance of financial transactions component**, which excludes transactions that do not alter the federal government's net assets – as in the case of debt-financed loans granted by the government. This financial transaction component has often been used to finance off-balance-sheet expenditure outside of the debt brake.

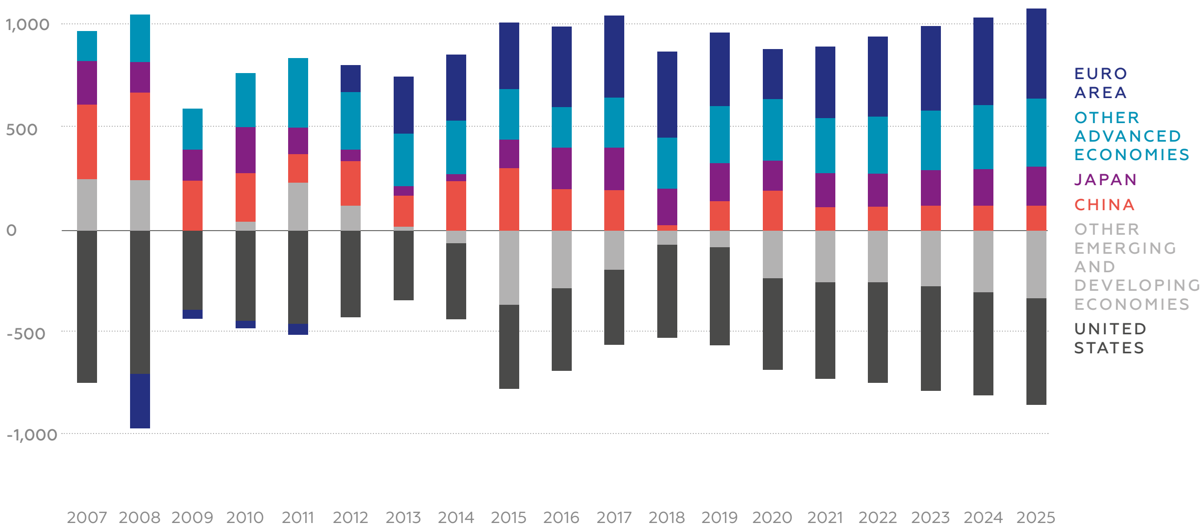
Between 2020 and 2024, the structural component will amount to roughly €12 billion.[9] With output planned to remain below potential until 2024, the cyclical component will stay positive during that period; it will, however, decrease quickly from €45 billion in 2020 to less than €13 billion in 2021.[10] Finally, while the balance of financial transactions was €15 billion in 2020, reflecting the expansive use of this accounting technique by the BMF, it is planned to be small in the following years.

8 Grundgesetz für die Bundesrepublik Deutschland [Basic Law for the Federal Republic of Germany], Art. 109 (3), Art. 115 (2), and Gesetz zur Ausführung von Artikel 115 des Grundgesetzes (Artikel 115-Gesetz – G 115): <https://www.bundestag.de/gg> (accessed February 12, 2021).

9 The nominal GDP of the budget statement for the previous year (*Nominales BIP des der Haushaltsaufstellung vorangegangenen Jahres*) is relevant for the calculation of the debt brake. See: "Finanzplan des Bundes 2020 bis 2024" [Federal financial plan 2020 to 2024], October 9, 2020 : <https://www.bundesrat.de/SharedDocs/drucksachen/2020/0501-0600/517-20.pdf?__blob=publicationFile&v=2> (accessed February 12, 2021).

10 The cyclical component is determined by the formula C = η x (Y+a), where η is the budget semi-elasticity, Y is the output gap, and a is the adjustment to the federal government's current macroeconomic forecast. The "a" adjustment is only applied ex post to determine the amount to be booked on the control account. For the budget plan ex ante, it is not used.

2 – CURRENT ACCOUNT BALANCES IN BILLION USD



Source: IMF World Economic Outlook Database, October 2020: https://www.imf.org/en/Publications/WEO/weo-database/2020/October (accessed February 12, 2021); own calculations. Note: Estimates start after 2019.

As a result of these elements, the planned borrowing by Germany's federal government for 2020 and 2021 is €199 billion and €114 billion, respectively, as seen in Figure 3. Both are above the maximum permissible amount under the debt brake, which is why applying its escape clause was necessary.[11] A return to the debt brake in 2022 would require that net federal borrowing be reduced from its 2021 level of €198 billion to the maximum permissible amount for 2022 of €24 billion – a reduction of almost €175 billion (around 4.5 percent of GDP).[12] Thus, this planned return will have a considerable impact on Germany's fiscal stance.

Länder

The structure of the debt brake for the *Länder* is similar to that of the federal government. It also has structural, cyclical, and balance of financial transactions components.[13] Its application became effective in 2020 after a long transition period.[14] But at the *Länder* level, the structural component is stricter than for the federal government as it requires a structurally balanced budget (rather than a maximum structural deficit of 0.35 percent of GDP for the *Bund*).

Very much like the federal government, all of the *Länder* have decided on additional credit authorizations under the debt brake's escape clause.[15] In total, they have collectively authorized nearly €130 billion

11 On March 25, 2020, and with a 89 percent majority, the federal government suspended the application of the debt brake. On June 3, 2020, the ruling coalition composed of the Social Democtratic Party (SPD) as well as the CDU and its Bavarian sister-party the Christian Social Union (CSU) agreed on an extraordinary budget bill.

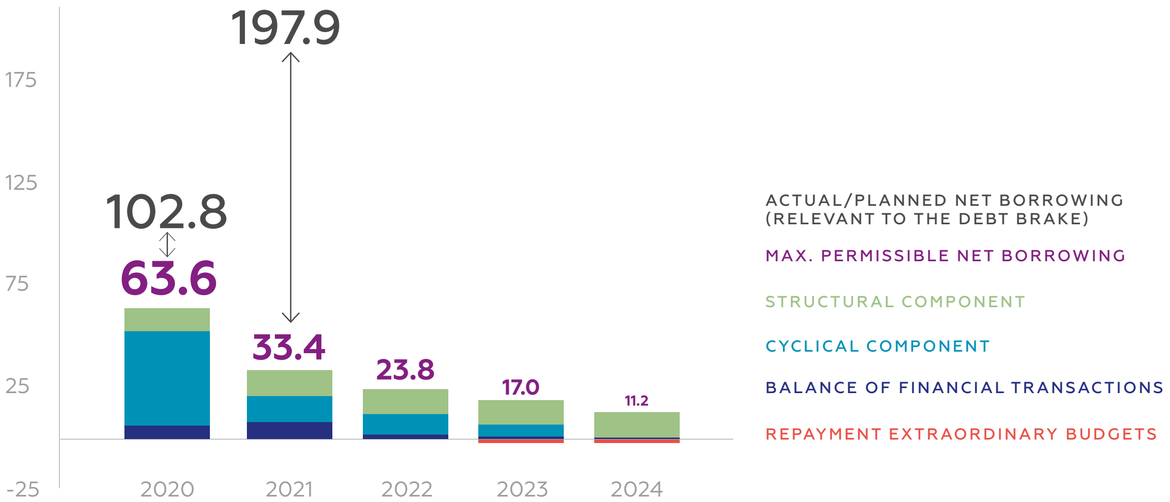
12 The BMF's net borrowing forecasts are often higher than their realized values. In 2020, for instance, net borrowing (relevant for the debt brake) was forecast at €198.7 billion. See: "Entwurf eines Gesetzes über die Feststellung eines Zweiten Nachtrags zum Bundeshaushaltsplan für das Haushaltsjahr 2020" [Draft law on the adoption of a second supplement to the federal budget for fiscal year 2020], June 17, 2020: <http://dipbt.bundestag.de/dip21/btd/19/200/1920000.pdf> (accessed February 12, 2021). But the actual amount of net borrowing in 2020 (relevant for the debt brake) was estimated in January to be €102.8 billion. See: "Vorläufiger Abschluss des Bundeshaushalts 2020" [Preliminary conclusion of the 2020 federal budget], January 2021: <https://www.bundesfinanzministerium.de/Monatsberichte/2021/01/Inhalte/Kapitel-3-Analysen/3-3-abschluss-bundeshaushalt-2020-pdf.pdf?__blob=publicationFile&v=4> (accessed February 12, 2021).

13 The treatment of financial transactions is heterogeneous across *Länder* – some, but not all, exclude them from the calculation of the maximum permissible amount of borrowing. See: German Budestag, "Umsetzung der Schuldenbremse in den Bundesländern" [Implementation of the debt brake in the federal states], 2019: <https://www.bundestag.de/resource/blob/654168/cc4e18e68753c49fb8e31c20dee16988/WD-4-092-19-pdf-data.pdf> (accessed February 12, 2021).

14 The rules are laid down in Art. 109 of Germany's Basic Law (see note 9) and in the consitutions of the respective *Länder*.

15 The *Landtage* (the name for the parliaments of the *Länder*) voted to suspend the debt brake.

3 – THE FEDERAL GOVERNMENT'S BORROWING LIMIT ACCORDING TO THE DEBT BRAKE AND PLANNED BORROWING IN BILLION EUR



Source: BMF, "Preliminary conclusion of the 2020 federal budget" (see note 28); German Bundestag, "Draft Law on the Adoption of the Federal Budget for the Fiscal Year 2021" (see note 30); German Council of Economic Experts, "Stabilisation Policy Amid the Coronavirus Crisis" (see note 1); own calculations. Note: the net borrowing relevant to the debt brake is the difference between the federal government's net borrowing and the funding balances of special funds. The 2021 budget published in December 2020 does not contain revised forecasts for the funding balances of special funds; therefore, we have used the forecasts contained in the draft budget published in September 2020.

of exceptional borrowing in excess of the debt brake (Table 2[16] on page 10), and they had to vote on a repayment schedule at the same time.

Kommunen

While the debt brake does not apply to municipalities (*Kommunen*), the control over their resources and expenditures happens largely at the *Länder* level. Municipalities themselves control only a fraction of their resources, which in most cases do not cover municipal expenditures. The *Länder* and the *Bund* receive most tax revenues and are responsible for ensuring that *Kommunen* receive adequate and sufficient funding.

However, the debt brake puts additional pressure on the relationship of the *Länder* and the *Kommunen*. As the *Länder*'s hands are institutionally tied, their ability to support municipalities decline. This can lead to a situation where the debt brake on the *Bund* and *Länder* levels lead to a negative knock-on-effect at the level of the *Kommunen* by intensifying their investment backlog and/or making their indebtedness less sustainable.

In principle, this design was supposed to tighten fiscal responsibility at every level of government. In practice, however, it has led to multiple problems that each required a new exceptional solution. To prevent large procyclical expenditure cuts at the municipal level, large transfers have just been approved from the COVID-19 packages of the *Länder* and *Bund* for a total of €13 billion in 2020 and another €4.3 billion per year thereafter.

Interestingly, two of the measures to support *Kommunen* and *Länder* included in the COVID-19 response of the federal government required changing the constitution. This highlights that – contrary to public perception – when there is a will, there is an easy majority to change both the debt brake and the constitution. The two amendments passed by the Bundestag (Germany's parliament) and Bundesrat (put simply, the higher chamber that represents the interests of the *Länder* vis-à-vis the federal government) on September 18, 2020, achieved the following:

16 See also: German Council of Economic Experts, Chapter 2 from the Annual Report 2020/21 "Stabilisation Policy Amid the Coronavirus Crisis," November 11, 2020: <https://www.sachverstaendigenrat-wirtschaft.de/fileadmin/dateiablage/gutachten/jg202021/JG202021_Chapter_2.pdf> (accessed February 12, 2021).

- With the addition of paragraph 3 in Article 104a of Germany's constitution, the *Bund* increases its support of the *Kommunen* and the *Länder* in organizing housing for job-seekers who become permanently relieved of bearing the financial costs for housing and heating as part of the "basic security for job-seekers" (*Grundsicherung für Arbeitssuchende*). The *Bund* increased its maximum contribution to these housing costs from 49 to 74 percent.
- With Article 143h, the *Bund* compensated 50 percent of the lost revenues from the business tax (*Gewerbesteuer*); the *Länder* compensated the remaining lost revenues. This change was temporary, however, and expired at the end of 2020.

Many municipalities already entered the crisis highly indebted. For this reason, in 2019, the Federal Minister of Finance proposed a scheme to relieve highly indebted municipalities by covering some of their *Altschulden* (debts that have been accumulating over time and that pose an insurmountable challenge to some municipalities). With only 4 out of 16 *Länder* benefiting from this plan – North Rhein-Westphalia, Rheinland-Palatinate, Saarland, and Hesse – the plan would be virtually impossible to pass the Bundesrat. With slightly more fiscal space, however, each of the *Länder* could now address the issue of a growing number of municipalities in financial distress despite the recent transfers and constitutional amendments. There might be a growing consensus to agree to a broader municipal debt relief plan along the lines of what the government of Hesse undertook in 2019 when it took over €4.9 billion *Altschulden* of 179 municipalities and supported investments of €700 million in 257 municipalities.

RETURNING TO AND/OR REFORMING THE DEBT BRAKE

A return to the debt brake in 2022 as planned would imply a large reduction in borrowing from 2021 and generate a large fiscal drag (Table 1).[17] Germany's federal government will have to decide whether to carry on with this plan when it outlines its budgetary plans in March, when it issues its stability program in the spring of 2021, or when it starts formalizing its draft budget for 2022. This is an entirely political decision of the ruling coalition, but it is likely to be heavily tainted by the political programs and strategies of the parties that make up that coalition in the run-up to Germany's general election in September 2021.

Several options to loosen fiscal policy in the short term are possible within Germany's fiscal framework and would not require constitutional amendments. Although we present these options first, we will then argue that bolder reforms that would require constitutional amendments are desirable and, eventually, necessary.

TABLE 1 – BUDGETARY PROJECTIONS IN BILLION EUR

	2019	2020	2021	2022	2023	2024
GENERAL GOVERNMENT BUDGET BALANCE, OF WHICH:	52.5	-166	-247	-74	-29	-8
CENTRAL GOVERNMENT	22.7	-105	-194	-38	-12	-1.5
FEDERAL STATE GOVERNMENTS	16	-23.5	-23	-15	-5.5	-3.5
LOCAL GOVERNMENTS	5.1	1.5	-6.5	-7.5	-6	-6.5
SOCIAL SECURITY FUNDS	8.7	-39.5	-24	-13.5	-5.5	3.5

Source: German Stability Council (*Stabilitätsrat*), 2020

17 See also: Jérémie Cohen-Setton and Shahin Vallée, "Measuring the European Fiscal Stance After Covid-19 from National and European Budget Plans" (see note 1).

1. Extending a State Contingent Suspension

In view of the exceptional nature of the current health and economic situation, the debt brake's escape clauses could be applied at the federal and state levels for as long as necessary – the constitution only asks that such applications be temporary.[18] Doing this would help convince economic agents that demand support will be provided for as long as required. Adopting this form of forward guidance for fiscal policy at the federal level may require a new vote every year, but a political commitment to extend the escape clause every year until the economy has returned to its potential could enable it and would likely support the adoption of similar suspensions at the *Länder* level.

2. Allowing a Gradual Reintroduction of the Rules

As the German Council of Economic Experts proposed in 2020, a transition phase for reintroducing the statutory limit could also help make the return to the debt brake more gradual. While this option may require amending the constitution, it would not be different than the transition period that was granted in 2009 when the debt brake was introduced – it allowed for a gradual adjustment of the federal budget (until 2016) toward the statutory limit of 0.35 percent of GDP.[19] If the escape clause is not used for 2022, the maximum permissible structural borrowing component would have to be high enough to avoid an unnecessarily abrupt fiscal consolidation. In this respect, the German Council of Economic Experts' 2020 proposal of a maximum permissible structural borrowing component of 1 percent of GDP in 2022 is, in our view, too small. It should rather be in the range of 1.752 to 2.25 percent of GDP in 2022 and aim to return to the statutory limit of 0.35 percent of GDP by 2026 rather than 2024.

3. Frontloading the Use of Reserves

In the past, the federal government has used fiscal overperformance to accumulate some €54.9 billion in reserves in various special vehicle funds (SPV): the asylum and refugee reserve (€48.2 billion),[20] the energy and climate fund (€6.2 billion), and the reserves for the Bundeswehr, Germany's armed forces and their civil administration and procurement authorities (€0.6 billion).[21] This was an intelligent way of appropriating fiscal overperformance to allow its future use, which the simple "control account" (*Kontrollkonto*) does not allow. At the time of this writing, frontloading the disbursement of these funds does not yet appear to be a policy pushed by the federal government.[22] But it could choose to do so in order to limit the contractionary fiscal impulse that a return to the debt brake would imply.[23] Fully drawing down the reserves of the special funds in 2022 would provide a buffer of up to 1.5 percent of GDP.

4. Modifying the Cyclicality of the Rule

The requirement that a cyclical component be included in the debt brake to adjust the amount of permissible borrowing depending on the economic situation is part of Article 115 of Germany's constitution, the *Grundgesetz*. But paragraph 5 of the implementation law for this article only requires that this cyclical component be calculated as the product of an "output gap" and a "budget sensitivity" parameter; the output gap is calculated according to a "cyclical adjustment procedure" (*Konjunkturbereinigungsverfahren*). Neither the methodology used to calculate the output gap, nor the methodology used

18 Some legal experts believe that the German constitution only provides for a suspension of one fiscal year; others emphasize that it only requires that the suspension of the debt brake be temporary. See: Germany's Basic Law Art. 109 (3) and Art. 115 (2) (see note 9).

19 The transition period toward the statutory limit of a structural budget balance lasted until 2020 for the *Länder*.

20 This reserve for asylum and refugees (*Asyl- und Flüchtlingsrücklage*) has served different purposes besides those that its name suggests. At the end of 2019, around €13.5 billion of the budget surplus were "parked" in this reserve. Reflecting the flexibility available in the use of these funds, questions arose as to whether this sum should be saved for future economic slowdowns or used to tackle longer-term challenges related to demographic change. See: Martin Greive and Jan Hildebrand, "Wohin mit dem Rekordüberschuss des Bundes?" [Where to put the record federal surplus?], *Handelsblatt*, January 1, 2020: <https://www.handelsblatt.com/politik/deutschland/haushalt-wohin-mit-dem-rekordueberschuss-des-bundes/25428736.html> (accessed February 12, 2021). On December 11, 2020, the opposition Free Democratic Party (FDP) party proposed to parliament that the entire €48.2 billion of the reserves be used to offset the necessary net borrowing. The FDP and two other opposition parties – the Alternative for Germany (AfD) and the Left (Die Linke) – voted in favor; the ruling coalition of CDU/CSU/SPD along with the opposition Green Party (Bündnis 90/Die Grünen) voted against.

21 BMF-Monatsbericht Januar 2021 [Monthly Report of Federal Ministry of Finance for January 2021]: <https://www.bundesfinanzministerium.de/Monatsberichte/2021/01/Downloads/monatsbericht-2021-01-deutsch.pdf?__blob=publicationFile&v=8> (accessed February 12, 2021); Cerstin Gammelin, "Wie viel Geld Deutschland übrig hat" [How much money Germany has left], *Süddeutsche Zeitung*, March 19, 2020: <https://www.sueddeutsche.de/wirtschaft/deutschland-ruecklagen-1.4850084> (accessed February 12, 2021).

22 Only the climate and energy fund appears together with the other special finds (*Sondervermögen*) in the budget plan: German Bundestag, "Entwurf eines Gesetzes über die Feststellung des Bundeshaushaltes für das Haushaltsjahr 2021 (Haushaltsgesetz 2021)" [Draft Law on the Adoption of the Federal Budget for the Fiscal Year 2021 (Budget Law 2021)], September 25, 2020: <http://dipbt.bundestag.de/dip21/btd/19/226/1922600.pdf> (accessed February 12, 2021).

23 The reserves of SPV funds should not be confused with the balances of the control account (*Kontrollkonto*) of the debt brake. Under the debt brake, past shortfalls and overperformances that lead to a net borrowing that is either too high or too low relative to what was specified in budget forecasts flow into a control account. If they exceed a certain amount, past shortfalls must be corrected in future budgets when output is above potential and at the maximum rate of 0.35 percent of GDP per year. But there is no symmetric built-in mechanism that would authorize for more borrowing in future years following past overperformances. As such, the positive balances of the control account are irrelevant for potentially increasing the amount of borrowing possible in 2022 and beyond.

to obtain a budget sensitivity parameter is, however, defined in ordinary implementation law. Consequently, both can be modified without changing the constitution.[24]

- **Changing the "budget sensitivity" parameter:** The federal government currently uses a budget semi-elasticity that is typically around 0.2.[25] For any 1 percent deviation of output from potential, net borrowing can thus be changed by 0.2 percent of GDP. That parameter could be increased to require more consolidation in good times and more stimulus in bad times and/or could be modified to only increase the amount of stimulus possible in bad times.
- **Changing the "output gap" reference:** The constitution requires that the federal government apply a specific procedure to calculate the output gap based on the EU's methodology (*aggregiertes Quotierungsverfahren* (AQV)).[26] Experts have, however, criticized this EU methodology for being particularly procyclical, generating unreasonably lower levels of potential output and, thus, artificially low output gaps during bad times.[27] Germany could use its influence as a member of the Output Gap Working Group of the Economic Policy Committee to push for methodological changes that would make estimates of potential output less cyclical.

5. Extending the Repayment Plans

The redemption schedule approved by the Bundestag for excess borrowing both at the *Bund* and *Länder* level will reduce the scope for countercyclical policy in future years. Indeed, the debt brake does not only require that a debt repayment plan be decided when the debt break's escape clause is used, but also reduces future maximum levels of permissible borrowing under the debt brake. The repayment plans at the *Bund* level approved by the Bundestag for 2020 and 2021 provide for a linear proportional repayment each year regardless of economic growth. For the federal borrowing that occurred in 2020, the repayment will amount to €2 billion per year between 2023 and 2042.[28] With €165 billion of borrowing in excess of the debt brake limit forecasted for 2021, the repayment would further reduce the maximum amount of permissible borrowing under the debt brake by another €9.1 billion per year between 2026 and 2042 (Figure 4[29]).[30]

According to the rules, all *Länder* had to vote on similar repayment plans agreed upon by the various *Landtage* (the parliaments of the *Länder*) to finance the debt issued to finance expenditures in excess of the *Länder* debt brake. The repayment periods are, however, more heterogeneous. Depending on the political coalition ruling each of the *Länder*, they range from 4 to 50 years with their starts staggered between 2020 and 2026. Altogether, we estimate that the repayments will amount to around €15 billion per year between 2026 and 2042. This may seem relatively small, but the cyclical component buffer allowed under the debt brake is also very small. Under the debt brake, a negative output gap of 1 percent of potential GDP would only allow for a cyclical buffer of 0.2 percent of potential GDP. Throughout the period from 2026 to 2042, this ranges from €7.5 billion to €11 billion.[31] During normal

24 Amending the cyclical component of the debt brake could be done by adopting a new ordinary law or by introducing a government regulation. The former would require a simple majority in the Bundestag.

25 C ~ cyclical component; η ~ budget semi-elasticitiy; Y ~ output gap; a ~ adjustment based on government forecast errors, $C = \eta \times (Y+a)$. There is heterogeneity in how state governments calculate cyclical adjustments. Some use a similar approach to that of the *Bund*. Others use completely different methods. But, irrespective of the exact approach, the formulae can be modified without reforming the constitutions of the *Länder*.

26 German Bundestag, "Konjunkturbereinigungsverfahren für die Haushalte von Bund und Ländern" [Cyclical Adjustment Procedure for Federal and State Budgets], August 20, 2014: <https://www.bundestag.de/resource/blob/295578/084e9366a936cb73d55cd8be26bcfdf8/konjunkturbereinigungsverfahren-fuer-die-haushalte-von-bund-und-laendernt-data.pdf> (accessed February 12, 2021).

27 For an early criticism of the cyclicality of output gap calculations, see: Jérémie Cohen-Setton and Natacha Valla, "Unnoticed potential output revisions and their impact on the 'stimulus/austerity debate,'" *VoxEU*, August 17, 2010: <https://voxeu.org/article/output-revisions-and-stimulus-debate> (accessed February 12, 2021). For a more complete treatment, see: Global Macro Views: Campaign against Nonsense Output Gaps (CANOO), Institute of International Finance, May 23, 2019: <https://www.iif.com/Research/Global-Focus/Global-Macro-Views/Output-Gaps/lapg-9452/2> (accessed February 12, 2021).

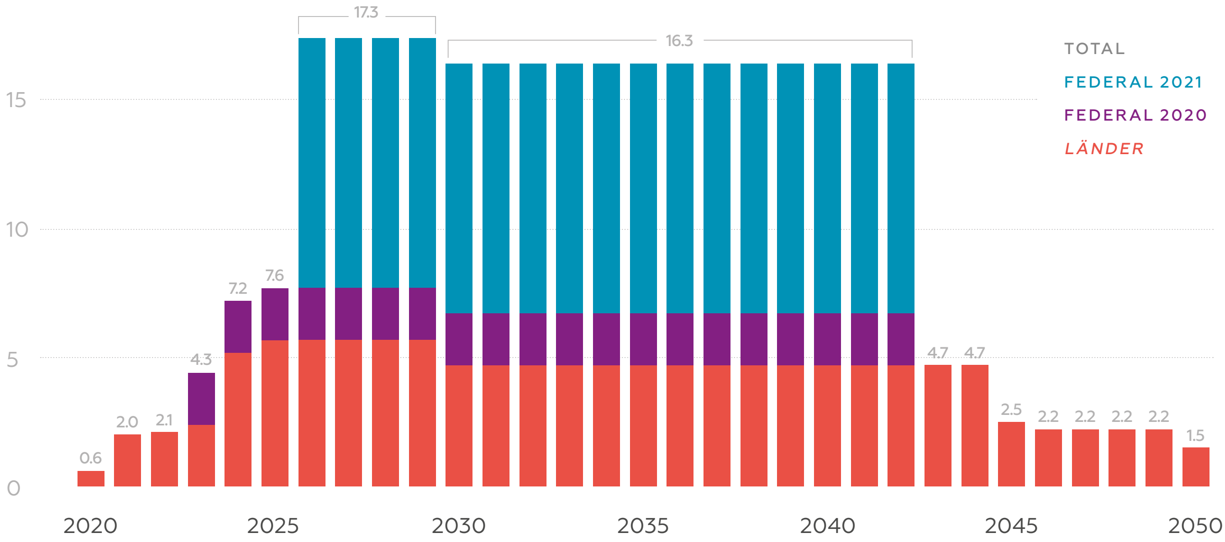
28 In 2020, the debt issuance ceiling defined by the debt brake was €63.6 billion. The net borrowing relevant for the debt brake is €102.8 billion (€130.5 billion net federal borrowing minus €27.7 billion of surplus from the special funds). Total repayment is thus €39.2 billion. The repayment structure is defined as one twentieth of the amount exceeding the ceiling defined by the debt break for 2020. See: Federal Ministry of Finance, "Vorläufiger Abschluss des Bundeshaushalts 2020" [Preliminary conclusion of the 2020 federal budget], January 2021: <https://www.bundesfinanzministerium.de/Monatsberichte/2021/01/Inhalte/Kapitel-3-Analysen/3-3-abschluss-bundeshaushalt-2020-pdf.pdf?__blob=publicationFile&v=4> (accessed February 12, 2021).

29 Actual debt burden may, however, be lower than the maximum debt allowances passed by parliament. In fact, the recent provisional closing of the 2020 budget shows that actual 2020 borrowing is at a mere €130.5 billion as tax revenues were higher and expenditures lower than expected in the second supplementary budget passed in summer 2020. See: Federal Ministry of Finance, "Vorläufiger Haushaltsabschluss 2020" [Preliminary budget closing 2020], January 19, 2021: <https://www.bundesfinanzministerium.de/Content/DE/Pressemitteilungen/Finanzpolitik/2021/01/2021-01-19-vorlaeufiger-haushaltsabschluss-2020.html> (accessed February 12, 2021).

30 In 2021, the government forecasts net borrowing of another €197.9 billion (€179.8 billion net federal borrowing plus €18.1 billion of deficit from the special funds), which exceeds the debt break ceiling by €164.6 billion. See: German Bundestag, "Entwurf eines Gesetzes über die Feststellung des Bundeshaushaltsplans für das Haushaltsjahr 2021" [Draft Law on the Adoption of the Federal Budget for the Fiscal Year 2021], December 4, 2020 :<https://dip21.bundestag.de/dip21/btd/19/233/1923326.pdf> (accessed February 12, 2021). Repayments are specified as proportional between 2026 and 2040.

31 These estimates were obtained by using the debt brake formula for the cyclical component with a budget semi-elasticity of 0.2 with no adjustment to either the federal government's current macroeconomic forecast for 2024 or the potential output series and GDP deflator from the Draft Budgetary Plan until 2022. We then assumed a constant real potential growth rate of 0.8 percent and rate of growth for the deflator of 1.5 percent.

4 – REPAYMENT PLANS FOR THE NET BORROWING EXCEEDING THE MAXIMUM PERMISSIBLE LIMIT IN BILLION EUR*



Source: Table 2, BMF, own calculations. Note: The total for all 16 *Länder* is €130.4 billion. The yearly repayment amount for each of them is determined by using the total appropriated amount and the repayment period, assuming a linear proportional repayment over the longest possible period. Repayments will continue for four of the *Länder* after 2050.*

* In December 2020, the German Press Agency (DPA) interviewed the finance ministers of the *Länder* to inquire about their net borrowing plans. DPA found that the total debt allowances given by the parliaments of the *Länder* totalled €128 billion. According to our research based on the newest developments, this collective debt could reach up to €130.4 billion.

business cycle fluctuations, the current repayment structure could introduce a systematic procyclical bias that would effectively cancel the small countercyclicality provided by the debt brake.

Given that there are no specific requirements that the federal debt be repaid by 2042, the repayment plan could be extended to avoid these effects. As the German Council of Economic Experts suggested, it could be cyclically adjusted as in the case of some *Länder*.[32] Under this approach, the size of the repayment would be linked to the strength of the economic cycle. This would imply a degree of uncertainty about when the repayment will be completed, but this cost is arguably much lower than the cost of procyclical fiscal consolidations.

REFORMS OF THE DEBT BRAKE ARE NECESSARY

The adjustments mentioned up to now are entirely possible within the existing rules and would go a long way to reduce the planned tightening and its effect on the overall policy of the euro area. Together, they would play a considerable role in avoiding a fiscal cliff that would put unnecessary pressure on Germany, Europe, and the global recovery. However, the current crisis – as well as the first decade the debt brake's application – has exposed critical limitations that should allow for a serious political debate on how to reform the German and, eventually, the European fiscal framework. Revising the debt brake, which governs the operation of the rule and German fiscal federalism, would require amending Germany's constitution and would entail securing a two-thirds majority in the Bundestag.

32 German Council of Economic Experts, Chapter 2 of Annual Report 2020/21 (see note 16).

TABLE 2 – *LÄNDER* EXTRAORDINARY BUDGETS AND REPAYMENT SCHEDULES

LAND	GOVERNMENT COALITION	AMOUNT (BILLION EUR)	AMOUNT AS A % OF THE *LAND'S* 2019 GDP	REIMBURSE-MENT PERIOD
Baden-Württemberg	Greens/CDU	7,200	1.37%	2024–2049
Bavaria	CSU/Free Voters	40,000	6.32%	2024–2044
Berlin	SPD/The Left/Greens	7,300	4.76%	2023–2050
Brandenburg	SPD/CDU/Greens	2,200	2.96%	2022–2052
Bremen	SPD/Greens/The Left	1,200	3.57%	2024–2054
Hamburg	SPD/Greens	6,000	4.87%	2025–2045
Hesse	CDU/Greens	12,000	4.10%	2021–2050
Lower Saxony	SPD/CDU	7,800	2.50%	2024–2049
Mecklenburg-Western Pomerania	SPD/CDU	2,850	6.12%	2025–2044
North Rhein-Westphalia	CDU/FDP	25,000	3.50%	2020–2070 (latest)
Rheinland-Palatinate	SPD/FDP/Greens	3,500	2.40%	2024–2049 (latest)
Saarland	CDU/SPD	2,071	1.91%	2020–2050
Saxony	CDU/Greens/SPD	6,000	4.70%	2021–2029
Saxony-Anhalt	CDU/SPD/Greens	258	0.41%	2020–2024
Schleswig Holstein	CDU/Greens/FDP	5,500	5.63%	2024–2064
Thuringia	Minority government by The Left/SPD/Greens (elections in April 2021)	1,560	2.44%	2022–2029
TOTAL		**130,439**		

Source: own calculations

Several aspects stand out and could justify a more ambitious reform:

- The debt brake has probably played a role in strengthening Germany's fiscal position even though fiscal consolidation preceded its introduction. But a framework resting on unobservable data such as the structural balance and output gap is prone to procyclicality, revisions, and mismanagement. The consistent overperformance of fiscal rules from Germany's federal government is not a sign of success, but rather a sign of consistent bias in the operation of the rules.
- The mandate to simultaneously have balanced *Länder* budgets and a small *Bund* deficit does not provide enough flexibility to respond to shocks. This is the reason why budgetary transfers are regularly contradicting the original intent of the rules.[33]
- The limited ability of *Länder* and *Kommunen* to raise autonomous revenues should impose more solidarity between the federal level and lower levels of government. In practice, these issues are being addressed through surgical but profound amendments to the letter and the spirit of Germany's fiscal rules. These include the constitutional amendment of 2017 that

33 Financial transfers across the levels of government are laid down in Art. 104b (2) of the constitution. If the transfers are part of a federal budget law, then only the Bundestag has to approve. If the transfers are part of a federal law requiring consent (*Zustimmungspflichtiges Gesetz*), then the Bundestag and the Bundesrat need to approve. In either case, the governments of the *Länder* that receive the transfers need to approve of the conditions under which the transfer will be made. See: Grundgesetz für die Bundesrepublik Deutschland [Basic Law for the Federal Republic of Germany], Art. 104b (2): <https://www.bundestag.de/gg> (accessed February 12, 2021).

prolonged (potentially permanently) transfers to Saarland, Bremen, and Berlin that were supposed to come to an end and the constitutional amendment of September 2020 that extended transfers to municipalities.
- The use of reserve and off-balance-sheet funds to offer some flexibility within the rules that govern the accumulation of fiscal overperformance and use of financial investment has made the budgetary process less transparent, less efficient, and less democratic.
- Last but not least, the debt brake has also profoundly undermined Germany's public investment. It has considerably weakened its ability to act in the face of crisis, modernize its economy, and allow for an effective climate and energy transition.

These drawbacks not only have profound and lasting consequences for the German economy, but also, more broadly, for the European economy as a whole. But since they have taken root against the backdrop of a fairly buoyant German economy, the urgency to redress them has been limited. With the previous administraton of US President Donald Trump and a stronger global economy, Europe and Germany could afford to ignore the importance of a coordinated global macroeconomic policy. If the EU is serious about being a cooperative international player and rebuilding transatlantic ties, however, it cannot ignore the role that its fiscal policy plays and the effect it has on external imbalances. Indeed, with the intense reflationary efforts currently taking place in the United States and the improved situation in Asia, the EU stands to be a freerider on global recovery.

CONCLUSION

Making fiscal policy is generally complex, but it is particularly so under the current circumstances in which usual instruments and measures are questioned. Indeed, since automatic stabilizers have proven to be insufficient, extraordinary measures are required. The typical output gap used to understand the deviation between economic activity at a given point in time and economic potential loses relevance in an environment in which output is deliberately suppressed to contain a pandemic. This makes policy planning and implementation extraordinarily difficult and requires more flexible thinking and ad hoc instruments.

Germany's fiscal policy in response to the COVID-19 crisis has allowed for a very substantial expansion – in large part because the fiscal rules were suspended. An early return to the strictures of the debt brake could have serious consequences for German and European recovery. With Germany accounting for almost one third of the total euro area, a contractionary impulse of 2 percent of GDP in Germany would in itself imply a contractionary impulse of almost 0.7 percent of GDP for the euro zone as a whole. Such a large fiscal contraction would be unlikely to be compensated by expansionary fiscal actions in other economies. If anything, this attempt at returning to the pre-crisis debt brake in Germany would put pressure on other European economies to also return to the pre-crisis European fiscal rules.[34]

German fiscal policy has global consequences and must be understood as such. While the fiscal rules have enough flexibility built into them to avoid the worst short-term risks, they have proven their limits and need for reform. Therefore, beyond transitory adjustments, a more serious political discussion about the pros and cons of the current fiscal framework is in order. This is necessary both to allow fiscal rather than monetary policy to play a greater role in the recovery and to limit the looming explosion in EU-US external imbalances that would have significant economic and political consequences. Indeed, the new administration of US President Joe Biden will rightly demand a greater degree of economic policy coordination at the global level than was the case during the previous administration of Donald Trump or even that of Barack Obama.

34 Jérémie Cohen-Setton and Shahin Vallée, "Measuring the European Fiscal Stance After Covid-19 from National and European Budget Plans" (see note 1).

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