

PUT FORWARD FOR DISCUSSION: TWO DIFFERENT VIEWS ON THE APPLICATION AND REFORM OF EUROPEAN FISCAL RULES

207. In the following section, council members put forward for discussion two different approaches to the application and reform of the European fiscal rules.

3. European fiscal rules (Monika Schnitzer and Achim Truger)

107. In the wake of the coronavirus crisis, the European Commission, with the approval of the European Council, **activated** the **general escape clause** for the years 2020, 2021 and 2022 for the first time since the introduction of the European Stability and Growth Pact (SGP) in 1997. [↘ BACKGROUND INFO 6](#) As soon as this clause is **no longer** applied, the rules of the preventive and corrective arm of the SGP that currently apply – such as those for the general government budget deficit, the structural deficit, the debt ratio and expenditure growth – become relevant once again.

Under the preventive arm of the SGP, i.e. for Member States that are not under an EDP, the rule applies that a country's structural deficit must be more or less in line with the country-specific medium-term objective (MTO) or on a path towards it at an appropriate pace (European Commission, 2019, p. 15). The necessary pace of adjustment depends on the national economic situation and normally requires a **reduction in the structural deficit in steps of 0.5 % of GDP per annum**. Under the corrective arm of the SGP, an EDP is opened as soon as the general government deficit of a Member State exceeds 3 % or a deficit of this magnitude is planned. While a violation of the rule to limit public debt can also trigger the opening of an EDP, so far the interpretation has been more flexible in practice. **In the corrective arm of the SGP**, more detailed monitoring rules and requirements with regard to planned national fiscal measures apply.

108. It is **an undisputed fact** that **fiscal rules** are **needed** in light of **political economy considerations** to contain the **deficit bias**, and also for the purpose of fiscal and monetary policy coordination within a monetary union. More recent deliberations on fiscal policy in times of low interest rates (Blanchard, 2019; von Weizsäcker and Krämer, 2021) make little difference to this. Rather, analyses concerning sustainability and interest rate risks [↘ ITEMS 100 FF.](#) demonstrate the continued need to limit debt ratios in the euro area and that the notion of perennially low interest rates, and therefore of self-financing deficits, is anything but convincing.
109. However, it does not therefore ensue that the fiscal rules in the euro area would need to remain unchanged after the crisis and that fiscal policy should pursue an intensified course of consolidation. Rather, the broad range of economic and financial impacts that continue to be felt in many Member States as a result of the

coronavirus crisis, coupled with the high degree of economic uncertainty, are arguments in favour of a **cautious fiscal exit strategy that does not jeopardise the economic upturn** and growth prospects.

110. As the euro crisis demonstrated, **substantial fiscal multipliers** and therefore markedly **negative macroeconomic consequences** can be expected from **consolidation policy** (Blanchard and Leigh, 2013; Gechert, 2015; Gechert and Rannenberg, 2018). The acute euro crisis in the countries on the European periphery could only be overcome from 2015 onwards when the European Commission significantly relaxed its interpretation of the fiscal rules and adopted a much less restrictive fiscal policy stance. Only then were the crisis-struck countries able to transition to a more or less neutral fiscal policy which, together with bond purchases by the ECB, led to a gradual upturn driven by domestic demand and whose outcome, nevertheless, was a significant budget consolidation and an end to the crisis-related rise in the government debt ratios (Truger, 2020).

If some countries were to face another crisis due to an **excessively restrictive fiscal policy** following the coronavirus crisis, quite apart from the economic and social costs this would also drive up the debt ratios and would therefore be **counterproductive from a consolidation policy perspective**. On the other hand, **prudent consolidation efforts** would not jeopardise the expected strong recovery and would also make it easier for the ECB to **normalise monetary policy**. [↘ ITEMS 181 FF.](#)

The fiscal rules, which are currently not applied due to the general escape clause, carry the considerable **risk of an overly restrictive fiscal policy** in some Member States if they are applied without any modifications following the coronavirus crisis. The regulations for the structural deficit in the preventive arm and the deficit criterion in the corrective arm of the SGP would be less problematic initially, even though this could indeed require additional consolidation efforts on the part of some countries. For example, Spain would need to step up consolidation efforts somewhat more in both 2022 and 2023, and France in 2023, than currently planned in their stability programmes. [↘ CHART 42 LEFT](#)

111. In contrast, the **1/20 rule to reduce the debt ratio** towards the limit of 60 % of GDP **extremely challenging** for some Member States. The debt ratio for the euro area average is expected to rise from 85.8 % in 2019 to 102.4 % this year due to the coronavirus crisis. Even higher increases are expected for a number of economic heavyweights in the euro area whose debt ratios were above average even before the coronavirus crisis: in France, Spain and Italy, the ratio is expected to increase by around 20 percentage points and more to 117.4 %, 119.6 % and 159.8 % respectively (European Commission, 2021d, p. 39).
112. Referring to the need for strong consolidation efforts in countries with high debt levels, in its 2020 Annual Report (EFB, 2020) the independent European Fiscal Board (EFB) **expressed doubts** as to whether it is **at all realistic** for these countries to **comply** with the **current 1/20 rule** governing the debt ratio. In simulations for Italy, the EFB shows that Italy would need to reduce its structural primary balance by around four percentage points in just three years in order to

comply with the rule. Active discretionary consolidation on this scale would risk derailing the economic recovery and tip Italy back into a recession.

113. In light of these problems, **the EFB points out** that a **continued implementation of the current rules** once the coronavirus crisis is behind us would ultimately **only be possible at the cost of a relaxation of the rules in practice – in the form of constant exemption decisions and new interpretations** – to the further detriment of transparency: “Compliance with the debt reduction benchmark, [...] is especially going to become a growing challenge for a sizeable group of countries, creating stronger tensions within the current system of rules. Deviations from the debt benchmark and a de facto differentiation of the speed of debt reduction are already being implemented under the current rules by way of new interpretations and by extending elements of discretion and judgement. Unless current rules are given an even wider interpretation, to the detriment of transparency [...] a one-size-fits-all prescription for debt reduction may no longer be tenable.” (EFB, 2020, p. 85). The Deutsche Bundesbank (2021d, p. 80), while itself in favour of the swift reapplication of the fiscal rules without modification, supports this assessment given that in its reasoning it points out that the debt rule has ultimately not been adhered to in the past.
114. For the reasons explained above, the EFB strongly advocates **country-specific differentiation** of (intermediate) **debt ratio targets** or the **speed of adjustment** towards a given reference value. In a recent interview with news magazine *Der Spiegel* Klaus Regling, the Chief Executive Officer of the European Stability Mechanism (ESM) and one of the negotiators of the SGP, states that compliance with the debt rule was not feasible for the likes of Italy, for example, and feared that sticking steadfastly to rules that had proven to be economically counterproductive could **result in a loss of credibility** (Regling, 2021). Regling obviously based his argument on an ESM discussion paper in which Francová et al. (2021, S. 15) conclude that compliance with the 1/20 rule for the debt ratio is unrealistic and therefore keeping the rule would undermine fiscal framework credibility. They propose raising the current reference value of 60 % of GDP for the debt ratio for all Member States.
115. **Another problem** with the current fiscal rules that most of the reform proposals discussed have touched upon [↘ BOX 10](#) is the **lack of investment focus**. Public investment, as an expenditure category discretionally adjustable in the short term, has faced drastic cuts particularly in periods of crisis and consolidation (Barbiero and Darvas, 2014). Furthermore, there are **good economic arguments for debt financing of public net investments** (Musgrave, 1959; Truger, 2015; Expertise 2007). For this reason, many proposals for reform make provisions for the preferential treatment of public investment spending. While this does pose a problem with regard to the definition and classification of public investment spending and could present a sustainability risk if overused, it should be possible to resolve the problems of classification (EFB, 2019b, p. 77; Expertise 2007) [↘ ITEM 218](#) and sustainability issues could also be limited by putting caps on preferential status expenditure (Truger, 2020).

116. Against this backdrop, there are strong arguments for a **reform of the fiscal rules** that links **country-specific targets** for the debt level or pace of adjustment with the **preferential treatment of public investment spending**. This could be combined with the advantages of an expenditure rule (EFB, 2020, p. 92 f.). ↘ [BOX 10](#) The slightly slower pace of consolidation and the somewhat higher debt ratio compared to the current set of rules that this implies is unlikely to be a problem in light of the current low interest environment. The analyses conducted also demonstrate that even a relatively sharp interest rate increase in the short-term would not overburden fiscal policy. ↘ [ITEM 109](#) Ultimately, a reform of this kind should be **legally feasible without EU Treaty changes** and therefore **politically realistic** (Repasi, 2013, 2021).

PUT FORWARD FOR DISCUSSION: TWO DIFFERENT VIEWS ON THE MOBILISATION AND FINANCING OF INVESTMENT

205. In this section, the council members discuss two different approaches to the mobilisation of private and public investment and how such investment could be financed.

4. Investment mobilisation and financing (Monika Schnitzer and Achim Truger)

229. **Fiscal policy** in Germany is facing **major challenges**. Firstly, it needs to **get back to normal** after the essential support measures and the strongly expansionary approach taken to combat the coronavirus crisis, **without jeopardising** the **economic recovery** and upturn. Secondly, it faces **substantial spending demands** to **shape transformation** in the areas of climate policy, education and digitalisation.

Shaping the transformation requires a credible funding strategy

230. Public-sector spending needs cannot be determined objectively and unequivocally. They are always an expression of democratically determined normative objectives. They also depend on the specific selection of instruments and on how they are divided between public or private financing. So it is no wonder that various studies on spending/investment needs in various sectors, [↪ TABLE 15](#) arrive at different quantitative assessments. However, based on the table, a total potential **public-sector spending requirement** across all spending areas of up to the **mid double-digit billions range** seems plausible.
231. The **GCEE** has itself spoken out in favour of measures that create **significant spending requirements** in a wide range of areas. In the area of climate policy, for example, fully funding the proposed **energy price reform** alone would require around €20 billion a year during the period of transition (GCEE Annual Report 2020 items 396 f.). Then there are **complementary measures** for expanding infrastructure and local public transport, as well as subsidies for industry (carbon contracts for difference) and private households (e.g. improving the energy efficiency of housing; GCEE Annual Report 2020 items 255 ff.). Support for **digitalisation** and **research and development** is another important area requiring additional spending (GCEE Annual Report 2020 items 570 ff.). Last but not least, the **extensive education investment** and reforms called for would lead to substantial spending requirements. [↪ ITEM 372](#)

Consequently, a **credible fiscal strategy** must include a **financing perspective** for spending needs in the mid double-digit billions range.

232. Essentially, expenditure can only be financed through tax rises, spending cuts, an increase in net borrowing or a combination of these. There is **no objectively**

correct funding option, just complex cost/benefit considerations in which macroeconomic and distribution-policy aspects play an important role. From a macroeconomic perspective, **neither substantial tax rises or drastic spending cuts** are advisable **in the short term** because both could jeopardise the recovery. In the medium and long term, however, it is a different story. The **removal of environmentally counterproductive subsidies** is likely to play an important role here, because this is consistent with environmental policy objectives (GCEE Annual Report 2020 items 382 ff.). However, not all of the revenue generated would be available to fund state spending, as some would have to be used for social compensation in order to avoid regressive effects and hardship cases. Large **tax cuts** [▶ ITEM 189](#) would be in **obvious conflict** with the funding of public-sector spending and would increase the funding need.

Financing part of the investment for the future through loans is economically justifiable

233. **Funding public-sector investment for the future through loans can make economic sense** as it enables intertemporal application of the pay-as-you-use principle (Musgrave, 1959; Occasional Report 2007; Truger, 2015), whereby net capital spending should be funded through borrowing to ensure intergenerational fairness. The underlying assumption is that net capital spending increases the capital stock and passes on the benefit to future generations, so it can be fair for future generations to help pay for the investment by servicing the debt. Future generations inherit the public debt, but gain additional capital stock in return. From this perspective, a refusal to borrow to finance investment creates a burden for the current generation, which has to pay higher taxes or suffer lower government spending. This creates an incentive for insufficient public investment – to the detriment of future generations.

This fundamental **incentive problem is exacerbated during times of budget consolidation**, because cuts in public capital spending often appear to be the simplest way of reducing the budget deficit (Barbiero and Darvas, 2014).

234. Overall, there is therefore much to be said for **targeted privileging of investment spending** within debt rules in order to provide lasting incentives for prioritisation. Such privileging is not about enabling limitless debt, and it does not remove the government budget restriction (Feld et al., 2021b). In fact, the privileging of certain types of spending requires a democratic debate about sensible and desirable prioritisation and institutional precautions for its implementation. For the non-privileged spending categories, the budget restriction continues to apply. To avoid abuse and sustainability problems, **caps can also be set on the privileged spending** (Truger, 2015).
235. Frequently, **non-financial obstacles** such as lack of capacity in the construction industry, lack of planning capacity or lengthy approval processes and legal action can hamper public-sector investment projects (Board of Academic Advisors at the BMWi, 2020). These obstacles have to be removed to enable a massive expansion of the necessary infrastructure. Non-financial and financial obstacles should not be pitted against one another, because **both the removal of non-**

financial obstacles and the provision of **sufficient finance** are required. So inadequate planning capacity, especially in public administration, may well be linked to lack of funding in the past. In addition, the Board of Academic Advisors at the BMWi (2020, p. 40) concludes there are signs that, since 2010, the **debt brake** has tended to **inhibit investment** in particularly fiscally straitened Länder.

As the public finances started to recover after 2015, public-sector investment also increased substantially across a broad front. ↘ [CHART 69](#) The limitation of planning capacities, however, was particularly noticeable in the German government's local authority economic development programmes, which were financed in the short term from unexpected budget surpluses and, under which, requests for funds were initially slow. This indicates that a **credible and reliable long-term financing perspective** is essential, especially for the removal of non-financial obstacles, so that the corresponding **construction and planning capacities can be developed**. A long-term privileging of the relevant expenditures, or a large investment fund that can provide sufficient funding over a longer period, would send a credible signal.

236. A **long-term privileging of future-focused spending** in the budget or via a large loan-financed investment fund could be achieved by means of an **amendment to the constitution**. However, the two-thirds majority this would require in the German upper and lower parliamentary chambers currently appears **politically unrealistic**, which means that legally permitted solutions within the scope of the constitutionally enshrined debt brake must be found.

Funding possibilities limited by temporarily greater budgetary headroom

237. A **temporary increase in general budgetary headroom** would be made possible by extending and amending the repayment schedules so as to minimise the impact on the economy, as discussed by the GCEE. ↘ [BOX 12](#) An **amendment of the repayment schedules** may be especially advisable in Länder whose budgets may otherwise come under considerable strain in the next few years because current repayment periods are very short. ↘ [TABLE 13](#) In addition, a more stable estimate of the potential output in connection with the **cyclical adjustment**, at least during the recovery phase, could provide a degree of leeway and help to avoid a procyclical fiscal policy in future (Fatás, 2019).
238. The option of a gradual return to the standard upper limit for structural new debt of 0.35 % of GDP tabled by the GCEE would also create additional budgetary headroom in the transition period following the coronavirus crisis (GCEE Annual Report 2020 item 222). Without a change to the constitution, the exemption would have to be invoked again beyond 2022. The decisive factor here would be whether the extraordinary emergency situation of the coronavirus crisis continues to have a **significant adverse impact on government finances**, i.e. whether a causal link can still be established between the coronavirus crisis and the resulting significant financial burdens (Korioth, 2020). There are strict limits on both

the reasons for and the amount of the net borrowing permitted in such circumstances. To the extent that there is still a need for additional pandemic-related spending, for example in healthcare or to stabilise the economy [▶ ITEM 147](#) or if funding is required to compensate for reduced tax revenues [▶ ITEM 148](#) or social insurance contributions, it would be possible to **invoke the exemption**. It is probably immaterial whether and precisely when real GDP has returned to its pre-crisis or normal level.

239. The options discussed above in connection with the debt brake would merely allow general leeway for a temporary period. They would therefore be more suitable for ensuring the smoothest possible fiscal-policy transition out of the coronavirus crisis or for short-term needs or as start-up financing for longer-term measures. They do not permit **long-term funding of specific public-sector investment needs**. Options currently being discussed for this purpose include, firstly, the loan-financed creation or funding of **reserves or legally dependent asset pools** from which the necessary expenditures are financed in later years, and, secondly, **legally independent extrabudgetary entities as investment companies** that can borrow outside the confines of the debt brake.

Explore lasting options for loan-financed investment under the debt brake

240. In principle, **reserves or asset pools** could play an important role in financing a long-term public-sector investment strategy. If they were given **sufficient resources** and were designed for **longer-term** use, they could also send a **credible signal** for the creation of capacity in the construction industry and in planning offices. The creation of a dedicated reserve has been proposed (Feld and Fratzscher, 2021; Fuest, 2021), making use of the exemption rule in the 2022 budget. Over the next few years, these funds could then be used to fund capital investment, for example in the area of climate policy or digitalisation. The volume would be limited by the allocation in the 2022 budget, so the instrument would be designed to be temporary, until the funds have been fully repaid.
241. It is unclear whether and under what conditions such reserves would be **permitted in law**, in part due to potential violations of the budgetary principles of universality and annuality. There could be a **risk** of successful **complaints of unconstitutionality**, as the recent judgment of the constitutional court of the federal state of Hessen (2021) showed. Moreover, the borrowing required to fund the reserves would itself have to be justified on the basis of the exemption rule of the debt brake. It is extremely doubtful whether there is sufficient causal connection between the coronavirus crisis and, for example, any comprehensive new climate change mitigation spending. Nor is it clear whether it would be legally possible to interpret the imminent threat of **climate catastrophe as an exceptional emergency situation** as defined by the debt brake and to reapply the exemption on this basis for the national efforts needed to avoid climate disaster, irrespective of the coronavirus crisis. Every time the exemption is invoked, it also has to be borne in mind that the repayment obligation can substantially restrict future budgets.

242. A second option for loan financing under the debt brake relates to the **use of legally independent extrabudgetary entities**, whose borrowing is not subject to the debt brake. These could be publicly owned companies constituted under private law or public-law institutions. Krebs (2021), for example, suggests expanding the equity base of existing public-sector companies, acquiring new equity investments or establishing new public-sector companies. Examples of existing public-sector companies in this case would include Deutsche Bahn. As a result of the equity investment and provision of equity, the German government could finance the spending and also control what it was spent on. Other proposals envisage the use of legally independently investment companies that could finance public capital spending through loans on behalf of the public sector (Bardt et al., 2019; Beznoska et al., 2021).
243. The **legal requirements** for permitted borrowing set out by Kube (2021) in relation to such proposals, namely the passing of the capital injection test and the exclusion of debt guarantees or the servicing of the debt by core public budgets, refer to the **Eurostat criteria** that govern the European Stability and Growth Pact (Hermes et al., 2020). However, these relate to the allocation of statistical entities or their debts to the sector of ‘market’ or ‘state’ in national accounts. But prevailing legal opinion holds that this narrow definition by Eurostat is **not relevant for the German debt brake** (Wieland, 2015; Hermes et al., 2020). For example, in his legal opinion for the federal state of North Rhine-Westphalia, Wieland (2015, p. 6), says, “The rules governing the debt brake laid down in the constitution refer only to the state budgets. The local authorities are deliberately not mentioned in the Basic Law. Also **not covered are** the budgets of the social security providers and other **legally independent asset pools and companies.**”
244. In addition to existing public companies (such as Deutsche Bahn) or corporate bodies such as the Institute for Federal Real Estate, other **public investment companies** could be established within the scope of the debt brake that are focused on specific topics and that can make use of synergies and economies of scale by pooling expertise (Board of Academic Advisors at the BMWi, 2020). [▶ ITEM 204](#) If these institutions have a clear **purpose** and are set up in accordance with **federal law**, they could be given authority to borrow (Hermes et al., 2020, p. 21 ff.). **Parliamentary scrutiny** would also have to be guaranteed in the **act establishing the institution** (Hermes et al., 2020, p. 30 ff.). A government guarantee could ensure that the institution receives favourable credit terms.
245. The new German government should formulate a **comprehensive and concrete strategy to shape the imminent transformation** as quickly as possible and identify the related public **spending requirements** in the areas of **climate policy, education and digitalisation**. If the new government acts pragmatically, there will be sufficient leeway for essential spending despite the continuing squeeze on public budgets due to the coronavirus crisis and politically imposed restrictions such as the commitment not to increase taxes and adherence to the constitutional debt brake. From an economic perspective, funding through higher net borrowing would be an option for some of the needs. In particular, legally independent extrabudgetary entities with a defined purpose, for example as

public-sector investment companies, are considered by prevailing legal opinion to not be subject to the debt brake and could be used **specifically for investment control and financing**.

