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A Challenge for the G20: Global Debt Brakes and Transnational Fiscal Supervisory Councils

Debt-to-GDP ratios have grown to unprecedented levels in many industrialised economies. To combat this threat, the authors call for a global debt brake following the Swiss or German example. The debt brakes should be incorporated into national constitutions and monitored by independent transnational fiscal councils, which should conduct regular evaluations of national budget plans in order to ensure that they meet the requirements stipulated by the debt brake.

The current eurozone crisis is a sovereign debt crisis which has its roots in a failure of the Maastricht Treaty and the exorbitant anticyclical measures passed in the Great Recession.[1] It started in Greece, whose fiscal policy was of insufficient quality both before and after admission to the eurozone and has spread to other countries in Europe (Ireland, Portugal, Spain, Italy). Political leaders have recognised the necessity of institutional reform in the eurozone. The European Stability Mechanism (ESM) is designed to act as a permanent insurance mechanism from 2012 onwards, and the Maastricht Treaty shall become more restrictive with respect to fiscal policy supervision. Furthermore, after their meetings in August and October, Angela Merkel and Nicolas Sarkozy called for a debt brake for all eurozone countries and a recapitalisation of European banks.

At their summit in late October, political leaders of the eurozone countries mainly focused on emergency measures such as leveraging resources of the European Financial Stability Facility (EFSF) and a discount on Greek public debt held by private investors, but they also acknowledged the importance of national debt brakes and proposed a strengthening of the European Commission with regard to economic and fiscal surveillance of euro area countries. At the G20 summit in Cannes, fiscal consolidation targets passed at previous summits in Toronto and Seoul were confirmed, but no further agreements aimed at a structural solution of the crisis were reached. At the most recent European Union summit in December in Brussels, it was decided that each eurozone country is required to adopt a constitutional debt brake. However, these new rules have not yet been implemented.

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Despite the emergency measures to combat the sovereign debt crisis, Standard & Poor's downgraded its credit rating for the USA, and Italy was downgraded by both Standard & Poor's and Moody's. Fitch also downgraded its ratings of Italy and Spain; Moody's did the same for Belgium and 21 European banks. The downgrading of additional G20 countries is likely to follow. For example, Fitch announced that it might reduce the ratings of China and Japan. Standard & Poor's made clear that even ratings for German and French government bonds might be reconsidered in the course of the eurozone crisis if their debt guarantees continue to grow. The uncertain political environment which casts sustained consolidation efforts into doubt is the main reason for the downgrading.

Against this backdrop, the transatlantic political strategy to defer necessary reforms into the future must come to an end. The time to act is now, and it is the G20 that has to take the lead. In addition to the emergency measures taken in the eurozone and the debt deal in the USA, which only provide short-term relief, structural reforms to overcome the sovereign debt crisis are desperately needed.

1 This article is a revised version of IZA Policy Paper No. 33 (M. Dolls, A. Peichl, K.F. Zimmermann: A Challenge for the G20: Globally Stipulated Debt Brakes and Transnational Independent Fiscal Supervisory Councils, IZA Policy Paper No. 33, 2011), which called on political leaders of the G20 to put a global debt brake complemented by transnational supervisory councils on the agenda of the G20 meeting in Cannes in early November 2011. We review the political progress achieved at the most recent EU and G20 summits with regard to our initial claims. The media coverage of our call for action is summarised under http://www.iza.org/en/webcontent/news?item=358. See in particular the more than 12 op-eds in international newspapers, including K.F. Zimmermann: Warum wir eine globale Schuldenbremse brauchen, in: Neue Zürcher Zeitung, 2 November 2011, p. 23; K.F. Zimmermann: How to Deal with West's Debt, in: China Daily, 4 November 2011, p. 9; and K.F. Zimmermann: How to Deal with Western Debt Crisis, in: The Economic Times (India), 14 November 2011, p. 16.

The G20 is the right place for the negotiation of global reform measures. The member countries represent about 90% of global GDP, 80% of international trade and about two-thirds of the global population. The G20 includes not only representatives of countries with the highest debt levels (EU, US, Japan) but also the BRIC countries and large developing economies whose impressive growth performance is particularly threatened by the sovereign debt crisis. BRIC countries, in particular China, have an important role for the stabilisation of the world economy. The BRIC group and other large developing countries such as Turkey, Mexico or Indonesia should also speak up for world regions which are particularly underdeveloped and not part of the G20; if a solution to the sovereign debt crisis is not reached, rich countries will provide less foreign aid in the medium term.

Part of the rising debt levels in many advanced economies results from government interventions to stabilise the financial sector and large fiscal stimulus packages during the Great Recession. But by no means is the Great Recession the only cause of the current sovereign debt crisis, which is one of the most urgent challenges at the beginning of the 21st century. Debt-to-GDP ratios were unsustainable in some eurozone countries and Japan even before fiscal stimulus packages acted as an accelerator of public debt. High levels of sovereign debt not only threaten economic recovery around the world (see e.g. C.M. Reinhart, K.S. Rogoff[2], who find that real GDP growth is negatively affected by debt-to-GDP ratios if the latter are above 90%) but also impose large burdens for future generations. In addition, the debt levels are expected to grow further over the coming decades due to demographic trends and ageing populations.[3]

There is a widespread view that now would be the wrong time for fiscal consolidation. Fiscal austerity usually leads to slower growth and might increase unemployment.[4] The weak economy and fear of a double dip recession have prompted Barack Obama's administration to announce a new stimulus programme, the American Jobs Act, and to call for similar programmes in other countries. However, an opposing argument contends that increased uncertainty among consumers and investors – with regard to economic prospects and the response of economic policy to the sovereign debt crisis – might negatively impact the economy.[5] Following this argument, consolidation plans which are perceived by economic actors as credible commitments are an important step towards higher confidence and increased economic activity. As most governments around the world are already constrained by high levels of existing debt and are still running deficits, it is indispensable that policymakers take action to reduce the uncertainty about public finances and thus ensure their long-term sustainability.

Therefore, we call for a global debt brake which stipulates a long-term consolidation path. In particular the advanced economies which have high levels of public debt need to include a debt brake in their national constitutions immediately. But in the long run, it is recommendable that all G20 countries implement a debt brake in order to stop the increase of global sovereign debt – including those developing countries with rather low levels of public debt today. The debt brake should follow the German or Swiss example, augmented by independent, transnational supervisory councils that allow for "constrained discretion".[6] The task of the fiscal councils will be to evaluate national budget plans and to monitor compliance with the rules of the debt brake in order to enact a global early warning system with the aim of avoiding sovereign debt crises in the future. The fiscal councils could be located at the ESM and the IMF. Thus, the institutional framework for a global early warning system, which so far consists of the Financial Stability Board, the successor to the Financial Stability Forum that was founded in 1999 with the goal of supervising the financial markets, would be consistently expanded to provide global supervision of sovereign debt.

Rising Debt Levels in Industrialised Countries

The pattern of a sovereign debt crisis following a banking crisis is a recurring one in economic history.[7] Economic crises which have their origins in the financial sector tend to have particularly strong effects on output and employment. The financial crisis which started in 2008 turned into the Great Recession. Industrialised countries in particular were confronted with large reductions in GDP (see Figure 1). The policy response was to stabilise the financial sector and to enact large fiscal programmes – in ad-

2 C.M. Reinhart, K.S. Rogoff: Growth in a Time of Debt, in: American Economic Review, Vol. 100, No. 2, 2010, pp. 573-578.

3 B. Eichengreen, R. Feldman, J. Liebman, J. von Hagen, C. Wyplosz: Public Debts: Nuts, Bolts and Worries, Centre for Economic Policy Research, September 2011.

4 D. Ball, D. Leigh, P. Loungani: Painful Medicine, in: Finance & Development, Vol. 48, No. 2, September 2011, pp. 20-23.

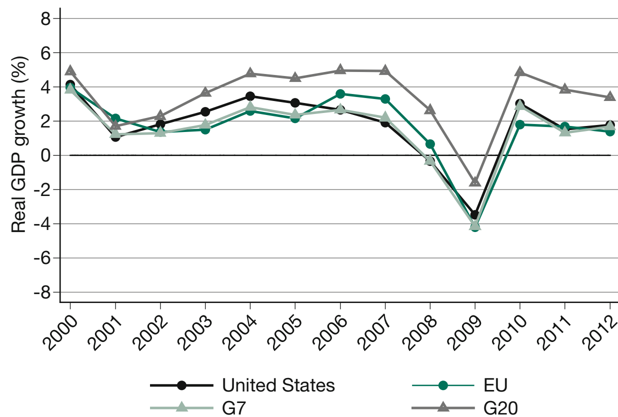
5 See e.g. N. Bloom: The impact of uncertainty shocks, in: Econometrica, Vol. 77, No. 3, 2009, pp. 623-685; S. Baker, N. Bloom, S. Davis: Measuring Economic Policy Uncertainty, Stanford mimeo, 2011.

6 A. Fatás, I. Mihov: Fiscal policy at a crossroads: The need for constrained discretion, VoxEU.org, 15 July 2010.

7 C.M. Reinhart, K.S. Rogoff: From Financial Crash to Debt Crisis, in: American Economic Review, Vol. 101, No. 5, 2011, pp. 1676-1706.

Figure 1

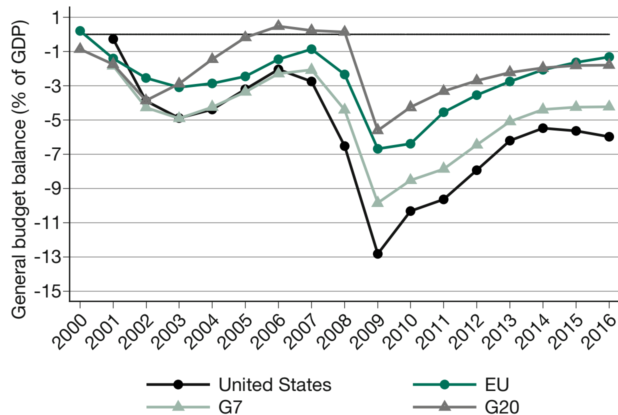
Real GDP Growth



Source: IMF WEO September 2011.

Figure 2a

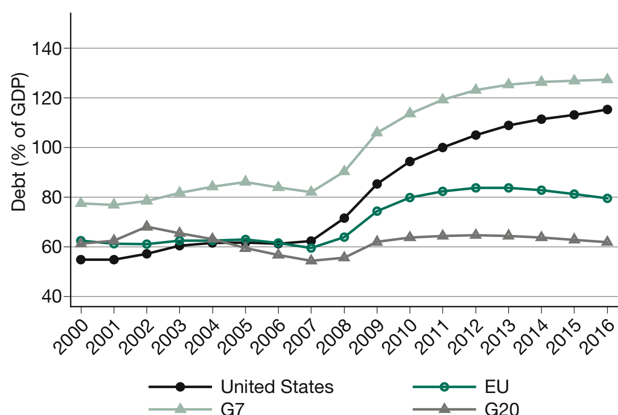
Development of General Budget Balance



Source: IMF WEO September 2011.

Figure 2b

Development of Debt-to-GDP Ratio



Source: IMF WEO September 2011.

dition to the workings of automatic stabilisers[8] – to stimulate the economy. These measures led to large budget deficits (Figure 2a) and rising debt levels (Figure 2b). Within the G20 there is considerable heterogeneity. High levels of public debt can be observed in particular for the advanced economies (Japan, Italy, USA), whereas levels are still rather low in some of the fast-growing emerging economies (Figure 3a and 3b).

Ten of the G20 members, including the EU as a whole, will have debt levels above 60% of GDP at the end of 2011. A similar picture emerges for budget deficits. At the end of this year, ten countries belonging to the G20 will have a deficit above 3%. IMF projections show that the debt-to-GDP ratios will only marginally decline by 2016, if at all. Among the G20 countries with the highest levels of public debt, no country will reduce its debt-to-GDP ratio below the pre-crisis level of 2007 until 2016 (Figure 4). Hence, fiscal policy conditions will deviate from what is stipulated by the Maastricht Treaty at least in the medium term and probably in the long term as well.

IMF projections (Figures 2a and 2b) show that G20 countries are on a consolidation path in terms of deficit reduction, but this will not be sufficient to reduce debt-to-GDP ratios. This is because in times of low economic growth, surpluses and not merely reduced deficits are necessary for a substantial debt reduction. However, the current situation is marked by a large degree of uncertainty about the economic recovery which is crucial for a successful consolidation. This uncertainty is exacerbated by the ongoing eurozone crisis and unsustainable debt levels in many other G20 countries, such as Japan or the United States. These fiscal constraints become more and more binding and impede further stimulus programmes: the sovereign debt crisis cannot be overcome by running up even more debt.

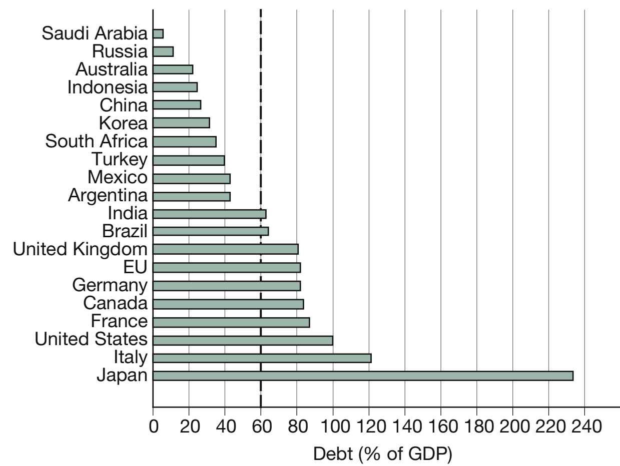
The Most Recent G20 and Euro Summits: Commitments and the Current State of Implementation

The sovereign debt crisis was already on the agenda of the 2010 G20 summits in Toronto and Seoul. G20 leaders agreed on concrete consolidation efforts, in particular for the advanced economies. According to the Toronto commitment, budget deficits are to be at least halved by 2013, and the government debt-to-GDP ratios have to be stabilised or even reduced by 2016.[9] Concrete measures for each country were agreed upon in the Seoul Action

8 See M. Dolls, C. Fuest, A. Peichl: Automatic Stabilizers and Economic Crisis: US vs. Europe, NBER Working Paper No. 16275, 2010, forthcoming: Journal of Public Economics.

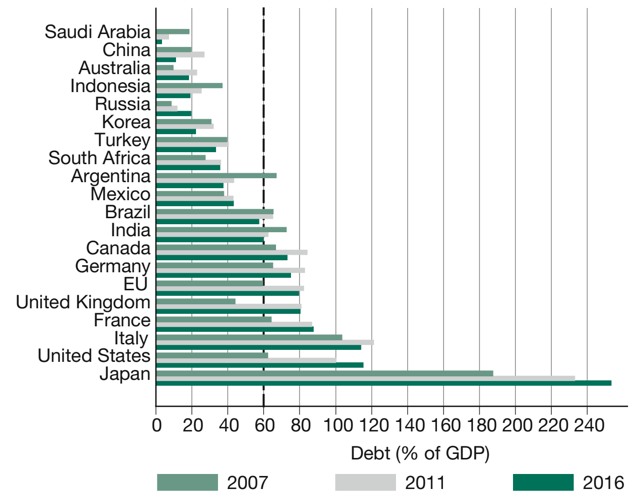
9 G20: The G20 Toronto Summit Commitments, accessed at: http://www.g20.utoronto.ca/analysis/commitments-10-toronto.html, 2010.

Figure 3a
Debt-to-GDP Ratios in the G20 (2011)



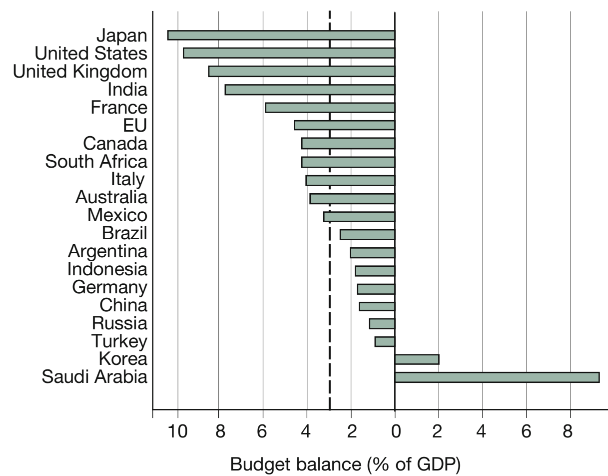
Source: IMF WEO September 2011.

Figure 4
Debt-to-GDP Ratios in the G20 (2007, 2011 and 2016)



Source: IMF WEO September 2011.

Figure 3b
General Budget Balances in the G20 (2011)



Source: IMF WEO September 2011.

Plan.[10] At the most recent summit in Cannes in November 2011, the G20 leaders confirmed these resolutions but did not go beyond them. The Cannes Action Plan of Growth and Jobs[11] states that fiscal rules are in place in some countries to reinforce consolidation plans. But there was no initiative at the Cannes summit for a structural solution to the sovereign debt crisis which would make the consolidation process binding – neither a debt brake for all G20 countries nor the introduction of independent fiscal supervisory councils were on the agenda. Hence, we conclude that the G20 summit in Cannes did not meet the expectations expressed in our pre-summit call.[12]

The euro summit in late October 2011 mainly focused on emergency measures such as a leveraging of the EFSF resources and a discount on Greek public debt held by private investors. Besides these measures – which do not tackle the structural causes of the sovereign debt crisis, namely excessive public debt accompanied by non-competitive economies at the periphery of the eurozone – some progress was achieved with respect to more stringent governance of the euro area. However, in the Euro Summit Statement[13], the importance of national fiscal rules which translate the Stability and Growth Pact into national legislation is stressed. Furthermore, the role of the European Commission, in particular the Commissioner for Economic and Financial Affairs, in monitoring eurozone members in the excessive deficit procedure is strengthened. At the most recent European Union summit in December, further steps towards a fiscal union were taken. Importantly, the inclusion of national debt brakes in national constitutions was an integral part of the fiscal compact.[14] The Court of Justice shall monitor the correct implementation of this compact into national law. While these proposals are important steps towards the sta-

10 G20: The G20 Seoul Summit Document, accessed at: http://www.g20.utoronto.ca/summits/2010seoul.html, 2010.
11 G20: Cannes Action Plan for Growth and Jobs, accessed at: http://www.g20.utoronto.ca/summits/2011cannes.html, 2011.
12 M. Dolls et al., op. cit.
13 EU: Euro Summit Statement, Brussels, 26 October 2011, accessed at: http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/125644.pdf, 2011.
14 EU: Statement by the Euro Area Heads of State or Government, European Council, Brussels, 9 December 2011.

bilisation of the eurozone, they are still insufficient for a long-term solution, since they do not guarantee fiscal surveillance in the politically independent eurozone. As long as other deficit countries – and not an independent body – are responsible for monitoring their peers, compliance with fiscal rules is unlikely, as the experience with the Stability and Growth Pact has shown.

What Needs to Be Done

The resolutions of the euro summit in October 2011 are only a first step towards national debt brakes in the euro area, one which needs to be transferred into national law by each member state of the eurozone. Some eurozone countries have already implemented a debt brake (Germany, Spain) or have committed to do so in the future (Austria, France, Italy). With regard to fiscal supervision, the euro summit resolution does not contain a proposal which stipulates an independent supervisory framework. Here, further development towards transnational and independent fiscal supervisory councils is needed. In addition, the eurozone needs clear exit rules.[15] Furthermore, in order to reduce the systemic risk of a financial crash due to the bankruptcy of a country and the resulting negative externalities, the equity requirements of banks need to be strengthened substantially.

The G20 summit in Cannes did not show progress with regard to an agreement on stronger fiscal consolidation efforts relative to the G20 summits in Toronto and Seoul. Therefore, our claim that G20 countries need a credible commitment to reduce government debt, not least to ease international financial markets, is still valid.[16] The inability of governments to maintain fiscal discipline is not new, and empirical evidence shows that constrained governments tend to deliver better fiscal policy.[17] Rotte and Zimmermann[18] show that the European Union, by committing itself to the rules of the Maastricht Treaty, made early progress in terms of fiscal stability. They argue that the Maastricht Treaty served at the time as a political-economic concept which used the popularity of the European idea to successfully enforce fiscal discipline on a national level, even at the cost of rising unemployment and slowing growth.

That successful fiscal austerity was, however, based on the high popularity of European integration, which nowadays continues to decline and is being replaced by a phase of disillusion. For this reason, today it is sensible and necessary to establish the right mix of instruments at different political levels with a debt brake incorporated into national constitutions and monitored by independent transnational supervisory councils.

Given that the sovereign debt crisis is not restricted to the eurozone but rather constitutes a challenge for the majority of advanced economies around the world, and given the large degree of international interdependence, the G20 is the right venue for this kind of international policy coordination. Importantly, the global debt brake also serves the interests of the BRIC countries and other fast-growing economies. Their economies would be substantially affected by a spreading of the sovereign debt crisis and the resulting increasingly cloudy economic outlook. Moreover, their own self-interest should restrain them from accumulating debt levels as high as those in the advanced economies. For these reasons, the agreement on a global debt brake should be part of the further development of a grand bargain for the G20.[19]

Benefits of a Globally Implemented Debt Brake

Implementing internationally enforced debt brakes in the national constitutions of all G20 countries would lead to several important benefits for future fiscal stability. First, the necessary consolidation plans would gain credibility and accountability. This would contribute to reduced sovereign risk premia.[20] Second, liquidity crises of countries which are not insolvent could be avoided.[21] In addition, by requiring that surpluses have to be generated in good times, pro-cyclical discretionary policy, which is itself a source of macroeconomic volatility, would become less likely.[22] At the same time, there should be enough leeway for automatic stabilisers and some discretionary action in economic downturns. Finally, such a policy would ensure

15 See C. Fahrholz, C. Wójcik: The Eurozone needs exit rules, CESifo Working Paper, forthcoming.

16 M. Dolls et al., op. cit.

17 A. Fatás, I. Mihov: The case for restricting fiscal policy discretion, in: Quarterly Journal of Economics, Vol. 118, No. 4, November 2003, pp. 1419-1447; A. Fatás, I. Mihov: The macroeconomic effects of fiscal rules in the US states, in: Journal of Public Economics, Vol. 90, 2006, pp. 101-117.

18 R. Rotte, K.F. Zimmermann: Fiscal Restraint and the Political Economy of EMU, in: Public Choice, Vol. 94, No. 3-4, 1998, pp. 385-406.

19 M. Goldstein: A grand bargain for the London G20 summit: Insurance and obeying the rules, VoxEU.org, 19 February 2009.

20 See e.g. M. Hallerberg, G. Wolff: Fiscal institutions, fiscal policy and sovereign risk premia in EMU, in: Public Choice, Vol. 136, 2008, No. 3, pp. 379-396, for the European Monetary Union.

21 See C. Fuest, op. cit., for a short discussion of multiple equilibria in financial markets.

22 See e.g. A. Fatás, I. Mihov: The case for restricting..., op. cit; F. Holm-Hadulla, S. Hauptmeier, P. Rother: The impact of expenditure rules on budgetary discipline over the cycle, in: Applied Economics, Vol. 44, No. 25, 2012, pp. 3287-3296.

that the provision of debt-financed stimulus measures is only temporary.

Which Form of Debt Brake?

Different forms of fiscal rules exist and some of those used in the past have proven to be ineffective. For example, golden rules which limit public net borrowing to the amount of gross/net public investment (the former rule in Germany) or simple deficit rules such as the one in the Maastricht Treaty did not prevent the excessive accumulation of public debt. A main problem with these kinds of rules is their asymmetry over the business cycle, i.e. they do not require governments to create budget surpluses in good times. At the other extreme, stringent budget requirements or spending limits which require a balanced budget in each period (e.g. as employed in some US states) should not be applied at the federal level. They have the drawback that fiscal policy can become procyclical and hence might exacerbate economic downturns.[23] In the USA, the federal government can counteract the recessionary impact of state-level fiscal policy during a downturn.

More promising are fiscal rules such as the Swiss or German debt brakes.[24] A key characteristic of these rules is the aim to achieve a balanced budget in the course of a business cycle. This can be achieved by tying spending to structural revenue or by restricting the structural budget deficit. Fiscal policy pro-cyclicality shall thus be avoided. For the sake of credibility, the debt brake should have constitutional standing. However, the enforcement of the rules has to be assured.

Major Problem: Enforcement

A major problem with the EMU Stability and Growth Pact was the inadequate enforcement of the rules. While the general idea was good in theory (balanced budgets, a maximum deficit of 3% of GDP in order to keep debt levels below 60% of GDP), in practice, the 3% deficit limit was interpreted as the rule for good times and not the exemption for bad times. As soon as France and Germany violated it without any consequences, the Stability and Growth Pact was irrevocably damaged.

23 See e.g. A. Fatás, I. Mihov: Fiscal policy at a crossroads…, op. cit.

24 See e.g. L. Feld: Sinnhaftigkeit und Effektivität der deutschen Schuldenbremse, in: Perspektiven der Wirtschaftspolitik, Vol. 11, No. 3, 2010, pp. 226-245, for an analysis of the German debt brake; and F. Bodmer: The Swiss debt brake: How it works and what can go wrong, in: Schweizerische Zeitschrift für Volkswirtschaft und Statistik, Vol. 142, No. 3, 2006, pp. 307-330, for the Swiss case.

Table 1

Actual and Hypothetical Debt-to-GDP Ratios

(% of GDP)

	Debt-to-GDP			Hypothetical Debt-to-GDP		
Country	2000	2007	2011	2007	2011a	2011b
Austria	66	61	72	51	49	58
Belgium	108	84	95	81	75	86
Brazil	67	65	65	30	22	28
Canada	82	67	84	52	49	60
France	57	64	87	44	47	65
Germany	60	65	83	53	53	58
Greece	103	105	166	62	73	110
India	72	73	62	33	18	45
Indonesia	95	37	25	33	18	22
Ireland	37	25	109	15	27	83
Italy	109	104	121	87	90	100
Japan	142	188	233	139	161	187
Portugal	48	68	106	36	45	65
Spain	59	36	67	31	36	60
United Kingdom	41	44	81	28	31	58
United States	55	62	100	39	42	74

Note: Table shows the observed debt-to-GDP ratios (in % of GDP) for 2000, 2007 and 2011 and the hypothetical government debt for 2007 and 2011 if countries had complied with the Maastricht rules beginning in 2000: a balanced budget if real GDP growth was positive and up to a 3% deficit if real GDP growth was negative. Scenario 2011b takes into account observed budget balances for the years 2008-2011.

Source: IMF WEO September 2011 and own calculations.

In order to illustrate the potential development of public debt throughout the last decade if governments had complied with the Maastricht Treaty, we calculate hypothetical debt-to-GDP ratios for the pre-crisis year 2007 and for 2011 for selected G20 and EU member countries (see Table 1). Compliance with the Maastricht Treaty is given if budgets are balanced or show a surplus in years with positive real GDP growth, while deficits of up to 3% of GDP are allowed when real GDP growth is negative. For the crisis years 2008-2011, we consider two scenarios. Scenario a) simply extrapolates the calculations of the period 2001-2007 (i.e. compliance with the Maastricht Treaty is assumed), whereas scenario b) is based on observed budget balances. Scenario b) is justified on the grounds that any meaningful debt brake must be flexible enough to allow for higher deficits due to extraordinary circumstances such as the Great Recession.

An important finding of this simulation is that eurozone countries such as France and Germany, as well as other

countries such as Canada and the United States, would have had debt-to-GDP ratios well below 60% in 2007 had they complied with the Maastricht rules in the 2000s. In reality these countries already had debt-to-GDP ratios higher than 60% even before the start of the Great Recession. High debt levels in 2007-2008 might have limited the ability of some governments to appropriately react to the economic crisis. For example, in a recent paper Aizenman and Jinjarak[25] find that the sizes of the fiscal stimulus programmes passed in 2009-2010 are negatively correlated with the fiscal space available before the start of the Great Recession.

A comparison of actual debt-to-GDP ratios in 2011 with those resulting from our hypothetical calculations shows that public finances would be much healthier today if countries had complied with budget rules such as those contained in the Stability and Growth Pact. Countries such as Greece and Portugal, which have required stabilisation mechanisms from the IMF, the ECB and the European Commission, or Italy, which faced an increase in its sovereign risk premia in recent months due to insufficient consolidation efforts, would probably be having fewer problems refinancing their government debt now. Furthermore, countries would have more fiscal room today to act against a possible double-dip recession.

These simulations clearly have to be treated with caution. They are based on the assumption that the economy would have developed as it actually did if governments had complied with the Maastricht Treaty. In some cases this is highly implausible. For example, in the Great Recession the Irish government was confronted with the collapse of its banking system, which made interventions inescapable. Nevertheless, these hypothetical calculations demonstrate the potential development of government debt had enforcement worked. They also show that an economically reasonable fiscal rule will turn out to be wholly ineffective if governments do not comply with it.

Independent Fiscal Policy Councils

In order to ensure enforcement of the debt brake – which is not guaranteed alone by its constitutional standing – compliance should be monitored and regularly evaluated by independent fiscal policy councils.[26] In the context of the debate on reforming the Maastricht Treaty at the beginning of the last decade, it was suggested that such a supervisory council should be established as an independent European institution serving as a complement to the European Central Bank[27] in order to limit national differences and to make the rules of the Maastricht Treaty politically enforceable.[28] Some countries have already started moving in this direction and made first experiences with national councils (e.g. Canada, Hungary, Slovenia, Sweden and the UK). The fiscal councils could be located on a European level at the ESM and internationally at the IMF and could operate as budget offices.[29] Sanctions in case of non-compliance with the debt brake would depend on the specific setting but could be imposed in the form of fines or other restrictions.

Independent fiscal policy councils are a good complement to strict budgetary rules for various reasons.[30] They can monitor and enforce such rules and prevent governments from manipulating numbers. In addition, such a council can give advice when it might be reasonable to depart from the fiscal rules, e.g. in times of extraordinary recessions when the budgetary rule might represent a poor alternative to optimal policy.

Reducing Deficits

No magic formula exists for reducing deficits and debts. The best way to reduce government debt is through growth (increasing the denominator). Growth potentials can be increased through various labour and product market reforms. In addition, in countries with high unemployment, more active labour market programmes as well as programmes to increase consumer confidence can be

25 J. Aizenman, Y. Jinjarak: The fiscal stimulus of 2009-2010: Trade openness, fiscal space and exchange rate adjustment, NBER Working Paper No. 17427, 2011.

26 See L. Calmfors, S. Wren-Lewis: What should fiscal councils do?, CESifo Working Paper No. 3382, 2011.

27 K.F. Zimmermann: Stabilitätspakt. Die Kriterien der EU sind zu starr, in: Handelsblatt, 25 April 2002, p. 8; id.: Fristverschiebung stärkt den Pakt, in: Handelsblatt, 2 Oktober 2002, p. 8; K.F. Zimmermann: Zur unabdingbaren Reform des Stabilitäts- und Wachstumspaktes, in: Zeitschrift für Staats- und Europawissenschaft, Vol. 1, No. 2, 2003, pp. 230-239; K.F. Zimmermann: Nur Reformen retten den europäischen Stabilitäts- und Wachstumspakt, in: Zeitschrift für Wirtschaftspolitik, Vol. 53, Vol. 1, 2004, pp. 72-80; T. Brück, A. Cors, K.F. Zimmermann, R. Zwiener: Stability Criteria and Convergence: The Role of the System of National Accounts for Fiscal Policy in Europe, in: Allgemeines Statistisches Archiv, Vol. 87, 2003, pp. 113-131.

28 Proposals for national councils can be found in C. Wyplosz: Fiscal Policy: Institutions versus Rules, in: National Institute Economic Review, Vol. 191, No. 1, 2005, pp. 64-78; J. von Hagen, I.H. Harden: Budget Processes and Commitments to Fiscal Discipline, in: European Economic Review, Vol. 39, No. 3-4, 1995, pp. 771-779; A: Fatás, J. von Hagen, A.H. Hallett, R.R. Strauch, A. Sibert: Stability and growth in Europe: towards a better pact, CEPR Monitoring European Integration 13, 2003; and, most recently, in L. Schuknecht, P. Moutot, P. Rother, J. Stark: The Stability and Growth Pact – Crisis and Reform, ECB Occasional Paper Series No. 129, 2011.

29 See K.F. Zimmermann: Her mit dem EU-Kassenwart, in: Financial Times Deutschland, 18 August 2011, p. 24; L. Schuhknecht et al., op. cit.

30 See e.g. A. Fatás, I. Mihov: Fiscal policy at a crossroads…, op. cit.

helpful. However, growth alone will not be enough to reduce debt to sustainable levels in many countries.

Therefore, spending cuts and tax increases also seem to be necessary. However, these measures might lead to slower growth and negative employment effects.[31] Therefore, the right mix of policies has to be found. Of course, there is no "one size fits all" formula for every country, and the optimal policy mix depends on the specific circumstances. In general, countries with rather high spending-to-GDP ratios could try to reduce expenditures, whereas countries with low tax-to-GDP ratios could put more emphasis on tax increases.

The effects of such austerity measures on growth depend on various factors. In general, spending cuts are found to have a smaller recessionary effect than tax increases.[32] For spending cuts, on the one hand, wasteful government spending exists in every country, and it should be eliminated. In addition, certain government consumption expenditures can actually harm growth, and cutting those would reduce the deficit and increase growth at the same time.[33]

When increasing taxation, it is important to look at the tax mix. Reducing corporate taxes and increasing indirect taxation stimulates investment and growth.[34] In addition to increasing indirect taxes, property taxes should also be raised.[35] Furthermore, reducing the tax burden on lower rather than higher incomes is more likely to increase employment and to have positive growth effects.[36] Therefore, increasing taxes on the rich, as even they themselves have publicly requested[37], is another option for increasing tax revenue. Furthermore, simulations show that the top marginal tax rate in optimal tax models is usually very high (above 60%), even when taking into account behavioural responses.[38] In addition, estate and inheritance taxes could be introduced or extended. Another policy instrument which only the G20 can realistically propose is a global tax on financial transactions.[39] In addition to raising revenue, this instrument would also increase the price for aggressive speculation on financial markets and could help to calm them down.

Conclusions

The financial and economic crisis is not yet over, having been followed by a sovereign debt crisis. The time for governments to commit themselves to credible long-term consolidation is now, and this commitment is needed even in the short term for the sake of increased confidence among consumers and investors and lower sovereign risk premia. The debt crisis calls for a reduction of government debt to sustainable levels. Therefore, G20 countries should commit to enacting a global debt brake following the Swiss or German example. At the same time, transnational independent fiscal supervisory councils should be established which – as a complement to monetary policy – would assume the regulation of fiscal policy. They could be located at the ESM and the IMF.

In an economic and political environment characterised by large uncertainties concerning economic prospects and the fear of a potential spreading of the sovereign debt crisis, a global debt brake in combination with an independent transnational supervisory council would send a credible signal that the reduction of sovereign debt to sustainable levels will no longer be delayed any further. Moreover, a well designed debt brake would ensure that the general government budget would be balanced over the business cycle. Consequently, it would be a more efficient instrument than the eurozone's abortive Stability and Growth Pact, which in fact stipulated a ceiling for the budget deficit but whose requirements regarding budget surpluses in good times were insufficient. This asymmetry is eliminated by the debt brakes already in force in Switzerland and Germany. The new fiscal policy framework thus leaves enough room for discretionary fiscal policy and the workings of automatic stabilisers in an economic downturn.

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